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June 2002

NEW ZEALAND'S PUBLIC SECTOR FINANCIAL MANAGEMENT SYSTEM: FINANCIAL RESOURCE EROSION IN GOVERNMENT DEPARTMENTS

NEW ZEALAND'S PUBLIC SECTOR FINANCIAL MANAGEMENT SYSTEM: FINANCIAL RESOURCE EROSION IN GOVERNMENT DEPARTMENTS

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of

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Susan M. Newberry

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Sue Newberry,

February 2002

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Abstract

New Zealand’s public sector financial management system: financial resource erosion in government departments

New Zealand's public sector reforms have been hailed as a model of theoretical consistency and coherence. The associated financial management reforms, known internationally as new public financial management (NPFM), were world-leading although they are no longer unique. The underlying nature and intent of public sector reforms have been the subject of considerable debate internationally. Early public sector reforms openly sought privatisation, often on ideological grounds. However, in the face of gathering public opposition, public discussion of privatisation softened. NPM and NPFM have been promoted instead — mainly on more pragmatic grounds such as improving public sector performance.

In New Zealand, the Public Finance Act 1989 is the key legislation underpinning the financial management reforms. The Act delegates regulatory powers to the Treasury and, over time, a considerable body of secondary regulation, including accounting rules, has been developed. However, this secondary regulation, and its contribution to the success or otherwise of the public sector reforms, has not been examined in detail to date.

In 1999, New Zealand’s Controller and Auditor-General suggested that the financial management system erodes government departments’ resources and that somehow this resource erosion escapes parliamentary scrutiny. The Treasury, on the other hand, defended the foundations of the financial management system as solid, arguing that retention of the existing framework would allow further and faster progress towards improved performance and value-for-money than would be achieved by a new set of reforms. This debate prompts questions whether and, if so, how and why a financial management system, ostensibly implemented to improve the performance and accountability of the public sector, could be linked to such effects, and whether parliamentary scrutiny is indeed avoided. This thesis examines the secondary regulation and explains the development of the financial management system with the intention of answering those questions.

The analysis undertaken in this thesis suggests that New Zealand's public sector financial management system fabricates the conditions under which privatisation initiatives might be accepted for pragmatic reasons. The erosion of departments’ financial resources is an essential mechanism in that fabrication process. As this system has developed, the time available for parliamentary scrutiny has reduced and the Controller and Auditor-General’s controller function has been eroded, while the control and discretion exercised within the Treasury has increased. Arguably, these developments have helped to conceal the system’s privatising intent. The thesis identifies features of the financial management system used to rationalise the financial resource-eroding processes. It also notes that if New Zealand's financial management system is no longer unique, then other NPFM systems may contain a similar combination of features.

1 Introduction

During the 1970s and 1980s, the relatively large size of the public sector in member countries of the Organization for Economic Co-operation and Development (OECD) was viewed as one cause of the reduced growth experienced by those countries. Privatisation, defined by Savas (2000, p. 3) as "reducing the role of government or increasing the role of the other institutions of society in producing goods and services and in owning property", gained increasing popularity as a remedy intended to help promote economic growth. From the late 1970s, public attitudes increasingly reflected antipathy to government involvement in essentially business activities; market resource allocation mechanisms were preferred over government intervention, and individual and corporate freedom were considered crucial to economic and social progress (Mascarenhas, 1990). This early enthusiasm for privatisation, however, eventually gave way to controversy and increasing opposition (Savas, 2000).

The privatisation movement originated in the United States, reflecting the aggregative, individualistic ideas commonly associated with that country (Buchanan, 1997; Savas, 2000, p. xiv). According to Savas, it was broadly consistent with, although not derived from, the anti-government, free market theories of new political economics (NPE). It is also associated with the new public management (NPM) style of public sector reforms which have become increasingly common and which, typically, are justified as necessary to improve government performance (see for example, World Bank, 1995). These reforms contain initiatives designed to reduce state intervention and increase the role of markets, with privatisation advocated and justified on the basis of improved efficiency, effectiveness and accountability that will result (March and Olsen, 1989; Mascarenhas, 1990; Hood, 1995; Rhodes, 1997; Feigenbaum et al, 1998; Savas, 2000; Barzelay, 2001). According to Savas (2000, p. 318-319):

> Public-administration reforms are underway in many countries, and they have common characteristics. 'New Public Management' is the label applied to this set of innovative reforms, whose defining feature is the infusion of market principles into the political world. Specifically, this means (1) striving for efficiency in the face of unresponsive bureaucracies; (2) utilizing economic market models for political and administrative relationships: public choice, negotiated contracts, transaction costs, and principal-agent theory; and (3) applying the concepts of competition, performance-

> based contracting, service delivery, customer satisfaction, market incentives and deregulation. Privatization is in the mainstream of the New Public Management, exhibiting all these characteristics.

Financial management reform is fundamental to NPM and known separately as new public financial management (NPFM) (Olson *et al*, 1998a). NPFM consists of a range of accounting techniques derived from private sector techniques, which shift the emphasis of parliamentary scrutiny and control of government expenditure away from the traditional focus on inputs towards a focus on outputs and assessment of results. The order of NPFM implementation differs from country to country, but the toolbox nature of the techniques eventually results in similar reformed public sector financial management systems (Humphrey *et al*, 1993; Olson *et al*, 1998a; Hughes and O'Neill, 2001; Scott, 2001). The NPFM system integrates management, budgeting and financial reporting systems, using the audited financial information produced to determine the costs and appropriate prices of public services, and for performance measurement (Hood, 1995; Olson *et al*, 1998a; Guthrie *et al*, 1999).

New Zealand's NPM-style public sector reforms received international attention for their scope, consistency and speed, as well as for adoption of a world-leading NPFM system (Hood, 1991). This NPFM system has provided a model for other financial management system reformers, although the wisdom of using that system as a model has been questioned (Schick, 1996; Pallot, 1998; Scott, 2001). According to Schick (1996), the system contains bugs. One of those bugs is the restrictive nature of the financial management practices which form part of an incentives structure Schick thought likely, over time, to reduce departmental resources below effective levels of capitalisation. Recent observations that government departments are losing their capability to perform core functions, at least partly because they cannot reinvest in staff and systems (State Services Commission, 1998; Controller and Auditor General, 1999) lend some support to Schick’s view, raising questions whether those bugs are the relatively minor matters implied by the term, or whether they represent fundamental flaws. This thesis aims to explain in detail the development of New Zealand's financial management system in an attempt to understand whether and, if so, how and why that system reduces departments’ financial resources to the point that they lose capability to perform core functions. The remainder of this

chapter consists of two major sections. The first considers the wider context of international trade liberalisation and legitimisation of public sector reforms in order to understand some of the interests involved. The second section briefly outlines events prior to and during New Zealand's public sector reforms, before giving more specific consideration to the concerns expressed about the operation of New Zealand's government departments today.

Wider context: international trade liberalisation

For many countries, including New Zealand, a neoclassical/neoliberal set of interests seeking to develop an institutional environment supportive of international trade liberalisation in goods and services provides the wider context for NPM-style reforms (Henisz, 1999; Hood, 2000, p. 3-4). The institutional environment sought by this trade liberalisation movement includes security of private property rights, protection and enforcement of contracts between freely contracting parties, and removal of international trade barriers. In most countries, at least some of the services included in trade liberalisation proposals, such as education, health, and energy are, or were, governmental services (Buchanan, 1997, p. 39). Whereas state controls previously imposed on such services may have been imposed for social purposes, those controls are now subject to challenge as barriers to competition (Drake and Nicolaidis, 1992). Public sector reform, particularly the privatisation of services provided by the public sector, is important to the international trade liberalisation movement because it offers major trading opportunities.

The Washington consensus

A group of key international agencies based in Washington, such as the OECD, the International Monetary Fund (IMF), the World Bank and its allied agencies, as well as credit rating agencies, support and help to legitimise both the international trade liberalisation movement and the NPM-style public sector reforms (Kelsey, 1995, p. 17). In what is known by commentators as the Washington consensus, these agencies advocate structural adjustment programmes intended to promote trade liberalisation and reform programmes to improve the operation of

governments (Williamson, 1994; Kelsey, 1995; Rhodes, 1997, p. 50; Henisz, 1999).

Williamson (1994), who represents part of this Washington consensus, listed its ten key elements. The trade liberalisation elements include tax reform to broaden the tax base while reducing marginal tax rates; removal of barriers to foreign investment so that foreign and domestic firms may compete on equal terms; financial liberalisation leading to market-determined interest rates; exchange rates at levels to encourage export industries; replacement of quota-based trade restrictions with tariffs, and reductions in the tariffs to a uniform level, preferably ten per cent; abolition of regulations impeding market entry and competition; and ensuring security of property rights (Williamson, 1994, p. 28; Kelsey, 1995). The public sector reform elements consist of: fiscal discipline such that governments do not run deficits greater than approximately 2 per cent of GDP after debt servicing; in the context of that fiscal discipline, reprioritisation of government expenditure to favour more economically productive causes and improved income distribution, although the criteria for what is meant by improved are not clear; and privatisation of government operations and assets (Williamson, 1994, p. 28; Kelsey, 1995). The public sector reform elements of the Washington consensus, which emphasise privatisation and reduced government operations, complement the trade liberalisation elements because trade liberalisation relates to the private sector. The expected outcome of these reforms is a smaller government with a residual role in which the government may "help design and implement appropriate policies and manage whatever public sector there is" (Rhodes, 1997, p. 50).

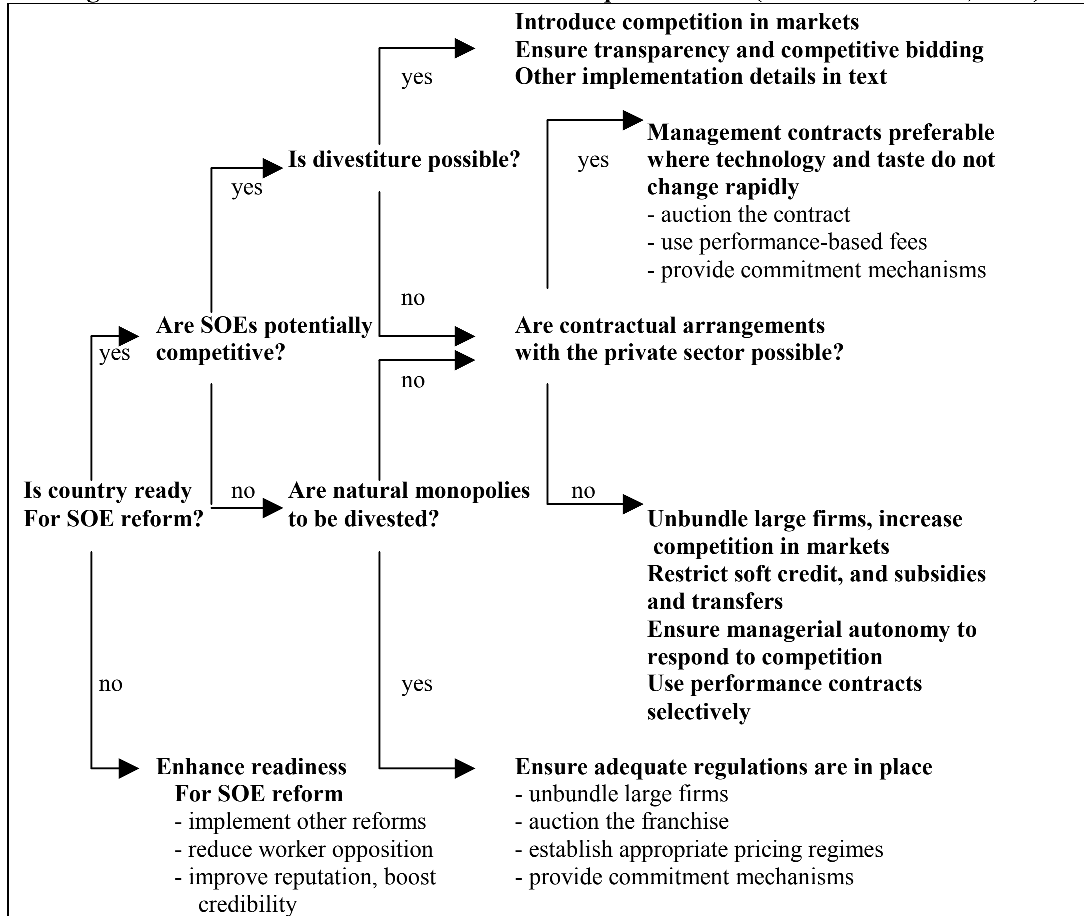
Before public sector reforms can commence, the government must be brought to a stage of readiness for reform (Williamson, 1994; World Bank, 1995). Few governments are considered likely voluntarily to implement reforms intended to reduce both their size and power (Haggard and Kaufman, 1992). A key feature of the readying process is the prior placement within key government agencies of econocrats who are insulated from politics, and the involvement of those econocrats in the planning, the archaeology, and the oversight of the reforms (Williamson, J., 1994; Williamson, O., 1996). Public acceptance that the reforms are both desirable and necessary is also required. Public perceptions of desirability

may be enhanced by the advocacy efforts of influential parties who will benefit from the reforms, while public recognition of necessity may be achieved if a financial crisis, deliberately provoked if necessary, helps to close off alternatives to those reforms (Williamson, 1994, p. 20; Haggard and Kaufman, 1992). According to Williamson and Haggard (1994, p. 565), crises have "often played a critical role in stimulating reform . . . These worst of times give rise to the best of opportunities for those who understand the need for fundamental economic reform".

The public sector reform elements of the Washington consensus allow for some flexibility in implementation, and this flexibility is apparent in the two distinct but complementary approaches the World Bank (1995) advocates for public sector reforms (figure 1.1). The first approach, the private sector development approach, involves the privatisation of state owned enterprises (SOEs) and encouragement for the private sector to develop in order to take over previously governmental roles.[1] The expected result of this approach is a reduction in the relative size of the public sector and the enhancement of economic efficiency. The second approach, the corporatisation approach, uses management incentives and the imposition of budget constraints to improve the financial performance of any remaining government operations (Demirguc-Kunt and Levine, 1994, p. 1). As is evident from figure 1.1 which is taken from World Bank (1995), within the two broad approaches, various detailed options are available and privatisation, rather than efficiency is the over-riding concern.

[1] The World Bank defines SOEs as government entities that derive most of their revenue from selling goods and services.

Figure 1.1 A decision tree for state-owned enterprise reform (from World Bank, 1995)

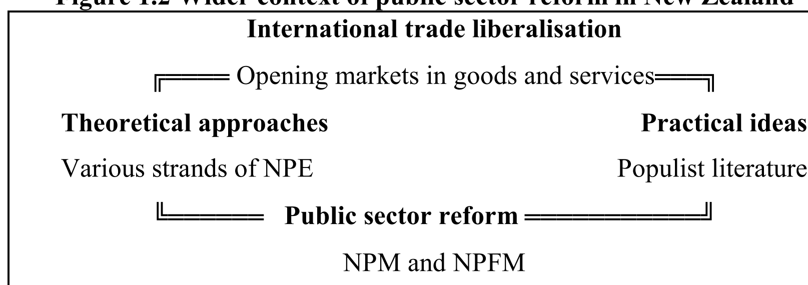


Foundations of NPM and NPFM

The trade liberalisation movement and the support given to that movement by the World Bank and its related agencies provides the wider context of New Zealand's NPM-style public sector reforms. NPM and NPFM emerged from a spectrum of related theoretical and practical ideas which underpin public sector reform generally, and which the World Bank has, evidently, taken up. At the theoretical end of this spectrum are the various strands of New Political Economics (NPE) theories, while the ideas at the more practical end came later (Savas, 2000). These ideas are represented by populist literature about privatisation and reform which proposes particular ideas and techniques for achieving reforms (for example, Savas, 1982; 1987; 2000; Osborne and Gaebler, 1992; Osborne and Plaistrik, 1997; Williams, 2000). The theoretical support of NPE clearly is important to this emergence of NPM and NPFM (Savas, 2000), but "the impetus and ideas came from practitioners, economists, management

consultants and New Right think-tanks" (Rhodes, 1997, p. 175; see also, Demsetz, 1993; Olsen *et al*, 1998) (figure 1.2).

Figure 1.2 Wider context of public sector reform in New Zealand



The spectrum of ideas from which NPM and NPFM emerged is the subject of the next chapter.

The development of New Zealand's public sector reforms

New Zealand was a late starter in the trend of economic and public sector reforms (Hood, 1995) but when it did start, it was an “extreme and rapid mover” (Ferlie *et al.*, 1996, p. 16). Prior to and during the time of New Zealand's reforms, key members of central government agencies, some of whom had been sponsored to study NPE theories in the United States, built up a small policy network seeking to put into practice some of the theories studied (Kelsey, 1995, 1999). Treasury staff members, and former staff members, were especially prominent in this network (Goldfinch, 1998b).

The reforms commenced shortly after a snap election in 1984 which resulted in a change of government. The new Labour government almost immediately was faced with a currency crisis and the need to devalue the dollar by 20 percent (Scott, 1996).[2] The high level of debt caused concern within the country over the manner in which the debt had grown. As Longdin-Prisk (1986) explained, parliamentary control over the executive had, over time, been eroded, leaving the Minister of Finance holding the delegated power to raise loans without Parliamentary scrutiny. She proposed the re-establishment of scrutiny and controls but this proposal was not seen as a suitable alternative to reform because the

country's "slow economic growth rate, very high fiscal deficits, high debt, and … highly sheltered private sector" meant that a broader set of initiatives was necessary (McCulloch and Ball, 1992, p. 7). The Treasury had already prepared a reform plan which the previous government, in which Prime Minister Muldoon was also the Minister of Finance had rejected. The new government viewed the currency crisis and the manner in which it was handled as increasing both the acceptability and the persuasiveness of the Treasury's plan (James, 1992; Scott, 1996).

New Zealand's reforms were dominated by a few Cabinet members who received their advice from a small group of people in the Treasury, the Reserve Bank and the Business Roundtable (Goldfinch, 1998b). The reforms were extreme, and were implemented at an "exhilarating and frightening speed", with important aspects receiving little or no debate (James, 1992, p. 152; see also Hood, 1995; Goldfinch, 2000). The early stages were similar to the trade-liberalising reforms identified by Williamson (1994) as part of the Washington consensus. Expected to achieve "sustainable medium-term growth with a more market-oriented economy", these reforms included "lower protection of local industry, the removal of price and wage controls and deregulation of the finance and other service sectors of the economy", as well as adoption of market-determined interest rates, a floating exchange rate, and the introduction of a retail sales tax which broadened the tax base and allowed significant reductions in marginal income tax rates (McCulloch and Ball, 1992, p. 7; see also Scott and Gorringe, 1989; James, 1992).

According to Henisz (1999) New Zealand's early reforms were not considered credible because subsequent governments could reverse their effect. The reforms were, therefore, reinforced by legislation intended to provide the required credibility (Henisz, 1999). The Reserve Bank Act 1989 gave the Reserve Bank some independence from the government of the day and restricted the bank's primary role to the control of inflation, thus putting "monetary policy beyond

[2] Kelsey (1995) suggests that the financial crisis may have been engineered. In the time prior to the election, Roger Douglas, who became Minister of Finance in the Labour government elected in 1984, had announced that if elected he would devalue the dollar.

reach of an unfavourable shift in the political winds" (Richardson, 1995, p. 164). The Fiscal Responsibility Act 1994 committed the government to observation of specified principles of fiscal responsibility, thus limiting government expenditure and bringing some predictability to the level and stability of future tax rates (Fiscal Responsibility Act, 1994). Ruth Richardson, Minister of Finance from 1990 until 1993, steered this piece of legislation through parliament and, in doing so, sought to put:

> institutional constraints on the conduct of fiscal policy . . . I wanted to help ensure governments continued to place major priority on lowering the deficit and reducing debt. As far as possible, I wanted to do for fiscal policy what the R[eserve] B[ank] A[ct] had done for monetary policy. (Richardson, 1995, p. 164).

Public sector reforms were a key part of these broader reforms and, according to Scott *et al* (1997 p. 140), consisted of "two main thrusts". The first thrust established limited liability companies to administer the government's major commercial activities, thus separating those activities from government departments. This corporatisation process was achieved through the State Owned Enterprises Act 1986 and represented the commencement of a process of privatising these entities (Mascarenhas, 1991).

The second thrust focused on reforming the remaining core government departments to make them "more efficient and responsive" (Scott and Gorringe, 1989, p. 82). Departments were made subject to regular assessments of their role and effectiveness, and their employment and financial management practices were changed, with the State Sector Act 1988 and the Public Finance Act 1989 providing the supporting legislation. These Acts also provided the base for the introduction of incentives intended to improve departments' efficiency and strengthen the government's ability to prioritise expenditure (Scott and Gorringe, 1989; Richardson, 1995). This thrust of the reforms took the Washington consensus to its "neo-liberal extreme" (Kelsey, 1995, p. 19) by viewing the role of the state as "a monopolist enforcer of rights or relationships" (Treasury, 1987, p. 34). Whereas the Washington consensus proposes corporatising and privatising reforms for SOEs, in New Zealand, the treatment applied to *all* government departments was similar to corporatisation. The rationale for this treatment was that the development of market conditions, or at least the potential for market

conditions, would improve both the efficiency and accountability of government departments (Treasury, 1987; Kelsey, 1995, p. 59).

Reviews of public sector reforms

Much has been written at an overview level about New Zealand's public sector reforms generally, about the reforms to the core public sector in particular, and about the reformed financial management system. Typically such literature comments on the legislation but ignores the considerable body of secondary regulation developed through delegated powers. That regulation, which includes accounting rules, impacts on the performance assessments made in practice. There has, to date, been no attempt to provide any detailed analysis of the financial management system. This thesis examines both the primary legislation enacted as part of the reforms and the delegated secondary level regulation in an attempt to develop a detailed understanding of that system.

The comprehensiveness and complexity of New Zealand's public sector reforms pose difficulties for any commentator, whether promoting or criticising the reforms. Publications by the key people involved provide a rationale for New Zealand's reforms, and important information on the nature of those reforms. They describe aspects of the intended or actual financial management system, although without clear distinction between the two (see, for example, Scott and Gorringe, 1989; Scott *et al*, 1990, 1997; Scott, 1996). Frequently, these promotional, "official-style publications" ignore or barely acknowledge controversial aspects and can, therefore, be deceptive, especially if the actual reforms diverged from the description of what was intended (Olson *et al*, 1998a, p. 24). Overseas academic commentators, such as Jones and Thompson (2000), rely on Scott *et al* (1990) for descriptions of the then-*proposed* financial management system, and assume that the *actual* system operates as described. For example, they draw on Schick's (1996) critique of the system and assert that "far too few" departments converted to the Mode C status specified in the Public Finance Act 1989 (p. 218), thus giving the false impression that some departments did convert to this status.

The comprehensiveness and complexity of New Zealand's reforms make extremely difficult the task of attempting an overall evaluation (Boston, 2001).

Even the few more independent and, potentially, more critical commentators have provided only relatively superficial overviews, possibly because of time constraints (see for example, Schick, 1996) or because of lack of awareness, or access to, the evolving secondary regulations (see, for example, Boston *et al*, 1991; 1996; Pallot, 1998). Overviews are needed, but the impression gained from a superficial consideration of some elements may be misleading. Schick (1996), for example, cites the Public Finance Act's definition of operating surplus and its prohibition of surplus retention by departments to support his view that New Zealand's contractual model treats surplus retention as a breach of contract (Public Finance Act 1989, s. 2, 14). That legislative requirement has been subjected to considerable reinterpretation via the Treasury's delegated powers and today, in many cases, departments must pay to the Crown considerably more than any reported operating surplus and may be required to pay amounts even when they report operating deficits. Arguably, Schick's assessment of New Zealand's financial management system as a contract model would change in light of a more detailed understanding.

Proposed research

New Zealand's NPFM-style financial management system has developed over a period of thirteen years since the 1989 enactment of the Public Finance Act. During that time, government departments have lost, or are losing, their capability to perform core functions (Schick, 1996; State Services Commission, 1998; Controller and Auditor-General, 1999; Gregory, 2001; Laking, 2001). Possibly, this is because financial resource erosion affects their ability to reinvest in skilled staff, information and control systems, and output production methods that do not appear in financial reports and are therefore easily overlooked. If so, this financial resource eroding process seems to escape parliamentary scrutiny:

> Capabilities can be built up or run down without such changes necessarily being evident in the organisation's financial statements . . . 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. (Controller and Auditor-General, 1999, p. 74).

The discussion about resource erosion, however, is not specific. Scott (2001) argues that the claims of capability losses are exaggerated, but suggests the controversial possibility that they may relate to the National, and National

coalition government's (1990-1999) continuation of former Minister of Finance, Ruth Richardson's, fiscal policies even after the government distanced itself from her views about the role of government. Others note flaws in the system, but comment only vaguely on the possible effect of those flaws (Gill, 2001; Kibblewhite, 2001). For example, there is comment about inflexibility and possible over-emphasis on the contractual purchasing model.

The debate over loss of capability and the links drawn to the financial management system and financial resource erosion prompts questions whether and, if so, how and why a financial management system, ostensibly implemented to improve the performance and accountability of the public sector, could be linked to such effects, and whether parliamentary scrutiny is indeed avoided. This thesis therefore focuses on what seems to be viewed, by some, as a serious flaw in the financial management system, financial resource erosion, and explains the development of the system with the intention of answering those questions. In undertaking that explanation, this thesis does not attempt to question the need for New Zealand's financial management reforms, or challenge the introduction of accrual accounting or deny that benefits have been achieved.

Internationally, it seems that the accounting techniques adopted as part of NPFM are, effectively, adopted as rules with which compliance is required (Hughes and O'Neill, 2001) and, in New Zealand, these requirements are legislated. The acknowledged strength of NPE theories in public sector reforms requires taking seriously NPE theorists' views about the importance of rules, or institutions, for influencing behaviour and achieving particular, desired, results. This thesis, therefore, examines the rules adopted and developed in New Zealand's public sector reforms, using historical research methods to trace the development of the rules and to consider what results might be achieved by their application. In undertaking this examination, it rejects the accounting profession's representations of accounting and accounting techniques as a neutral set of techniques applied to allow the impartial and representationally faithful production of financial reports, which are, in turn, intended to do no more than to provide information useful for decision-making. Those claims have, at any rate, long been refuted "epistemologically, socially and historically" (Lehman, 1992, p. 145). Instead, in this thesis accounting and the accounting rules adopted as part of New Zealand's

NPFM-style financial management system are viewed as institutions intended to "exercise control by defining reality" (Olsen *et al*, 1998, p. 442; see also Lehman, 1992, pp. 78, 83).

Most literature about New Zealand's financial management system explains and comments on the legislation underpinning the reforms but none has considered the extensive delegated regulatory powers or examined the regulations developed. Accounting rules are developed at this delegated level. These rules, and the use made of the results of applying these rules, play an important part in the way in which departments' financial resources are eroded. Accounting is, therefore, implicated in this financial resource erosion process. Further, given the tendency for NPFM developments to spread, to the extent that others adopt these accounting rules and techniques, some understanding of the nature of those rules and their operation is important. Because this thesis explains rules developed at a delegated level, it draws on and presents information obtained from archives subject to the Official Information Act 1982, much of it originating from the Treasury. Access to that information was essential, and understanding of that information was aided by the support, assistance and openness to challenge of current Treasury staff. The archival information is incorporated in Chapters 4 to 9. The information was obtained subject to the conditions set out in the agreement reproduced on page 15. The Treasury has reviewed this thesis and has not required any deletions or imposed any conditions on its release. Some of the archival information, although largely originating from the Treasury was obtained from archives similarly subject to Official Information Act requirements, but with the condition that the Cabinet Office may vet the thesis prior to publication. The conditions are similar to those reproduced on page 15. The Cabinet Office has also completed its review and has not required any deletions or imposed any conditions on the release of this thesis. For the purpose of assisting with this vetting process, this thesis was written using full references to refer to the various archival documents.

NPE theories incorporate an element of institutional theory and the research method adopted for this research, which is explained in Chapter 2, uses a descriptive-inductive approach to study the institutions developed in New Zealand's financial management system. Chapter 3 reviews the NPE literature and

the related populist literature which represents the intellectual and practical foundations of NPM and NPFM, and has provided the theoretical underpinnings for New Zealand's public sector reforms. This chapter also identifies some of the accounting techniques which typify NPFM and considers some of the international debate over NPFM and those techniques. New Zealand’s public sector reformers set about those reforms intending to change the role of the state, and Chapter 4 considers their intent and approach to reform, the legislative base they created from which the financial management system was developed, and notes the level of power delegated to develop that system. Accrual accounting simply provides a base on which NPFM techniques must be built and, because a transition time was required for all government departments to adopt accrual accounting systems, the addition of NPFM techniques did not commence in earnest until after a change of government in 1990. The structure and strategies adopted by that government therefore affected the financial management system developed and the options available to subsequent governments. Chapter 5 explains the structure and strategies, while Chapter 6 notes that many of the developments to the financial management system have occurred in the context of an ongoing series of incentives projects, and outlines those projects. The government adopted a fiscal strategy to reduce expenditure, and the manner in which this strategy has been designed into the budgeting process and the rules developed to control access to resources is the subject of Chapter 7. The government’s policy strategies included commercialisation, and Chapter 8 explains how this commercialisation strategy was applied to the whole of the public sector, with the idea that comparative cost assessments between public sector and private sector operations would enhance the expenditure reduction strategy if goods and services provided by departments may be obtained at less cost from other sources. While Chapters 7 and 8 both cover decisions about departments receiving financial resources, Chapter 9 considers monitoring and review processes which are used to assess departments’ operations, and, in effect, to decide whether departments should receive further resources or whether they should return resources. Chapter 10 draws on the literature reviewed and the archival material to produce my interpretation of the nature of the financial management system and to make brief suggestions for change.

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2 Research focus and method

Chapter 1 noted that New Zealand's NPFM-style financial management system has evolved over the thirteen years since the enactment of the Public Finance Act 1989. Recent comment attributes to the financial management system government departments' loss of capability to perform core functions, with argument that resource erosion occurs without parliamentary scrutiny (State Services Commission, 1998; Controller and Auditor-General, 1999). Legislative change has been suggested although there has, so far, been no explanation of how the system erodes resources (Controller and Auditor-General, 1999). Those responsible, at least for the early stages of system development, have promoted the financial management system as successful, accepting that the system may contain bugs, but arguing that the government's ownership interest in departments may have been neglected rather than damaged by the system (see, for example, Scott, 1996; Scott *et al*, 1997; Scott, 2001). Evidently, the Treasury (1999, pp. 47-48) believes the system is soundly based. This thesis aims to explain the development of New Zealand's financial management system with the aim of determining whether, and if so, how and why the system might erode departments' financial resources, with such erosion assumed at least partly responsible for loss of departments' ability to perform core functions.

A spectrum of related ideas underpins financial management reforms of the type adopted in New Zealand, ranging from NPE theories at the theoretical end to populist advocates proposing specific rules at the practical end. NPE theories apply economics to politics, and have drawn from political studies a pillar of that discipline, the study of rules, or institutions (Jones, 1992a, p. 149; Rhodes, 1997, p. 64). The development and adoption of rules feature strongly in both NPM and NPFM. The first part of this chapter defines institutions and explains the relevance of the study of institutions to understanding New Zealand's financial management system, while the second part explains the research method adopted, followed by a description of the sources of information used in this research and the nature of that information.

The study of institutions

Institutions are systems of "formal rules, compliance procedures and standard operating practices that structure relationships between individuals in various units of the polity and the economy" (Rhodes, 1997, p. 78, citing Hall, 1986). For as long as these institutions are in force, they will regulate behaviour, even if the rules are flawed and the resulting behaviour is dysfunctional (Furubotn and Richter, 1991, p. 2-3).

Approaches to the study of institutions tend to focus either on the rules or on the behaviour that the rules are intended to regulate, although the difference between these approaches is merely one of emphasis because the behaviour and the rules cannot be separated. The descriptive-inductive approach focuses on and describes the rules, with the aim of understanding the whole combination, or system, of rules. According to Rhodes (1997), institutions tend to grow, often by accretion and without conscious design and, because of this tendency, the use of historical research techniques is central to the descriptive-inductive approach. Early descriptive-inductive approaches tended to describe the institutions but to ignore theory, and thus to overlook any theoretical implications of the institutions. Expectations today are that the descriptive-inductive approach should be "located in an explicit theoretical context" for such understanding to emerge (Rhodes, 1997).

The formal-legal approach to the study of institutions views institutions as causal and therefore focuses on the behaviour caused by institutions, with that behaviour considered likely to cause particular results. Causality interpreted strictly ignores the possibility of any other influence and therefore views the institution as the sole cause of the behaviour. A less strict interpretation of causality accepts that factors other than the institutions may also have an effect and therefore views institutions as part of a larger incentive structure which influences behaviour (Israel, 1987). The formal-legal approach to institutions may also be applied normatively by identifying the desired results and then, based on assumptions about likely behaviour, deducing the rules necessary to achieve those results.

Early NPE theorists, especially those associated with the Virginia School, believed that theoretical study alone would achieve little and sought some way to bring their theories into practice (Jones, 1992a). The normative formal-legal approach to institutions became popular with NPE theorists, all of whom have adopted the same behavioural assumptions, that opportunistic and boundedly-rational individuals will always act in their own self-interest (Moe, 1984; Williamson, 1996; Boston *et al*, 1996). Consequently, the legitimised rule-making processes of legislators and regulators, as well as trade associations and other standard-setting organisations, which are ideal for NPE theorists' purposes, became of increasing interest (Jones, 1992a; Deakin and Wilkinson, 1998). Arguably, all that is required to achieve the desired results is to ensure that the various rules in operation are structured to generate those results, and that compliance with the rules is enforced.

The normative formal-legal approach to institutional studies emphasises the intended outcomes, suggesting the need for careful attention both to the rules and to any rule changes in order to ensure that these desired outcomes occur. Some theorists have noted that not all people are so attentive, and the ease with which institutional changes may be agreed and implemented without agreement or understanding of the intended or likely effects (March and Olsen, 1989; Jones, 1992a; Buchanan, 1997, p. 49; Barzelay, 2001).

NPM, NPFM and accounting

NPFM consists of various accounting techniques applied in combination. Barzelay's (2001, p. 156-157) description of NPM makes clear that NPFM, which relates to financial matters, is a fundamental part of NPM:

> New Public Management is a field of discussion largely about policy interventions within executive government. The characteristic instruments of such policy interventions are institutional rules and organizational routines affecting expenditure planning and financial management, civil service and labor relations, procurement, organization and methods, and audit and evaluation. These instruments exercise pervasive influence over many kinds of decisions made within government.

Controversy surrounding NPFM reveals contrasting views about the nature of accounting and its role in NPFM. On one hand, the accounting profession and some NPFM reformers represent accounting as a set of neutral techniques which allow impartial reporting about some objective form of financial reality. This is

the case in New Zealand where, especially in the early stages of financial management reform, key reformers claimed that the support of both main political parties for New Zealand's financial management reforms meant that those:

> reforms are seen as providing a technical approach toward improving the operations of government agencies which was neutral with regard to the outcomes desired by the government of the day. It also indicates that the success of the reforms will be judged by their practical effects and not on ideological grounds. (Scott *et al*, 1990, p. 26).

Arguably, accounting's neutrality and impartiality is assured by the accounting profession's conceptual framework from which its accounting standards and practices are, ostensibly derived, thus ensuring consistency and reducing political interference (McGregor, 1999; FASB, 2001). On the other hand, accounting's usefulness for devising institutions intended to achieve particular results has long been recognised (Jones, 1992a; Lehman, 1992; Covaleski *et al*., 1995; Olsen *et al*, 1998).

The recent revival of some early uses of accounting to produce particular effects is evident in NPFM, even though some of those uses require the endorsement of ideas apparently rejected by the profession's conceptual framework (Storey and Storey, 1998; Poskitt and Newberry, 1998). For example, John Commons, an early institutional economist, introduced into the law such connotative concepts as reasonable value and best practices, both of which are undergoing resurgence in popularity today. The manipulable concept of reasonable value was interpreted as requiring physical valuations, "the cost of construction or reconstruction of the physical property", while those physical valuations provided the asset valuation base used to devise accounting rates of return on which monopoly price regulation and utility regulation were based (Covaleski *et al*, 1995, p. 17, citing Commons (1907)). Commons acknowledged that the rules devised greatly benefited the assets' owners and disadvantaged those required to pay for the services.[3] This use of accounting in the regulatory process, however, changed the nature of conflict over rate regulation by providing a

[3] The idea of the assets' owners is based on a proprietary theory view which views an entity as merely an extension of its owners or proprietors. According to this view, assets are the property of the proprietors and liabilities are the proprietors' obligation. Accounting has since distanced itself from this theory, with a rather more muddled theory operating today but one which regards assets and liabilities as belonging to the entity, not to proprietors (Crook, 1997).

"rhetorical device for setting forth the concept of reasonable value which makes rage, coercion, physical force unreasonable" (Covaleski *et al*, 1995, p. 26).

An institutional approach to understanding New Zealand's financial management system

If institutional changes may be implemented without agreement or understanding of the intended effects of those changes, then technical changes, such as the many financial management changes found in NPFM, may be vulnerable to the production of effects unintended by those who agreed to their implementation (March and Olsen, 1989; Jones, 1992a; Buchanan, 1997; Feigenbaum *et al*, 1998; Olson *et al*., 1998; Barzelay, 2001) This possibility is strengthened by Olson *et al*'s (1998, p. 459) suggestion that politicians may have relied too heavily on their advisers and NPE theorists' assumptions about opportunism which suggests that such reliance may be unwise.

Hopwood (1984) observed that the stated aims of financial management reforms in the public sector tend to be both general and ambiguous, an observation no less true in New Zealand, where the stated aims included accountability, improved performance, and the extraction of "better value from public spending" as just some of the many positive outcomes to be achieved (Scott *et al*, 1990, p. 2).

New Zealand's key reformers of the financial management system state that they applied comprehensively "a consistent set of principles and approaches" Scott *et al*, 1997 p. 357), acknowledging their debt in this application to "an interpretation of contemporary institutional economics as developed, for the most part, by American theorists" (p. 359), and to ideas about the "sociology of organizations" (p. 360). They paid careful attention to the incentives required to ensure that "the policy objectives that legislatures establish either directly or though authorized governing bodies" are achieved (p. 360). Apparently, these reformers used a normative, formal-legal approach to developing New Zealand's public sector financial management system. This research therefore adopts the alternative emphasis for its study of institutions and takes a descriptive-inductive approach to understanding that system. Given the acknowledged sources of

inspiration for New Zealand's financial management reformers, these same sources, the contemporary institutional economics and related literary sources, provide the theoretical context for this research together with a summary of international debate over NPFM. These are considered in the next chapter.

A descriptive-inductive approach

According to Hopwood (1984), technical developments should be interrogated to determine what is achieved, rather than simply accepting the stated rationalisations. He proposed that such interrogation would allow the deeper questions to be asked about NPFM including, "what effects it truly has on the size of government; on the capacity government requires to fulfil its job; and on the fundamental mechanisms of elected democracy" (p. 460). Given the loss of capability receiving comment in New Zealand, the first two of these questions, in particular, are issues on which this research might shed some light.

The descriptive-inductive approach to the study of institutions requires the use of historical research techniques to "systematically describe and analyse phenomena that have occurred in the past and which explain contemporary political phenomena with reference to past events. The emphasis is on explanation and understanding" (Rhodes, 1997, p. 65, citing Kavanagh, 1991, p. 482). This research therefore aims to describe New Zealand's financial management system using a descriptive-inductive approach in an attempt to understand the likely effects of that system.

Following J. Scott (1990), New Zealand's financial management system may be viewed as a system consisting of three layers: a conceptual instruments layer, a technical instruments layer and a situated interpretation layer. The conceptual instruments layer consists of definitions of key terms and provides a system's framework. In any system, the definitions may be specific to the system and may differ from the understandings of others. The conceptual instruments layer of New Zealand's financial management system apparently consists of two sets of conceptual instruments, one embedded in the other. The interpretations of terms used or assumed in the Public Finance Act 1989, such as outputs and other expenses are at least partially embedded in the second set of conceptual

instruments through which performance may be assessed and accountability discharged. This second set of conceptual instruments is linked to the accounting profession's conceptual framework for financial reporting, and its definitions of elements of financial reports, assets, liabilities, equity, revenue and expenses. Arguably, by adopting the accounting profession's generally accepted accounting practice (GAAP), accountability and control of the public sector may be achieved through financial reporting by reporting on and assessing the production of outputs, thus allowing assessment of the government's different interests in a department. These conceptual instruments are important because any assessment of the meaning of published reports requires prior understanding of the meaning attributed to the conceptual instruments (Scott, 1990, p. 85). For example, reports about outputs and their cost requires understanding of the meaning attributed to these terms in the Public Finance Act 1989.

The technical instruments layer of a system consists of the methods used to collect and process the information which will, eventually result in reporting on the conceptual instruments. It requires that the conceptual instruments be "translated into specific administrative procedures", with those procedures used to produce the reports which "depend upon, and help to define, the conceptual instruments that are employed" (Scott, 1990, p. 62, 85). In this way, both the conceptual and the technical instruments affect the administrative records and record-keeping required. For example, although the interpretation of outputs in the Public Finance Act 1989 has remained unchanged, changing ideas about how the costs should be determined affect both the record keeping requirements and what is reported about outputs.

The technical instruments layer of New Zealand's financial management system consists of accounting requirements prescribed by GAAP and instructions issued by the Treasury, the Department of the Prime Minister and Cabinet, and the State Services Commission. The most prominent of the instructions issued from within government are Treasury circulars, Cabinet Office Circulars and various sets of guidelines and requirements. Application of these technical instruments result in financial reports presented as part of a department's annual report, and in the forecast reports used to support appropriations, which, in turn, provide the

means of assessing, for example, outputs and performance, and the government's purchase interest and ownership interest in a department.

The situated interpretation layer of any system results from the ambiguity remaining even after defining the conceptual instruments and specifying the technical instruments which, in turn, report on the conceptual instruments. This layer leaves some flexibility to bend or reinterpret the conceptual and technical instruments layers. According to Scott (1990, p. 90):

> No matter how precise the concept and no matter how systematic the method, those responsible for applying it to particular cases will always have a high degree of discretion in the decisions they make. It is never possible for a general rule to be unproblematically applied to particular cases: an official must decide that in *this* situation, under *these* circumstances, the rule will be applied. It is always necessary for agents to construct concrete interpretations of the rules under which they operate and which they see as relevant in the situations with which they are faced.

The situated interpretation layer may be viewed with either dismay or approval. Gregory (2001), for example, who considers New Zealand's financial management system inappropriate, views it with some hope:

> The encouraging aspect of all this is that effective and able officials will get on and try to do as best they can, using their energy, skill and intelligence to try to work their way around contextual constraints placed on them, when they find those constraints oppressive or irrelevant. T'was ever thus, and I have no doubt remains so. (p. 218).

Whereas the use of historical research techniques is appropriate for describing the first two formal layers of the financial management system, the conceptual instruments and the technical instruments layers, such techniques are inadequate for understanding the situated interpretation layer. Although the research techniques adopted in this research will not uncover that layer, any researcher seeking to explain this layer may find helpful a detailed description of the first two layers.

Data sources

The descriptive-inductive approach to the study of institutions relies heavily on documentary, especially archival, analyses to explain those institutions. Following Yin (1989), multiple information sources are important for triangulation and enriched analysis. The sources used in this research include publications by those involved in the public sector reforms, legislation, regulations issued under

delegated powers, archival records, documentation, and, to a lesser extent, interviews.

Publications by those involved in the public sector reforms

Following each election the Treasury has provided a comprehensive briefing to the incoming government which includes discussion of the financial management system and proposes developments to it. These briefings give some indication of developments of the time. New Zealand's public sector reforms received considerable international attention and key reformers, mostly Treasury staff or former staff writing as individuals, have published their views about the reforms. Much of this literature is, as Olson *et al*. (1998a) suggest, in the nature of promotional work but it does explain some of the thinking of the time and provides a helpful cross-check with the detailed system developments.

Legislation

New Zealand's financial management system is legislated and this legislation provides an important source of information about the financial management system. In effect the legislation provides the conceptual instruments layer of the financial management system. The legislation reviewed for this research includes the State-Owned Enterprises Act 1986, the State Sector Act 1988, the Public Finance Act 1989, and the Fiscal Responsibility Act 1994.

Regulation

The three central departments in New Zealand's government, the Treasury, the State Services Commission and the Department of the Prime Minister and Cabinet, each advise their respective Ministers, the Minister of Finance (Treasury), the Minister of State Services (State Services Commission) and the Prime Minister (Department of the Prime Minister and Cabinet) about the ongoing coordination and operation of the core public sector. To some extent, but not always, these departments work together. The Treasury is the key central department in relation to the financial management system and has conceptualised its relationship with departments as analogous to that of a head office relationship with branches. The Public Finance Act 1989 delegates to the Treasury the power

to issue instructions to departments and, provided the instructions are lawful, departmental chief executives are required to comply with those instructions. These instructions may regulate the management of public money, or regulate accounting and financial management and control procedures (Public Finance Act 1989, s. 80).

The Treasury issues a manual which may be found on the Treasury's web-site. The manual contains predominantly general instructions covering such matters as financial reporting policies and costing policies. In addition, the Treasury issues circulars which contain specific detailed instructions with which departments are required to comply. Requests to the Treasury and to the Audit Office brought forth some circulars and the revelation that neither organisation holds a file containing a complete set of circulars. Other documentary sources, including departmental sources, supplemented the set obtained for this research.

Cabinet Office circulars relevant to the financial management system establish limits for delegations and requirements for appropriations. These are issued by the Department of the Prime Minister and Cabinet. Current Cabinet Office circulars are available on the web-site of the Department of the Prime Minister and Cabinet.

The State Services Commissioner employs departmental chief executives on behalf of the Crown and must assess their performance. Part of that performance assessment uses information drawn from the financial management system and the system, therefore, traces through to the State Services Commission at various points. The Treasury and the State Services Commission have developed some requirements in relation to the financial management system jointly. Some of these are published and available on the State Services Commission's web-site.

Archives

Three sets of archival records were perused in this research: the Parliamentary Library's archives relating to the enactment of legislation; former Minister of Finance Ruth Richardson's archives; and Treasury files in relation to aspects of the financial management system.

For three Acts of Parliament, the Public Finance Act 1989 and its amendments, the Fiscal Responsibility Act 1994, and the Financial Reporting Act 1993, all bills were obtained, together with records of parliamentary debate on those bills. The Parliamentary Library holds public submissions on bills, officials' commentary about the submissions, and the reports of the relevant select committees to Parliament. For those three acts, this information was examined at the Parliamentary Library and relevant comment was either noted or photocopied. The objective of examining these documentary sources was to discover the debate of the time and how it was addressed.

Ruth Richardson was Minister of Finance from 1990 to 1993, an important period in the development of the financial management system. Although the previous Labour government enacted the Public Finance Act 1989, a considerable amount of work on the detailed development of the system occurred during Ruth Richardson's term as Minister of Finance. These developments occurred largely through the issue of instructions and policies and therefore in relation to the technical instruments layer of the financial management system.

On her retirement from parliament, Ruth Richardson contributed her papers to the MacMillan Brown library at the University of Canterbury. The Official Information Act 1982 applies to those archives and access required Ruth Richardson's written permission and the permission of the Cabinet Office. An index of those archives was used to request particular files for retrieval from an off-site warehouse. Files requested included Treasury advice to and correspondence with the Minister of Finance, and the minutes and papers of Cabinet Meetings, Expenditure Control Committee meetings, some Cabinet Strategy Committee meetings, some Cabinet State Sector Committee meetings, as well as documents related to specific issues. Because, at the time of examining these archives, the intended research involved a case study of two departments, the Department of Justice and the Department of Statistics, information related to those portfolios was also collected. Permission was obtained to photocopy relevant documents and these photocopied documents were catalogued and sorted into one of 13 categories according to the then-vague understanding of the financial management system.

The task of perusing Richardson's archives commenced with about ten days work in January 2001, after which it became apparent that the volume of information requested was straining library staff resources. After January, the arrangement changed to two days each week perusing between six and eight large boxes of files each time. Because the archives were stored off-site, the size of this task was not apparent. Subsequent information obtained from MacMillan Brown library staff revealed that this set of archives consists of approximately 160 linear metres. At a rough estimate, approximately 250 - 300 large boxes of files were examined.

The Treasury is the department responsible for the development and management of the financial management system. Development commenced prior to Ruth Richardson's term as Minister of Finance and the system has undergone continuous development throughout its existence, although the 1990-1993 period was a time of major development. A request to Treasury for information about the financial management system resulted in three visits to the Treasury, each of several days duration, and access to Treasury files, with the information derived from those files subject to the requirements of the Official Information Act 1982.

The three visits were in late February 2001 (three days), June 2001 (four days), and early August 2001 (three days). Desk space was provided in the Treasury's information department with access to the photocopier and library resources. A schedule of files which may be of interest was provided and the files requested were retrieved by a Treasury staff member, although a few requested files were missing, or in use by others. Information department staff arranged discussion sessions with relevant staff and these sessions allowed debate and clarification of information retrieved from files as well as information already retrieved from other sources. Typically following these sessions, further documentary sources were identified and additional documents obtained.

Intensive reviewing and photocopying documents from the files made available dominated the first visit to the Treasury. The second and third visits allowed for filling in the gaps. While these later visits also involved documentary information retrieval and photocopying, this aspect of these visits was less intensive than previously. Instead, the typical nature of these visits consisted of questions to

people concerned with particular aspects of the financial management system and a request for particular documents to support the further discussion. In addition, other sources of information were suggested, resulting in referral to the State Services Commission and information about the Commission-led CAP project (Chapter 5).

The documents obtained from Treasury were catalogued and then sorted into the categories and files obtained from Ruth Richardson's archives. The objective of this process was to develop, for each category of information, a picture of the evolution of the various aspects of the financial management system. These documents were sorted and re-sorted several times as system understanding gradually emerged. They are presented in the references in date order because the date is the only consistent reference point, which allows a reader to check the references cited against the documentary sources.

Other documentation

As noted above, at the outset of this research a case study approach was intended to examine how two departments fared under the financial management system. Two departments were chosen, one smaller department which had not been restructured, the Department of Statistics, and one larger department which did undergo restructuring, the Department of Justice. The annual reports of these departments were obtained for every year from the date of implementation of accrual accounting. For the Department of Statistics this documentation consists of eleven years of annual reports, from 1990 to 2000 inclusive, while for the Department of Justice, which commenced accrual accounting in 1991, this consists of five years of annual reports, from 1991 to 1995 inclusive at which time the department was restructured into three departments, the Ministry of Justice, the Department for Courts, and the Department of Corrections. The annual reports for each of these departments from 1995 to 2000 were obtained. Subsequently, a third department, the Inland Revenue Department, was included following a request from the State Services Commission to provide a long-term financial analysis. All financial reports were analysed and summarised into Excel files to give a picture of each department's operation over the whole period under review.

The financial analysis and, particularly, the obvious erosion of departments' resources through the development of the repayment of surplus rule resulted in recognition of the need to understand fully the financial management system itself. This, in turn, led to a changed research focus from how particular departments fared under the financial management system to how the financial management system has been developed for application to all departments. Information from those annual reports and from the Treasury's files and Ruth Richardson's archives is presented in Chapters 6 to 10 to illustrate the financial management system and its operation.

Interviews

In research intended to interrogate technical developments, stated rationalisations are of less use than documentary sources. Multiple documentary sources support both triangulation and a pattern matching approach to piecing together the system, with the multiple sources allowing some corroboration. For example, the development and operation of the repayment of surplus rule was corroborated by cross-checking section 14 of the Public Finance Act 1989, information from Ruth Richardson's archives and Treasury instructions against the surplus repayments shown in departmental financial reports. To the extent discernible in the published financial reports, other developments were also corroborated in this manner but this was not always possible, usually because parts of the system are not necessarily revealed in the published financial reports.

When important aspects of the financial management system either could not be corroborated from documentary sources or were unclear, attempts were made to clarify and corroborate through discussions with staff of Treasury, the State Services Commission, and a former Treasury staff member. Interviews were also conducted with a former departmental chief executive and a current knowledgeable staff member of each of the Department of Statistics and Department of Corrections. These discussions were treated as informal for two reasons: first, the complexity of the system, the period of time over which it developed, and some of the early comments made by Treasury staff led to the view that the system understanding of those commenting may be partial, with limitations on their understanding imposed by such matters as level of

involvement and focus of attention, and time and length of service. The system, for example, comprises both budgeting and financial reporting aspects, but these are separate functions within Treasury. Further, the budgeting rules are administered via the Cabinet Office while the State Services Commission is involved in performance review functions. Also, the developers of New Zealand's public sector financial management system have changed over time, suggesting the possibility that the originators of the system may no longer understand, or fully agree with the system that has evolved, while subsequent developers might not fully understand the base on which they are building. These possibilities help to explain why historical research techniques are appropriate for the study of political institutions, because institutional developments can occur, often without conscious design (Rhodes, 1997). The decision made was to place greatest reliance on the system documentation and examination of the formal system, rather than oral explanations and/or rationalisations for it.

The second reason for treating discussion as informal follows from the first. Given the decision to rely on documentation, the potential quotability of comments made during discussions was thought more likely to hinder, rather than to assist with the research objective. Those with whom discussions were held were advised that their comments would not be quoted. Discussion provided a source of information for understanding documents obtained, how they linked to other aspects of the system, and for seeking further documentation. There was considerable follow up from discussions to obtain such additional documentation. Arguably, the discussions resulted in a more extensive and comprehensive set of documents than would otherwise have been possible. Where reliance has been placed on discussion for supporting particular assertions, such reliance is largely related to the current status of particular parts of the system. Those with whom discussions were held were advised that they would be quoted only after receiving advance notice of the matters on which formal comment was sought.

The nature of the documentary sources

Almost all of the documentary sources obtained for this research consist of government administrative records. Two of those sources are not accessible to the general public except under application via the Official Information Act 1982.

Before considering the general nature of government administration records some explanation of the Official Information Act and the manner in which it is applied for researchers is necessary.

Official Information Act 1982

New Zealand's Official Information Act 1982 is based on the principle that official information should be made available unless there is good reason for withholding it. The reasons for withholding official information are set out in sections 6 (conclusive reasons), 7 (special reasons) and 9 (other reasons) of the Act. Neither the conclusive reasons, which relate largely to the country's security, nor the special reasons, which refer to New Zealand's relationship with some Pacific Islands are relevant to this research. Some of the other reasons set out in section 9, however, do apply to this research. Section 9 allows for information to be withheld to:

> (a) protect information which is subject to an obligation of confidence;
>
> (f) maintain the constitutional conventions for the time being which protect . . .
>
> > (iii) the political neutrality of officials;
> >
> > (iv) the confidentiality of advice tendered by Ministers of the Crown and officials;
>
> (g) maintain the effective conduct of public affairs through
>
> > (i) the free and frank expression of opinions by or between or to Ministers of the Crown or members of an organisation or officers and employees of any Department or organisation in the course of their duty; or
> >
> > (ii) the protection of such Ministers, members of organisations, officers, and employees from improper pressure or harassment.

Generally, obtaining information under the Official Information Act requires an application citing the specific information required. In the event of a decision to withhold information, reasons for withholding must be stated if requested and an appeal may be made to the Ombudsman (s. 19, 28-30). For the purposes of research such as this thesis, however, a practice has developed of applying the Official Information Act in reverse. Access to a particular set of records may be allowed provided that the information obtained is treated as confidential and that anything written for publication which incorporates that information is submitted to the relevant authority(ies) for assessment under the Act.

The information obtained from Ruth Richardson's archives and Treasury files, may, potentially at least, be withheld under section 9 of the Act. There is however, some balance required, in any decision to withhold information. Section 9 requires consideration of particular circumstances, especially whether the "withholding of that information is outweighed by other considerations which render it desirable, in the public interest, to make that information available". Also, the Act does not include as reasons for withholding information such reasons as "political sensitivity, embarrassment or shame" (New Zealand Official Yearbook).

The Cabinet Office granted access to Ruth Richardson's archives which are held at the MacMillan Brown Library at the University of Canterbury. The Treasury granted access to its files which are held in its offices in Wellington. Both applied the Official Information Act in reverse, with the Treasury requiring a signed agreement before access was allowed (reproduced at the end of Chapter 1). The support, cooperation, and assistance of Treasury staff was essential, willingly given, and extended to preparedness to read and comment on early drafts. The detailed contents of the documents obtained from both sets of files, cannot necessarily be divulged. For this reason, throughout chapters 6 to 9, documentary sources are cited to support statements made but quotations from the documents are minimised to those necessary to show the direction, development and, apparent reasoning of the time.

Government administrative records

Most of the documents studied in this research are government administrative records which typically are "shaped by the political context in which they are produced and by the cultural and ideological assumptions that lie behind it" (Scott, 1990, p. 60). Although such documents tend to present action as rational and calculative, generally by separating any proposed action from its context, they should not be viewed as neutral (Scott, 1990, p. 61). Scott (1990) proposes that for evidential research, the information obtained requires assessment of its validity according to four criteria: authenticity, credibility, representativeness, and meaning.

Authentic records must be genuine and of unquestionable origin. The documents used for this research are drawn from primary sources and their authenticity may, therefore, be fairly well assured.

According to Scott (1990), credibility implies freedom from error, evasion and distortion. To the extent that the documents obtained in this research contain errors, at least some of those errors may be discovered through examination and triangulation. Alternatively, errors may be expected to translate through to the system or to the understanding of the system and thus result in misunderstanding. Evasion is rather more difficult to assess with the most obvious forms of evasion in relation to these documentary sources being omission and unrecorded discussion.

The possibility of omission was suggested by some documents which mentioned the Official Information Act and the fact of discoverability. Potentially, some documents might not be filed and one noted feature of this research was the lack of debate in Treasury working documents, especially given the Treasury's reputation for intellectual rigour. The recent publication of Gorringe's work suggests that there was considerable disagreement within Treasury in 1994 and 1995 over the development of the financial management system. Although some disagreement is noted at the time, its nature is not evident from the files obtained.

Many of the documents retrieved from Ruth Richardson's files were forwarded to her in advance of discussion. The terminology in the documents suggests rationality but the nature of the matters under discussion suggests considerable scope for evasion and distortion to the extent that the language used in the documents may belie the actual intent which may have been clarified in discussions. That documents may be lost or omitted from archives, or that discussion may be more revealing than the documents should not be surprising, but it does require recognition that information retrieved from these sources may be partial.

Representativeness implies that documentary evidence obtained should be "typical of its kind". The need for representativeness relates only to the Treasury files and Ruth Richardson's archives because, where possible, complete sets of

other documents were obtained, that is, Cabinet Office circulars and departmental annual reports. The documents retrieved from Ruth Richardson's archives and the Treasury's files were drawn from large files each of which required perusal to decide which documents were relevant to the financial management system. Very large volumes of documents were sighted and copies taken of all assessed as relevant, with potential error on the side of copying too many documents. In the case of the Treasury files, there was some supplementation by Treasury staff members who provided, for example, a copy of the very important "Report on Departmental Incentives" (Treasury and State Services Commission, 1989) which was not in the archival files supplied. From the files examined, however, the documents extracted were representative of the type of documentation.

Representativeness also requires consideration of the different sources from which information was obtained. Although access was obtained to both Ruth Richardson's archives and Treasury files, Ruth Richardson's role as Minister of Finance means that the dominant source of documented information is the Treasury, with the documents taken either direct from the Treasury files or indirectly from Ruth Richardson's files. This domination of Treasury-sourced information could be misleading. It would be easy to conclude from the evidence available, for example, that the financial management system has been devised and developed gradually over time by the Treasury and that politicians play only a very small part. The validity of such a conclusion, however, may be questionable. A different research method would be required to draw any conclusions about the driving force behind the financial management system and such a question would, in any case, require a different research topic. This research focuses on the system itself and *not* on its developers, recognising that the documentary sources involve a heavy reliance on Treasury information and the possibility of misleading partiality. Clearly, other parties were involved in the financial management system and its development (for example, the good practice proposals of some major consultancy firms) and this research makes no attempt to identify the particular roles played by the different parties involved. There is, therefore, no suggestion that the research findings represent anything other than an analysis of the financial management system itself which is the research focus.

Understanding the meaning of the evidence collected requires some assessment and understanding of the terminology used and the meaning attributed to that terminology in the context in which it is used. Official documents may be based on a political intent to sell a particular viewpoint, often by presenting that particular choice of action in a manner which justifies it, and so the terminology can be misleading (Scott, 1990, p. 23). Although the documentation used in this research provides evidence about the development of the financial management system, the documents cannot necessarily speak for themselves, thus requiring some interpretation. This may require some frame of reference to assist with understanding, a point consistent with current expectations that descriptive-inductive research be conducted using a theoretical context. The frames of reference used here consist of the theoretical frameworks that the reformers acknowledged, especially NPE and the wider international trade-liberalisation context within which New Zealand's public sector reforms have occurred, together with the published work of key reformers and commentary about the public sector reforms. According to Scott (1990) "the most that can be achieved by a researcher is an analysis which shows how the inferred internal meaning of the text opens up some possibilities for interpretation by its audience and closes off others" (p. 35).

Chapter summary

This research adopts a descriptive-inductive approach intended to explain the development of New Zealand's financial management system and to understand the nature of that system as it operates today. Although this research may be expected to access the conceptual and technical instruments layers of New Zealand’s financial management system because those are both formal layers which may be uncovered through the predominantly documentary research method adopted, the informal situated interpretation layer of the system will not be revealed.

NPE theorists' acknowledged views and assumptions of behaviour suggest that the stated rationalisations for particular institutional reforms should not be taken at face value. Neither should the documents obtained during the course of this research, with recognition that, as government administrative records, those documents must project an appearance of rationality. Assessment of the

institutions developed requires a theoretical context and the context adopted for this research is that of the various NPE theories and the more practical proposals of populist advocates of the reforms, as well as the debate over particular NPFM techniques. This context is adopted because of its acknowledged influence on NPM and NPFM, and because key figures involved in the development of New Zealand's financial management system acknowledge that this literature has provided much of their inspirational source.

The next chapter provides the theoretical context for this research while Chapters 4 to 9 set out the research findings to explain the financial management system developed in New Zealand.

3 Influences on NPM-style public sector reforms

Chapter 1 identified the spectrum of related ideas from which NPM and NPFM emerged, with new political economics (NPE) at the theoretical end, and the work of populist authors such as Osborne and Gaebler (1992) at the more practical end (see figure 1.2). Much of this literature is from the United States of America and its application in New Zealand may be questioned. New Zealand's NPM-style public sector reforms are renowned for their application of ideas drawn from "the literature on institutional economics and contemporary macro-economic and micro-economic theory" (Scott *et al*, 1997, p. 359; see also, Boston *et al*, 1991; 1996; Schick, 1996; Barzelay, 2001), but the populist literature has received almost no acknowledgment. There are, however, clear indications of a strong link. For example, a novel feature of New Zealand's Public Finance Act was the distinction between the government's purchaser and owner interests in departments, but Savas (1982), who devised this distinction (Osborne and Gaebler, 1992), receives only coy acknowledgment from Scott *et al* (1997, p. 363), even though Savas's book has been in the Treasury library since 1984. Similarly, Osborne and Gaebler (1992) and Osborne and Plaistrik (1997) cite New Zealand's developments and report discussion with New Zealand's reformers, thus suggesting that New Zealand's reforms have influenced them, although whether there is an influence in the other direction is not clear from their work.

This chapter outlines the ideas in the spectrum from which NPM and NPFM emerged, beginning with an explanation of NPE, identification of different waves of NPE theories, and discussion about their consistency and validity. It then considers the more practical populist literature which proposes various techniques for use in public sector management and financial management systems. Finally, it explains the international debate over NPFM and especially the accounting techniques adopted as part of NPFM.

New political economics (NPE)

New political economics consists of a body of relatively recently developed, and still developing, theories that became popular in the United States in the 1970s and are associated academically with the Chicago and Virginia Schools (Moe, 1984; Goldfinch, 2000). A key difference between these schools is that the Chicago School suggests that only money matters whereas the Virginia School believes that institutions (rules) are crucially important (Meckling, 1978, p. 106).

These NPE theories apply economics to politics, and include public choice theory, constitutional economics, transaction cost economics, and agency theory, which, in combination, focus on government and the management of government (Jones, 1992a, p. 149; Buchanan, 1997).[4] The ideas underlying these theories range from ideas about people's voting behaviour, about how a government operates and ideal constitutional rules, to ideal structures for organising and coordinating activities, and arrangements for controlling relationships within those structures.

All of these NPE theories rely on the same underlying assumptions, that individuals are self-interested, opportunistic and boundedly rational. In the context of self-interested rationality, opportunistic means that individuals will take advantage of any opportunity to pursue their own interests, while boundedness indicates their lack of perfect knowledge, so their actions occur in an environment of some uncertainty about events and likely outcomes (Moe, 1984; Williamson, 1996; Boston *et al*, 1996). These individualistic assumptions reject, or at least ignore the possibility of, any concept of public interest or altruistic behaviour. Two waves of NPE theories are of particular interest in New Zealand's public sector reforms: the early wave associated with the Virginia School, which developed in opposition to Keynesian economics and draws on ideas about markets and market efficiency; and a later wave which focuses on politicians and their behaviour.

[4] Transaction cost economics and agency theory were developed in the context of the business sector and require adaptation for use in relation to government. Both, for example, take for granted the enforceability of

Early wave NPE theories

The Virginia School's early wave of NPE theories seemed to commence in the late 1940s to counter Keynesian economics, then dominant in Western countries (Jones, 1992a). Keynesian economics proposes that governments should try to counterbalance economic cycles and allocate resources to maximise welfare. The NPE theorists, however, argued that Keynesian economics and, in particular, the rules of functional finance theory associated with Lerner, contained an inbuilt bias towards government expansion and caused increased public sector debt and inflation (Buchanan and Wagner, 1978). They proposed a set of rules (meaningful constitutional norms) intended to reverse the rules of functional finance theory and, therefore, the effects of Keynesian economics by tightly constraining a government's access to resources. Their proposed norms consisted of a government's commitment to a balanced budget without incurring debt; a constitutional limit to the amount of tax that a government may take; creation of a central banking institution charged with ensuring that "a country might achieve … low and predictable inflation"; and constraints on a government to prevent it from removing private property rights, thus providing incentives for private sector investment (Buchanan and Wagner, 1978, p. 176; see also Buchanan, 1989, p. 56; Jones, 1992a, p. 153).[5]

According to these Virginia School NPE theorists, economics should focus on "the creation of value . . . and . . . the interactive relationships among persons that define the order of the economy" (Buchanan, 1997, p. 65). They therefore seek to impose rules for this purpose, using, at times, highly emotive language revealing strongly-held philosophical views. Buchanan (1997, p. 41), for example, argued that any "means of production that are collectively owned and managed" amounts to socialism and that many government activities should be the preserve of markets (see also Buchanan *et al*, 1987). Meaningful constitutional norms did not

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private property rights, ideas requiring considerable translation in respect of the elected authority to govern (Moe, 1984).

[5] The proposed commitment to a balanced budget commenced with an argument that current taxes should cover the costs of current public spending but subsequently equivocated over whether all government spending is current spending or whether non-current spending could be debt financed provided it could earn an acceptable return (Jones, 1992a; Rowley, 1993; Musgrave, 1999).

directly address these government activities, but Niskanen's (1971) development to NPE theory did. Niskanen argued that government provision of services will always be inefficient when it is the "only game in town" and that self-interested, budget-maximising bureaucrats cause this inefficiency (1975, p. 617). This early wave of NPE may therefore loosely be described as the market-efficiency wave because Niskanen's proposals to restore efficiency subsequently became:

> the cornerstone of a scientific movement of sorts, led by the public choice school of economists and political scientists, against the bureaucratic supply of public services and in favor of two fundamental dimensions of reform: privatization and competition. (Miller and Moe, 1983, p. 297).

Later wave NPE theory

A later wave of NPE theory, the New Economics of Organization (NEO) seems to have commenced in the late 1970s (Moe, 1990b), and is consistent with the Virginia School in that it views institutions as crucially important. NEO conceptualises politicians as legislators who want to obtain and retain power, and governmental relationships as hierarchically structured. It proposes that voters organised into powerful interest groups can influence elections, and therefore that legislators must gain the support of those interest groups (Horn, 1995, Chapters 1 and 2). In this context, politics becomes a game of legislation-passing because the legislators must pass legislation (rules) designed to provide on-going benefits to the supporting interest groups.

NEO conceptualises governmental relationships as a hierarchical chain of agency relationships in which the powerful interest groups are the ultimate principals and legislators are their agents. At the next level, legislators are principals in relation to their bureaucratic heads who are their agents, the bureaucratic heads are the principals of their bureaucratic staff agents, and so on. This results in a three-tiered approach to understanding public management, with the first tier involving a corporate view of executive government; the second tier dealing with the relations between legislators and bureaucrats; and the third tier addressing management within a bureau (Barzelay, 2001, p. 102-103). NEO also recognises that elections bring about changes in legislators, and distinguishes between enacting legislators, those legislators who pass particular legislation while in power, and incumbent legislators, those legislators who may follow the

enacting legislators and receive their support from different interest groups. Because incumbent legislators may amend or reverse earlier legislation, the powerful interest groups make their continued support of enacting legislators conditional on the provision of assurance (credible commitment) that the legislation will continue to deliver its benefits even when those legislators are no longer in power. Embedding the legislation so that it remains effective even when subsequent incumbent legislators are opposed to its effects may provide this assurance.

The embedding of legislation requires decisions about its administration. Very detailed legislation implies greatest certainty about its subsequent administration but has drawbacks because its beneficiaries may be identifiable and it can be too inflexible. Often less detailed legislation is preferable, with the administration and interpretation of that legislation delegated to one of three forms of regulatory agency: courts, a commission, or a bureaucracy. All regulatory agencies are tax-financed and may expect expert outsiders to assess their performance but differ in the extent of their independence from the legislature: courts are independent; a commission is subject to the legislature's power of appointment, generally on fixed terms, but the legislature which creates the commission can promote continuity in thinking by staggering the first members' terms; and the bureau is subject to the direction of the legislature. The differing levels of independence are appropriate for administering and interpreting different types of legislation (Horn, 1995, Chapter 3).

Legislators must also determine the procedures to be adopted by the legislation's administrators. Much of NEO's concern with the delegated administration of legislation focuses on administration in bureaux (government departments) because they are most subject to influence by subsequent legislators (see Horn, 1995, p. 13 for more detailed explanation).

NEO assumes that administrators of government departments are self-interested but apolitical, and that the heads of such departments will serve under any legislature. Based on these assumptions, it identifies three key influences on their decisions. The first influence is the terms and conditions of employment, which affects the type of person likely to consider appointment. The second

influence is the level of control imposed over access to resources for the department, and over the use of those resources. Starving a department of resources, for example, can prevent it from performing its function. Although incumbent legislators might appear able to control departments' access to resources by requiring them to compete for resources in the annual appropriations process, prior legislation may mandate expenditure, either by establishing particular entitlements, or by requiring permanent or multi-year appropriations. Mandated expenditure, therefore, helps to bind subsequent incumbent legislators, reducing their influence over department administrators. Those incumbent legislators would be forced to amend or repeal the relevant legislation to regain control of the resources and departmental administrators (Horn, 1995).

Once legislators control departments' resources, agency theory concerns about the use of resources within a department may be addressed through the appropriations process by imposing controls on the amount that may be spent on specific expense items, and by imposing "separate capital spending controls, restrictions on realising assets, and restrictions on the ability to borrow and lend" (Horn, 1995, p. 89). These restrictions, together with a requirement to return revenues to the Treasury, help to prevent discretional "intertemporal transfers" which otherwise would allow departments to evade the control provided by annual appropriations and, effectively, the control of incumbent legislators.

The third influence on departmental administrators' decisions is the determination and operation of incentives. Legislators use incentives to ensure that the apolitical public servants, when administering legislation, respond to the interests represented in that legislation at the time it was enacted, rather than to the desires of whichever legislature is incumbent.

Horn (1995, p. 95) summarises these NEO issues from the perspective of enacting legislators seeking to reassure powerful supporting interest groups that they will receive ongoing benefits from the legislation:

> the enacting legislature will look for arrangements that promote the selection of administrators who have the incentives to administer legislation in the way the enacting legislature intended. In addressing the commitment problem, the enacting legislature will also want administrative arrangements that explicitly limit the extent to which future legislatures can control administrative outcomes.

Challenges to the validity and nature of NPE theories

Some NPE theories are built on relatively simple and, perhaps, intuitively appealing ideas and assumptions. Their validity has been challenged (see, for example, Sen, 1977; Miller and Moe, 1983; Moe, 1990b) but even contradictory ideas seem to endure (Barzelay, 2001). For example, the market efficiency ideas suggest that the public sector is inefficient because legislators are the victims of self-interested, budget-maximising bureaucrats, while the NEO ideas suggest that bureaucrats are mere agents of self-interested legislators, who are in turn agents of powerful interest groups (Miller and Moe, 1983; Horn, 1995, p. 90). Both views seem to be overly simplistic: legislators might not be victims of bureaucrats, but little evidence exists to suggest that they want to apply the rational control measures that NEO implies (Aucoin, 1995, p. 36-37; Moe, 1990a). Instead, both legislators and bureaucrats may prefer less conflict-oriented structures and seek to "put distance between themselves and whatever conflicts arise" by adopting institutionalised routines or objective processes to resolve disputes (Moe, 1990a, p. 139). Further, if dominant interest groups are the prime movers in politics, as NEO suggests, then all three sets of actors — interest groups, legislators and bureaucrats require consideration in light of the way each group operates to further their own ends rather than through narrow application of agency theory ideas (Moe, 1990a; 1990b).

These theories may also be misleading. For example, the chain of accountability traced through the NEO hierarchical control structure may appear simple and straightforward, but the reality is far more complex. The existence of multiple powerful interest groups suggests multiple chains of accountability in relation to different politicians and groups of politicians within a legislature (Moe, 1990a, 1990b; Barzelay, 2001). Similarly, legislation focused on the provision of benefits to particular powerful interest groups may be technically dysfunctional or subversive (Moe, 1990a, 1990b).

If bureaucrats are not in control, as NEO suggests, competition and privatisation will not necessarily improve efficiency and may even reduce it (Miller and Moe, 1983). Moe (1984, p. 773) advised caution when considering the practical application of simple models, arguing that they "threaten to supply us

with theoretical 'insights' that are actually quite incorrect; given the difficulty of conducting empirical research on these topics, these could easily gain acceptance and serve to mislead us for years to come”. Horn (1995, p. 34), however, rejected such caution, proposing a weak test, satisfied when a "theory in its early stages of development . . . [is not] . . . vastly inconsistent with the readily available institutional evidence".

Philosophical, as opposed to technical, dimensions?

NPE theorists are noted for their tendency to ignore contrary views, and to build on each other's work, including the inconsistencies, as if there are no contradictions (see for example, Barzelay's (2001) discussion of Aucoin (1995)). It seems that philosophical views may provide a better key to understanding and appreciating their work, a point that acknowledged sympathisers with those views have made clear (see, for example, Meckling, 1978; Demsetz, 1993, while for philosophical views see, for example, Buchanan and Wagner, 1978; Buchanan *et* al, 1987; Buchanan, 1993; Wagner 1993; Rowley, 1993). Some NPE theorists acknowledge both philosophical and technical dimensions to their arguments which generally emphasise privatisation in public sector reforms. The philosophical dimension represents a government with its coercive powers as a necessary evil which should be constrained to enforcing, but not setting, the rules within which a market economy can function (Tullock, 1993, p. 78; Wagner, 1993). This implies a "liberal position that rejects the desirability of collective control" (Buchanan, 1997, p. 42), and views privatisation as simply preferable because it supports liberty and freedom from state coercion (Buchanan and Musgrave, 1999, p. 1; Rowley, 1993; Williamson, 1996).

NPE theorists may present their proposals using technical terminology but some acknowledge their philosophical stance as the key to those proposals. For example, arguments that property should be held in the private sector because that sector will use the property more efficiently have more to do with the view that possession of private property acts as a defence against state coercion (Rowley, 1993). Similarly, the meaningful constitutional norms advocated to reverse the rules of functional finance theory are rationalised with technical arguments: a monetary constitution will ensure that "a country might achieve not only low and

predictable inflation but fiscal discipline as well" (Parkin, 1987, p. 331); a constitutional limit on taxes will force a government to be efficient (Buchanan, 1989); and a balanced budget constraint will demonstrate fiscal responsibility (Breit, 1978). Economic efficiency and fiscal responsibility, however, are acknowledged as minor issues (Buchanan, *et al*, 1987, pp. 69). The proposed norms are intended to cause governments to shrink: a monetary constitution prevents the imposition of disguised taxes by removing a government's easy ability to print money, and thus dilute the value of money already in circulation; a constitutional limit on taxes helps to regulate the master-slave relationship between the state and its citizens (Buchanan, 1989, p. 54); and the real force behind a balanced budget constraint is the way in which it keeps a government in a state of starvation and thus limits the size of the state (Breit, 1978, p. 13).

Initially, NPE theorists seemed to advocate for all of a country's taxpayers, viewing them all as engaged in a virtual slave relationship with an overly powerful state (for example, see Buchanan, 1989, p. 54). More recently, this apparently civil society view has evaporated in light of NEO theories. With trade liberalisation developments increasing the mobility of capital while leaving countries' citizens relatively immobile, Buchanan proposed that governments should compete to attract businesses with favourable business conditions. According to Buchanan, differential tax rates could be imposed, with citizens paying taxes sufficient to provide those favourable conditions (Buchanan and Musgrave, 1999, p. 257). This suggests that Buchanan now represents a particular set of taxpayers, rather than all taxpayers. Musgrave noted this change, commenting that fiscal competition is no more than "a glorious arrangement for rent seeking by capital" (Buchanan and Musgrave, 1999, p. 144, 257).

NPE theorists admit that their philosophical views encounter public resistance (see, for example Buchanan, 1997), and acknowledge that proposals for reform require symbolic rhetoric (such as economy and efficiency) intended to appeal to the particular government structure and political climate (March and Olsen, 1989, p. 76; see also Henisz, 1999). They also recognise that the "pragmatic objectives of internal efficiency" increase the likelihood of privatisation:

> The necessary trade-off is seen to be that between the sacrifice of collective control - a sacrifice that is intrinsically undesirable —and the promised gains in productivity, an objective that is valued. (Buchanan, 1997, p. 42)

Whether such promises of efficiency and productivity gains should be believed, or whether privatisation should stop once optimum efficiency has been achieved, however, is another matter.

> [E]ven if the overall size of the politicized sector of the economy should be set precisely at some efficiency-enhancing optimum, the utility value of independence itself would dictate some reduction in public sector size. (Buchanan, 1993, p. 57).

Populist advocates for public sector reform

Populist advocates for public sector reform, exemplified by Drucker, Savas, and Osborne and his co-authors, sought, and still seek, privatisation (Savas, 2000). They draw on practical, rather than theoretical, backgrounds but recognise consistencies between their work, that of new political economists, and NPM. Savas, for example, who views NPM as consistent with both the practical and the theoretical approaches, maintains that "privatization *is* the New Public Management" but acknowledges public resistance and the need for euphemisms (Savas, 1987, p. 111-112; 2000, p. 319, emphasis in original).

Privatisation

Savas was influential from the late 1970s when he advised President Reagan and collaborated with those promoting privatisation in the United Kingdom (Savas, 2000). At that time, he proposed four privatising strategies: load-shedding; limitation of government arrangements; the imposition of user charges; and competition, which includes contracting. Load-shedding allows the government's role to diminish gradually, either systematically, by identifying which services should revert to the private sector, or more simply, and with less likelihood of "bruising" ideological battles, by allowing services to run down to sub-standard levels, thus encouraging "natural forces" to develop markets in those services:

> To implement load shedding, then, can involve no more than a no-growth policy for government and natural growth for the alternative arrangements. Limiting devices such as . . . spending caps, budget cuts, revenue cuts, revenue limitations and balanced budgets all facilitate this process. Inflation can actually help to the extent that limitations are applied in absolute dollar amounts. (Savas, 1982, p. 123).

The limitation of government arrangements require institutional structures intended to minimise government involvement. Savas identified four types of goods, alternative structures for providing those goods, and a set of criteria to evaluate those alternatives. For collective goods, those goods used jointly and from which people cannot be excluded, he identified a limited set of alternative structures: government provision, contract, and voluntary arrangements. For the other three types of goods he identified additional possibilities. For common-pool goods, goods consumed individually but which people cannot be prevented from consuming, in addition to those structures for collective goods, grants or vouchers may be used; for toll goods, those goods used jointly and for which users must pay, additional alternatives include government vending, franchises, and markets; while for private goods the possibility of self-service could also be added (Savas, 1982, p. 124-131; 1987, p. 39, p. 94).

According to Savas, contracts are appropriate for all types of goods. The limitation of government arrangements necessary for contracts require a "distinction between *providing for* a service and *producing* the service" (1982, p. 134, emphasis in original). Such arrangements offer "an excellent opportunity to introduce and institutionalize competition by employing procedures such as competitive bidding", especially if the public sector and the private sector produce the same services (1982, p. 145). This requires carefully devised contract specifications which define the required service and performance requirements, but do not "transgress the bounds of management prerogatives" by specifying exactly how the service will be produced (p. 150). It requires valid cost comparisons, achievable only if the government-produced services reflect full costs, which include interest costs on capital expenditure, recognition of the opportunity cost of land and buildings, and taxes (p. 145-154; see also 1987, p. 259-261).

Arguably, units of government could make significant savings without adverse effects on either the quality or level of service by applying contracting at lower levels. Savas, however, observed reluctance to take this step, noting the need for "serious fiscal stress" facing that unit and the political feasibility of contracting. He identified as essential motivating factors, "some precipitating event that makes it impossible to continue with the status quo", such as the threat of closure; and

the force of a strong advocate who builds the consensus needed to make feasible this form of privatisation (1982, p. 256; 1987).

User charges should, eventually, force users to bear "fully the true cost of service". Savas (1982) proposed the imposition of user charges on government-provided private or toll goods, arguing that budget and tax limitations would force gradually-increased charges, and the eventual prohibition of "hidden subsidies for government-produced services" would prompt citizens to seek alternative services if they believe that "the service isn't worth the price" (p. 131-133).

Savas viewed all of his privatising strategies as mutually reinforcing (1982, p. 155):

> A decline in the quantity or quality of service leads some citizens to seek out or devise alternatives to supply or supplant the service. This invites load shedding. User charges provide information that facilitates evaluation and accelerates the process. Contracting and vouchers encourage competition and promote efficiency, and can be employed in concert with load shedding.

Savas (1982, p. 89) noted the ideological arguments adopted by most advocates of privatisation but, by 1987 recognised gathering opposition to those arguments. Acknowledging that privatisation "is more a *political* than an *economic* act" (p. 277, emphasis in original), he advised the use of euphemisms to help overcome opposition to privatisation, especially euphemisms likely to appeal to the populist and pragmatic forces, such as productivity enhancement, and alternative service delivery (p. 280).

Reinventing government and steering

Osborne and Gaebler are well known for promoting the distinction between steering and rowing, and for arguing that governments should do no more than steer, but they acknowledge Savas as the source of this idea:

> The word government is from a Greek word, which means "to steer." The job of government is to steer, not to row the boat. Delivering services is rowing, and government is not very good at rowing. (Osborne and Gaebler, 1992, p. 25, quoting Savas).

Osborne and Gaebler argue that a government must retain its governance role of collective decision-making through which the rules of the market are both made and enforced (p. 45). They also recognise that the nonprofit sector cannot

carry the whole welfare load of health care for the poor and housing for the homeless, so they argue that privatisation is not the only answer to poor government performance. Drawing heavily on Savas's earlier work, they propose reinventing government, listing 36 alternatives to government service provision which would reduce a government's functions to steering.

Osborne and Gaebler define an entrepreneur as one who "shifts economic resources out of an area of lower and into an area of higher productivity and greater yield" (1992, p. xix). They propose that their reinvented government would be entrepreneurial and innovative, with innovation prompted by reducing available resources. This would force government managers to "constantly use their resources in new ways to heighten both their efficiency and their effectiveness" (p. xix).

According to Osborne and Gaebler (p. 137), an entrepreneurial government would adopt accrual accounting, focus on “information about the results of government spending”, and “marry their budget systems to performance measures”. For output budgeting, it would focus on the volume of outputs to allow determination of true unit costs, while allowing scope for innovative productivity increases by avoiding any link between the money spent and the volume of outputs (p. 39, 162-165). Such a government would evaluate its investments in assets by the return to be gained from them using, for example, a rate of return calculation (p. 207). Its managers, however, would require incentives by receiving a portion of savings. Alternatively, or additionally, departments could "keep all or part of any funds they save or earn", thus allowing retention of capital for innovation. These incentives would require budget formulae to prevent "green-eyeshade budget officers" from trying to capture savings or earnings. (p. 210).

Osborne and Plaistrik (1997) aim to re-invent governments and cite New Zealand as a leading and extreme example of re-invention. They argue that successful public sector reforms require rewriting the genetic code for "a system's purpose, its incentives, its accountability systems, its power structure . . . and . . . its culture". Osborne and Plaistrik proposed rewriting the code for each of five "most fundamental pieces of public sector DNA". They identified these codes

as strategies: core strategy, consequences strategy, customer strategy, control strategy and culture strategy ("the five C's") (Osborne and Plaistrik, 1997, p. 38).

The core strategy represents a government's most important steering role, while the other four strategies are merely subsidiary, rowing functions. Central to the core strategy is a "clear the decks" procedure which Osborne and Plaistrik propose should be institutionalised as a series of small periodic exercises intended to "gradually and continuously" reduce the government's role to a steering function. Success is more likely from these small and regular routines than from less regular major ones. They present the prior options reviews adopted in the United Kingdom as a leading example of such routines. These reviews consider:

> Is there a continuing need for the activity? If so, does the government have to be responsible for it or can it be privatised and left to the market? Where the government needs to remain responsible for an activity, does it have to carry out the task itself, or can it contract the task to one or more outside providers? If the latter, should the government contract out the entire activity, or should it be market tested, with civil servants competing with outside suppliers to determine which method provides the most value for the money? (Osborne and Plaistrik, 1997, p. 93).

Examples of small, routine exercises include performance or programme reviews ("periodic exercises . . . to develop recommendations for abandoning, privatizing, devolving, restructuring, or otherwise reforming public programs"), sunset rules, asset sales and quasi-privatisation methods in which asset ownership is retained but its operation is assigned to private sector entities, viz franchising.

There are two other parts to the core strategy. One is the separation of functions such as policy, regulatory and service functions (uncoupling steering and rowing). This allows the use of a flexible performance framework using contracts and competitive bidding. The other part is the clarification of direction by requiring frequent definition and re-definition of core purposes (improving your aim).

Osborne and Plaistrik recognise that the decks cannot completely be cleared, but argue that that clearing the decks "narrows and orders the universe” to which the other four C's may be applied to improve performance. They propose a comprehensive decision tree for reinventors which illustrates their approach to public sector reform (Box 3.1), but deny that public sector reform is all about "eliminating, privatizing and reorganizing functions" (p. 94-95).

Osborne and his co-authors are less open than Savas about the intent of the reforms they propose. The approaches they propose for adoption are inconsistent, severely flawed and, to the extent that their advice provides little clear guidance for would-be public sector reformers, discredited and misleading (Williams, 2000). Nevertheless, the inconsistencies, and the emphasis in the decision tree suggest that as with Savas, privatisation and minimal government is the aim.

Box 3.1 A decision tree for re-inventors

(From Osborne and Plaistrik (1997, p. 318-319)

1. What are the outcomes we desire?

2. Should government play a role in producing these outcomes?
If not, abandon, sell, or give away the existing asset, or eliminate the existing policy, regulatory, service-delivery, or compliance function

3 Should government operate the activity?
If not, what arrangement would be best? . . .

- Contracting out
- Regulation of private sector activities
- Tax incentives or disincentives
- Franchising
- Subsidies to producers (grants, loans, equity investments, favorable procurement policies, favorable investment policies)
- Subsidies to consumers (vouchers, tax credits)
- Policies allowing use of public property
- Risk sharing (insurance, loan guarantees)
- Information for customers
- Technical assistance
- Demand management through fees or taxes
- Persuasion
- Catalyzing voluntary activity
- Public-private partnerships

4. If so, which level of government should operate the activity?

- National
- State/Provincial
- Regional
- Local

5. If government should operate the activity, can the public steering and rowing roles be uncoupled?
If so, the options include

- Flexible performance frameworks
- Competitive contracting systems

6. How should the organization be given incentives and consequences for performance?
The options include:

- Enterprise management
- Managed competition
- Performance management

7. Should the organization be accountable to its customers?
If so, the options include

- Customer choice
- Competitive choice
- Customer quality assurance

8. Where should control of resources and operations lie?

- With policy makers and central administrative agencies
- With the organization's top managers
- With work teams within the community
- With some combination of the above

9. How should we change the organizations culture?

10. How do we need to reform our administrative systems to accommodate these changes?

- The budget and finance system
- The personnel system
- The procurement system
- The auditing system

Privatisation is the New Public Management

Savas (2000) emphasises that governments should divest both enterprises and assets, with divestment essential to block arguments for resumption of previously discontinued activities. He revised his earlier analyses of types of goods and

alternative institutional structures, identifying worthy goods as a subset of private and toll goods for which the argument has been accepted that they should be either produced or subsidised by government. Examples of worthy goods include education, mass transit, sports arenas and museums. Savas argues that the fundamental purpose of government is the provision of collective goods, and the collective action needed to regulate the acceptable supply of all other goods. Because government operations have extended to include a large proportion of worthy goods, the provision of collective goods is now a relatively small proportion of government operations. This is "a source of profound unease for libertarians and conservatives, and highlights the important question of the proper role of government in today's society" (p. 60).

Savas also added to his earlier set of alternative structures the public-private partnership (PPP) as appropriate for the continued supply of those toll goods requiring major investment, especially infrastructure. He believes that toll goods could be financed with private capital, "thereby reducing or obviating the need for government borrowing . . . this can leverage limited public funds and may improve the government's credit rating" (2000, p. 237-240).

Savas (2000) continues openly to advocate privatisation, arguing that the profound distinction between providing for and producing a service is "at the heart of the entire concept of privatization and puts the role of government in perspective" (p. 65). Nevertheless, he acknowledges that:

> Privatization is like dismantling a bomb — it must be done *very* carefully, for wrong decisions can have nasty consequences. There are obstacles to be overcome, arguments to be rebutted, proponents to be mobilized, and opponents to be thwarted. (p. 284, emphasis in original).

According to Savas, the continued contentious nature of privatising reforms requires some understanding of the different forces behind the privatisation movement. The ideological force prefers a free market and seeks a smaller and less powerful government; the commercial force prefers more business, and seeks redirection of government spending to businesses and privatisation of government-owned operations and assets; the populist force wants a better society, choice in public services, and seeks to generate increased reliance on community and community support instead of on government; and the pragmatic

force seeks better government, with more cost-effective public services achieved by prudent privatisation (Savas, 1987, p. 4-10, p. 233, 277, 280). Savas argues that ideological views should be de-emphasised and that other objectives should be stated for privatising NPM-style public sector reforms. Acknowledging overlap among alternative objectives he suggests pragmatic, commercial and populist rationalisations such as: withdrawal from public sector provision of services is appropriate because increased affluence enables people to provide for themselves; the shrinking of government is appropriate because increased business opportunities are needed and government activity crowds-out the business sector; the privatisation of government organisations and contracting out might improve the cost-effectiveness of services and therefore help to overcome the constraints imposed by rising costs and increased resistance to tax increases; and a greater role for the community and the potential for increased choice of public services might result in a better society (2000, p. 119-120). Irrespective of the need for euphemistic terminology or the need to present privatisation as a pragmatic response to circumstances, Savas argues that privatisation has now "advanced beyond the point of no return", and that this is being achieved through NPM (p. 318, see also p. 5-15).

NPFM and international debate

If privatisation is NPM (Savas, 200, p. 319), and if NPFM is a fundamental part of NPM (Olson *et al*, 1998a), then the possibility arises that privatisation is also NPFM. NPFM consists of a range of accounting techniques adapted from the private sector and implemented in combination in the public sector. The result is a financial management system built on the base provided by accrual accounting concepts and practices developed in the private sector, but including accrual-based budgeting and financial reporting, integrated costing systems, cost centres, full costing and full-cost pricing methods, performance measurement and auditing (Hood, 1995; Scott, 1996; Guthrie, 1998; Olson *et al*, 1998; Guthrie *et al*, 1999). Typically, the use of these techniques for financial management in the reformed public sector is justified on the basis that there should be no differences between sectors, that private sector techniques are equally applicable to the public sector, and that the techniques are helpful.

International debate about NPFM covers a variety of issues ranging from the early debate over the form of accounting appropriate for the public sector and especially whether it should be based on the concepts and practices developed for the private sector. After adoption and adaptation of the private sector base, the debate shifted to the techniques applied in the public sector: whether cross-sectoral differences really have been removed; the appropriateness of the techniques for the public sector; whether the techniques improve accountability; and the connections and intent of NPFM's promoters.

Form of accounting appropriate for the public sector

Interest in applying accrual accounting to the public sector developed in the mid-1970s when the Financial Accounting Standards Board (FASB) in the United States was developing its private sector-oriented conceptual framework. Anthony's (1978) study concluded that, with some specified modifications, the FASB's conceptual framework could be applied to the non-business sector but Anthony later opposed the modifications the FASB made (Anthony, 1983; 1989). The FASB did not obtain jurisdiction over governmental financial reporting, but its modified private sector-oriented conceptual framework was taken up in Australia and NZ, with NPFM reformers arguing that this conceptual framework is, with the addition of a few explanatory paragraphs, equally applicable to the public sector (see for example McGregor, 1999).

The appropriateness of applying this conceptual framework to the public sector has been the subject of ongoing debate over the appropriateness of its user needs/decision usefulness focus on shareholders, and the tendency for the chosen focus of accounting to select what is made visible, making invisible those things not selected (Roberts, 1991). Pallot (1992, p. 39-40), for example, argued that "democratic control over the use of funds" is the distinguishing feature of government accounting, and that financial reports should allow effective parliamentary scrutiny. She cited Gladstone's concerns about the consequences should that democratic control be lost, linking the need for constitutional constraints to accountability issues. Other authors have also argued for a focus on accountability and for consideration of the nature of accountability (Day and Klein, 1987; Glynn, 1987; Patton, 1992; Fowles, 1993; Sinclair, 1995; Boston *et*

al, 1996). Alternative foci suggested include the needs of other users (Lapsley, 1992; Mayston, 1992a; 1992b; Rutherford, 1992), intergenerational equity issues (Robinson, 1998c), the pre-existing system of national accounts (Jones, 1992b), and, given privatisation objectives, the accounting requirements appropriate for regulated industries (Vass, 1992). Development proceeded, however, on the accrual accounting base provided by the private sector, and this accrual accounting base seems to provide an essential foundation for NPFM (Scott, 1996; Guthrie, 1998). Debate shifted to the nature of the particular accounting developments built on that base.

Techniques to remove sectoral differences?

The modification of private sector accounting concepts for application in the public sector generated debate over whether the modifications are merely minor adjustments to remove sectoral differences or are instead a poor attempt to disguise fundamental differences between sectors, and whether the differences are such that cross sector comparability is impossible (Stanton and Stanton, 1998; McGregor, 1999; Newberry, 2001). Although the techniques introduced may remove some sector differences, they also introduce new differences and their derivation from the concepts is, at times, debatable (Guthrie, 1998). Examples of these include requirements for valuation and depreciation of assets, which use valuation and depreciation techniques previously rejected in the private sector, and the imposition of a capital charge, which bears no resemblance to the use of cost of capital ideas in the private sector.

Asset valuation and depreciation

Unlike the private sector, which can choose between historical cost and modified historical cost for financial reporting, public sector entities have no such choice. Replacement cost has been adopted as the valuation base of some major assets, a requirement that has been supported by the accounting profession

through its financial reporting standard-setting activities (Robinson, 1998a; 1998b).[6]

Clarke (1982) delivered a devastating critique of the replacement cost ideas and current value accounting developments undertaken by the accounting profession in the late 1970s. The replacement cost ideas were imported from utility pricing regulation practices in the United States but their use for a different purpose, external financial reporting, and in a different context was dubious. Eventually, these practices were rejected in the private sector, and the accounting profession's conceptual framework project distanced itself from those techniques. In New Zealand at least, the accounting standard-setters wrote a remarkable piece of "mumbo-jumbo" to justify both the adoption of replacement cost and depreciation requirements, and to imply that these accounting requirements are consistent with the profession's conceptual framework (Poskitt and Newberry, 1998; Storey and Storey, 1998). Generally, replacement cost-based valuations increase the reported asset base and this, in turn, increases both the capital charge and depreciation expense, with the result that the financial reports of public sector and private sector entities cannot validly be compared (Newberry, 2001).

Capital charge

Typically, governments carry debt at a central level which means that government departments reporting separately carry no debt in their individual financial reports. This gives the impression that the resources necessary for departments to acquire assets are provided free and, potentially, biases some decisions. First, in the event of comparisons with private sector providers of goods and services, lack of finance costs may result in decisions biased in favour of public sector provision of services; and secondly, departmental expenditure decisions may be biased in favour of capital expenditure.

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[6] Officially, the values required for the public sector may be called deprival values, optimised deprival values, value to the entity, or even fair value but this approach to valuation generally requires determination of three different values, depreciated replacement cost, discounted cash flows and market value. Frequently for public sector assets, determination of the latter two values may be impossible, and the method of valuation reverts to depreciated replacement cost.

One element of NPFM is the imposition of a capital charge to remove these biases, with the charge acting as a proxy for both interest and dividends. Even when imposed at a supposedly private sector rate, the capital charge does not merely remove the bias but reverses it. Government departments do not share the commercial freedoms businesses enjoy and are, therefore, less flexible and less able to adjust to the effects of a capital charge. Further, the requirement that a capital charge must be paid irrespective of economic conditions or results operates on a government department as if that department is fully debt-financed, whereas a business's sources of finance tends to be partly debt and partly equity. A business that reports poor results or wishes to retain funds would pay reduced or no dividends to its equity holders (Robinson, 1998b).

Robinson observed that, despite stated intentions, capital charges tend to be nominal — with departments reimbursed for the charge — rather than true charges requiring government departments to bear the full risk involved. This defeats one stated justification for a capital charge, that it should demonstrate to departments that their capital is not free, although it has no effect on a significant implication of a capital charge, its impact on determination of costs and prices.

Full cost requirements

NPFM typically requires the adoption of full costing techniques to determine the costs and prices of government-produced goods and services, and inclusion in those full costs both the capital charge and depreciation. Jones and Thompson (2000) view the full costing model as consistent with Anthony's project prime model, but Anthony states that his model was based on historical cost, and required a capital charge but not depreciation (Letter, Anthony, 2001). Full costs are well recognised as irrelevant for many decisions but, in the context of NPFM, they seem to be important for pricing purposes (Guthrie, 1998; Robinson, 1998b).

The idea underpinning the full cost pricing model is that prices which include depreciation expenses calculated on a replacement cost basis will allow the accumulation of cash for asset replacement (Guthrie and Carlin, 1999). The idea may be intuitively appealing, but none of its proponents has explained how depreciation can "create a cash fund adequate for the replacement of assets", and

neither have they explained the idea of physical capital maintenance on which the replacement cost model is based. "The 'physique' of the capital assets may be retained and restored by incurring maintenance costs, not by debiting the income account with depreciation charges" (Clarke, 1982, p. 206). Further, the replacement cost ideas imply a static environment with an unchanging asset base, whereas today's economic environment emphasises organisational flexibility (Guthrie and Carlin, 1999).

The pricing model derives from early utility pricing regulation in the United States where utilities operated under restrictions that "their capital be employed primarily for the continuous provision of a public service of a specified quality" (Clarke, 1982, p. 208). The depreciation component of the prices operated, in effect, as hypothecated taxes, implying that any cash accumulated as a result of those pricing practices is restricted to asset replacement. Arguably, the combination of a capital charge *and* full costing on a replacement cost reporting base results in overcharging because the capital charge is a charge for the financing costs on the depreciated replacement cost of today's assets, while depreciation charged is supposedly sufficient to replace those assets (Aiken and McCrae, 1992a; 1992b).

These pricing practices were also intended to simulate the price effects of competitive forces. The ideas underlying them, however, are almost 100 years old. The danger of translating the pricing practices to a different context, external financial reporting, in today's fast-changing and relatively unregulated setting is that the early constraints that the cash be used to replace assets may not be imposed, or that the assets may not be replaced (Clarke, 1982; Whittington, 1985, Aicken and McCrae, 1992a; 1992b; Whittington, 1994).

Appropriateness of the techniques for the public sector

Some accounting techniques applied as part of NPFM are not necessarily helpful for public sector management. Debate has centred around the appropriateness of some techniques for the public sector, the limits of accounting (Carnegie and Wolnizer, 1995; 1997; 1999; Micallef and Peirson, 1997; Guthrie, 1998; Barton, 1999a; 1999b), and proposals made for the use of alternative

accounting techniques, such as renewal accounting, which may provide superior information for public sector management (Pallot, 1997).

Other accounting techniques in the NPFM toolbox have already been widely discredited in the private sector (Mayston, 1993). Performance assessment techniques, for example, rely heavily on the accounting profession's techniques and standards, many of which are of questionable validity, while rejecting the assessment techniques and standards of other professionals from other, less numerically-oriented fields, especially those within government (Gray and Jenkins, 1993; Thompson, 1999; 2001). Many of the financial performance assessment techniques rely on costing systems which are well recognised as arbitrary, while the discredited replacement cost ideas which underpin these costing systems in the public sector make little sense in today’s economic environment (Guthrie and Carlin, 1999). Non-financial performance assessment techniques, although widely promoted, remain undeveloped (Thompson, 1999; 2001).

Effect of the techniques: improved accountability?

NPFM has been promoted on the basis of the improved accountability likely to result, but some techniques seem more likely to erode accountability and to erode Parliament's ability to scrutinise and control public money (Pallot, 1991; Guthrie and Carlin, 1999). According to Pallot (1991, p. 193), the use of accrual accounting for appropriations increases the executive government's and management's discretion while reducing parliamentary scrutiny and control because paying departments for the full costs of their services allows the accumulation of funds prior to their being needed to replace equipment: "Such funds can be used to finance other activities in the short term, and this tends to undermine the control taxpayers would normally have over management".

Evidently, the capital charge regime erodes accountability by encouraging off-balance-sheet financing arrangements (Heald and Dowdall, 1999). Because the capital charge is calculated on the reported asset base, the sale of assets reduces that base and reduces the capital charge. Entry into off-balance sheet financing arrangements allows the use of assets without them appearing in the balance sheet

and therefore without triggering an increased capital charge. Operating leases are the most obvious form of off-balance-sheet arrangement but a variety of executory arrangements are possible in which legal ownership of assets is avoided, thus avoiding recognition of the associated financial obligation. Some of these, involving major commitments, are known by names similar to the PPP mentioned by Savas (2000).[7] That this perverse effect receives support, and even encouragement at central government level is highly inconsistent with the accountability justifications for financial management reform (Broadbent and Laughlin, 1999).

Engaging in off-balance sheet financing arrangements may appear less expensive for an individual government department because of savings in the capital charge, but it may be considerably more expensive for the government as a whole. Such arrangements always contain a financing component, yet governments can raise funds at a lower cost than can the private sector partners in such arrangements. Further, the improved efficiency and effectiveness expected on commencement of such arrangements are at risk because of the inflexibility of the arrangements, the length of time involved, and the cost of renegotiating service specifications (Lapsley, 1999; Hodges and Mellett, 1999; Broadbent and Laughlin, 1999; Mayston, 1999).

Connections, intent, and evaluations of NPFM

NPFM has developed most strongly in those countries where accounting standards are set in the private sector by the accounting profession and where the very large transnational accountancy firms are most influential. Apparently, NPFM developments have been accomplished through epistemic communities comprised of professionals (both economists and accountants) who hold similar views and values, who seek out like-minded others to spread their ideas, and who control developments to exclude other views (Laughlin and Pallot, 1998; Ryan 1999; Ryan *et al*., 1999).

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[7] The private finance initiative (PFI) is a common reference in the United Kingdom.

Often the promoters of NPFM techniques are seen as pragmatic, practically-oriented management consultants and members of the accounting profession, particularly members of the transnational accountancy firms, merely applying a useful set of accountants' toolbox techniques. Their strong links with the theoretically-oriented economists who support NPE and the closed method of development of NPFM, however, generates debate about unstated intent, and the philosophy and implications of NPFM (Ezzamel and Willmott, 1993; Fowles, 1993; Humphrey *et al*, 1993; Mayston, 1993; Deegan, 1995; Olson *et al*, 1998; Laughlin and Pallot, 1998; Hughes and O'Neill, 2001). Much of that debate centres on the issue of whether "in a whole series of ways the practices of accounting are increasingly being used to infiltrate and change, rather than merely record, the activities of the State" (Hopwood, 1984, 171; Humphrey, *et al*, 1993; 1998; Olson *et al*, 1998).

Surprisingly, given that an important focus of NPFM is on stating in advance the results to be achieved and then comparing those expected results with actual results, overall evaluations of NPFM are lacking (Humphrey *et al*, 1993; 1998). Although NPFM reforms typically have been advocated on the basis of the improved efficiency, effectiveness and accountability they will achieve, before- and after-implementation comparisons have proved impossible, at least partly because of the magnitude of the changes. Differences between the claimed benefits of implementing particular NPFM techniques and the consequences of such implementation have been noted (Humphrey, *et al*, 1993; 1998; Olson *et al*, 1998; Guthrie *et al*, 1999). Also noted has been the tendency to attribute adverse effects to teething problems, which the application of more NPFM techniques will correct.

Acceptance that NPFM will achieve the results claimed for it requires faith in the system's designers, and rejection of the many reservations expressed in international debate as unfounded and unwarranted. Given the theoretical and practical literature reviewed earlier in this chapter, such faith in NPFM system designers may be misplaced. International debate about NPFM and about the connections and intent of those designers suggests that some politicians may have relied too heavily on their advisers for financial management developments (Olson *et al*, 1998).

Chapter summary

The three broad strands of literature reviewed here as underpinning NPM-style public sector reforms consist of two waves of NPE theories and a set of populist literature on how to achieve reforms. Although these three broad strands state different intentions, they also recognise that privatisation as an objective in itself and debate about the appropriate role of government encounter public resistance. The need to use euphemisms and to claim other stated intentions is recognised, with terminology matched to the political climate of the time. Evidently, however, there is considerable appeal in claims the NPFM reforms will improve government and/or ensure efficiency through competition (Niskanen, 1971; March and Olsen, 1989; Osborne and Gaebler, 1992; Buchanan, 1997; Horn, 1995; Savas, 1987; 2000). The technical rationality of the proposals for privatising techniques has been challenged, raising questions about those stated intentions (see for example, Miller and Moe (1983); Williams (2000)), but privatisation is always an underlying theme which some, such as Wagner (1993), Buchanan (1997) and Savas (1982, 1987, 2000), acknowledge openly, while others, such as Osborne and Plaistrik (1997) deny is their sole objective but make clear in their reform proposals that it is a major objective. The problem facing all, theorists and populist authors alike, seems to be how they may achieve privatisation, especially in the face of resistance. Savas (2000, p. 319) believes that "privatization *is* the New Public Management", and implies that privatisation may be achieved through NPM-style reforms. If that is the case, then the consistency between the rules and techniques he proposed and the techniques adopted as part of NPFM suggests that NPFM may be a tool in privatising developments, rather than purely a means of improving accountability.

Clearly, in all three strands of literature, the authors expect to achieve their desired objectives by obtaining and exerting control over others, with that control achieved through legislation or rules. Tight financial constraints are important to all authors, although they offer different reasons for imposing them. Some acknowledge their privatising intent to starve the government, limit the size of the state, and force services to sub-standard levels (Breit, 1978; Savas, 1982). Others offer technical rationales, such as efficiency and fiscal responsibility, and, perhaps

noting Savas's advice to use euphemisms, the idea that reducing resources prompts innovation (Buchanan, 1989; Osborne and Gaebler, 1992).

The desire to devise and adopt legislation or rules is also consistent throughout the two waves of NPE and in the populist work. These rules range from macro-level norms intended to reverse Keynesian biases and thus shrink the size of the state to micro-level strategies intended to privatise government operations, including budget caps or cuts, load-shedding, the imposition of user charges, and limitation of government arrangements such as contracting (Savas, 1982, p. 123; 1987, 2000). Given recognition that controlling financial resources is a key to achieving control over others, the fundamental role of NPFM in NPM-style reforms seems apparent. Accounting offers the opportunity to develop various rules which will be used for decision-making, and the accounting rules proposed for, and adopted in, the public sector have been highly contentious. Among the many particular accounting techniques adopted as part of NPFM is included a replacement cost base for reporting assets, imposition of a capital charge, and pricing based on full costs. These techniques are consistent with Savas’s proposals for costing government services, but they are inconsistent with both the private sector conceptual framework and with current private sector techniques. Whether the NPFM techniques adopted improve accountability has also been debated. The development of off-balance sheet financing arrangements in the context of arguments for improved accountability seems somewhat surprising but such arrangements are consistent with Savas’s (2000) promotion of PPPs. The consistencies between NPM and NPFM, and the concerns expressed about the connections and intent of NPFM reformers, raise the possibility that NPFM reforms may have more to do with privatisation objectives than with the possibly euphemistic claims made for them.

4 New Zealand’s NPFM-style financial management reforms

New Zealand’s radical economic reforms were intended to affect all sectors of the economy. After initial economic restructuring, public sector reform soon followed:

> It is not entirely clear where economic restructuring ends and public sector management reform begins, or where the latter ends and financial management reform begins. All are related components of a set of reforms designed to improve the performance of the New Zealand economy in delivering social and economic outcomes. (Treasury, FMRP1, August 1989, p. 1, Treasury files).

This chapter explains the stated intent of New Zealand's public sector reformers, before setting out the public sector reform process which commenced with the State Owned Enterprises Act 1986 and the corporatisation of market activities, then extended a similar set of ideas to the core public sector, before adding a set of macro-level constitutional norms evidently intended to function as a balanced budget constraint.

Intent of the public sector reformers

From the beginning, the proposals for public sector reform were argued on two bases: the appropriate role of government and the appropriate fiscal and financial management of the public sector. The intention was to make "fundamental changes to the strategic direction of New Zealand's economic policy [and] to profoundly alter the role of the state" (Scott *et al*, 1997, p. 359).

Role of the government

The Treasury (1984) proposed a greatly reduced role for the government, and by 1987 (p. 34), suggested that the government was no more than a "monopolist enforcer of rights or relationships". This implied such changes as withdrawal from the direct government provision of many services, including social welfare services. The early suggestion was that either these services should cease altogether, or they should be replaced with the delivery of financial assistance to targeted individuals, leaving them to purchase for themselves whatever services

they desired (Treasury, 1984, p. 259). Later proposals retreated from the idea of individuals purchasing services to represent the state as a purchaser of outputs on behalf of those individuals (see for example, Treasury, 1987, p. 159), and this developed into the idea that Ministers would do the purchasing, selecting from the range of outputs available in the market (Treasury, 1990, p. 85).[8] Ruth Richardson, Minister of Finance from 1990 until 1993, discussed this role of state issue in moralistic terms:

> There are few, if any, areas where the state should be a provider of goods and services . . . We should . . . transfer to the private sector the government's current provider functions in social services. . . Under my proposals the government would retain a crucial role as funder of social services and setter of standards (Richardson, 1995, p. 230).

Lack of public support for this reform agenda soon became evident. Public debate changed to avoid comment on the role of government, focusing instead on affordability, and implying that "the welfare state is a 'good thing', and that the only discussion we can have is over how much of a good thing we can afford" (Richardson, 1995, p. 208). The parallel proposals for fiscal and financial management reform became increasingly important as the role of government debate foundered. After a close election result in 1993, Richardson was replaced as Minister of Finance (Richardson, 1995).

Fiscal policy

The Treasury (1984, p. 135) defined fiscal policy as the "use of government expenditure and revenue collection to affect the use of resources and distribution of income across the economy and through time". It defined a fiscal deficit as the excess of government expenditure over government revenue, and regarded it as depicting the government's overall borrowing requirement (see also Treasury, 1987, p. 231). It (1984, p. 195-207) predicted damaging effects should the existing trend of increasing fiscal deficits continue, proposed that on average, the fiscal deficit should be zero, and recommended improved expenditure control procedures and the publication of medium-term fiscal policy settings such as

[8] More recently, the Institute of Chartered Accountants of New Zealand has supported this approach with proposals for financial reporting standards which use the concept of a purchase interest to help determine

expenditure and revenue projections or a particular deficit target. Following the 1990 general elections the new government, with Ruth Richardson as Minister of Finance, aimed to eliminate the fiscal deficit by reducing expenditure (Scott *et al*, 1997, p. 359; see also Scott and Gorringe, 1989).

The Treasury proposed that "the Government should aim to finance out of current revenue all current expenditures including replacement of capital", thus confining the need for government borrowing to increases in capital stocks and any required on-lending activities (Treasury, 1984, p. 183-184, 233). Further, it argued that:

> Where the [Government's] objectives can be achieved using commercial processes, then that option should be selected. . . . Where the goods or services might be provided more efficiently by the private sector, the Government should review its involvement in that area. . . . Where assets produce a better return in the private sector than the public sector, they will be more valuable if they are sold than if they are retained in government control. (Treasury, 1984, p. 233).

The commercial processes differed, however, depending on whether the activities concerned were market activities, those activities producing goods or services which could be sold, or non-market activities, those activities about which a decision had been made on behalf of the community to supply them collectively (Treasury, 1984, p. 275). The public sector reforms commenced with the market activities.

The government's market activities

In 1984 when New Zealand's radical economic reforms commenced, the government played a major role in the economy, with extensive involvement in such services as electricity generation and supply, air and rail transport, and banking, as well as the provision of social welfare services and benefits. The Treasury (1984) advised that the government's market activities would perform better in a competitive environment. This would require treating those activities as profit centres and removing all: commercial advantages and disadvantages affecting performance, including inappropriate management incentives; constraints on activities caused by the slow and uncertain process of obtaining

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business combination issues (ED83, 84), and to develop the supposedly non-financial statements of service performance into statements of purchase performance.

parliamentary funding, and the input controls imposed by the central control agencies; free capital provided by government; exemption from taxes and many regulations; and the ability to cross-subsidise sales to third parties. The use of corporate plans, measurable performance targets and appropriate management incentives would motivate managers to meet specified targets while improved information systems would allow performance assessments (Treasury, 1984, p. 283-286). The State-Owned Enterprises Act 1986 provided the means to corporatise these activities, and, eventually, to privatise them.

The State-Owned Enterprises Act 1986

The State-Owned Enterprises Act 1986 provided for state-owned enterprises (SOEs) to be corporatised as limited liability companies. It removed from SOEs the responsibility for non-commercial functions and required that they operate as successful businesses with managers responsible to a board of directors for achieving agreed performance objectives. SOEs would operate without political interference in decisions about the use of inputs, pricing or marketing (Mascarenhas, 1990).

SOEs' annual financial reports and their Statements of Corporate Intent must be tabled in parliament. The annual financial reports must comply with generally accepted accounting practices, while the Statements of Corporate Intent identify an SOE's objectives and the scope of its activities, its accounting policies, the ratio of shareholders' funds to total assets, performance targets and the amount of profits expected to be distributed to the Crown, the value of the Crown's investment in the SOE, any non-commercial activities for which agreed compensation would be sought, and the type of information to be provided to Ministers (Mascarenhas, 1990).

With the passage of this Act, many of the government's activities were corporatised into SOEs and the Treasury (1987, p. 74) identified significant efficiency improvements. By 1990, however, their public ownership and lack of tradeable equity apparently impeded further efficiency improvements. Some SOEs had already been privatised and the Treasury questioned the need for continued government ownership of the remainder (Treasury, 1990).

The government's non-market activities

The Treasury (1984, p. 288) proposed that performance of the government's non-market activities would be improved by treating departments as cost centres, and devising a system providing benefits comparable to those of the competitive price system. This would require appropriate management incentives, managerial freedom to determine the mix of inputs to produce outputs, and sufficient relevant information to allow performance assessment based on outputs.

In 1987, the Treasury proposed that the nature of government expenditure implied the appropriate manner of financing that expenditure (p. 239). Goods and services that could be supplied in a commercial manner should be financed by user charges, while any capital expenditure required to support those goods and services should generate investment returns sufficient to cover the borrowing costs.[9] For the goods and services supplied in a non-commercial manner, the borrowing costs associated with any capital expenditure should be spread across the life of those assets:

> By charging departments undertaking such expenditures for depreciation and interest costs, and financing these out of taxation like other current expenditures which cannot be recovered from user charges, enough current revenues will be raised to cover interest and full principal repayment during the life of the asset. The net effect for the Government is that only net additions to the stock of assets is funded from borrowing. (p. 235).

The earlier market/non-market distinction suggested that the extensive government-provided social welfare system was a non-market activity. By 1987, however, the Treasury (p. 74) no longer referred to public sector activities as market and non-market activities. It referred to them instead as commercial and non-commercial activities, acknowledging that the distinction between commercial and non-commercial was imprecise. The activities remaining in the public sector were identified as a mixture of commercial and non-commercial activities covering "policy, regulatory and operational functions" (Scott *et al*, 1990; p. 17, 23). The introduction of competitive conditions, transferable and contestable ownership, and the removal of impediments to the development of a

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[9] Subsequent legislation related to Local Government develops these ideas.

market were thought likely to change non-commercial activities to commercial ones (Treasury, 1987, p. 112).

The success of the earlier SOE reforms had led to the view that a similar corporatising set of reforms could be applied to the core public sector and this required both management and financial management reform.

The need for management and financial management reform to the public sector

The Treasury (1987) argued that both the existing cash-based financial management system and the performance assessment processes were inadequate for effective public management. Although the cash-based financial management system was effective for "constraining cash expenditure, and hence the tax burden for a given year", it focused on controls over the expenditure of public money in the current year, failing to present "an accurate picture of the amount of activity which is being undertaken". It ignored future commitments, which ranged from "signed contracts to public assurances from the Government", and even encouraged entry into such commitments as well as encouraging departments to spend the full amount of their appropriations (Treasury, 1987, p. 59, 81, 82). This system was, therefore, less effective for controlling the executive government because:

> To the extent that liabilities and others result in future expenditure the Estimates understate current activity . . . ;
>
> To control the activities of the Executive, Parliament requires more indication of the *output* it is purchasing from the Executive;
>
> Concentrating on cash payments alone could result in an unnoticed deterioration in our stock of assets. There is presently no comprehensive record of state owned assets in terms of historic let alone current cost. It is therefore difficult to judge whether the stock of assets is being maintained. (Treasury, 1987, p. 81)

Performance assessment was also a problem, partly because of the fragmented governmental structure under which "no single government body is responsible for reviewing overall expenditure, nor for focussing on broad management issues" (The Treasury, 1984, p. 288). As the central control agencies, the Treasury and the State Services Commission were responsible for different functions and liaison between them was probably insufficient (p. 288). Neither of them was responsible

for assessing the "best use of resources", output monitoring, or "performance in meeting goals" (Treasury, 1984, p. 289; 1987, p. 59,82).

The Treasury was responsible for expenditure control, largely in the context of budgeting, and therefore imposed input controls on departments' resource use, while the State Services Commission was responsible for management reviews and imposed input controls on departments' staff. The onerous nature of some input controls affected management's ability to control performance, and departments tended to withhold information in an attempt to resist those controls. Recognising their limited information, the central control agencies responded with further input controls, thus further constraining management freedom (Treasury, 1987, p. 80-93). Arguably, rejection of the input controls and the cash based system would allow an alternative system to be devised. This system would have "clearer objectives for departments and staff, appropriate incentives, and a proper review mechanism" (The Treasury, 1984, p. 293). It would allow managers greater freedom to manage, with that freedom at least partly offset by increased accountability requirements. Such a system would contribute to the country's economic well-being and improve parliamentary scrutiny and control (Treasury, 1987, p. 80-93):

> A focus on net consumption of resources and resource commitments backed up by supporting information (stating performance objectives and historical accounting for performance against objectives) would enable Parliament both to measure more clearly the commitment by the Executive of future and current revenues and to establish more clearly the nature of the activity being conducted. (Treasury, 1987, p. 84).

Management and financial management reform would, therefore, allow the extraction of "better value from public spending" by focusing on outputs, and calling attention to "the choices of goods and services and the transfers paid for by taxpayers" (Scott *et al*, 1990, p. 20). Both the decisions made and the results achieved would be transparent (Scott and Gorringe, 1989). The State Sector Act 1988 provided the means for management reform, while the Public Finance Act 1989 provided the means for financial management reform.

Management reform: the State Sector Act 1988

The State Sector Act 1988 defines the public service as comprised of all government departments. It requires the State Services Commissioner:

a) to review the machinery of government including —

(i) the allocation of functions to and between Departments; and

(ii) the desirability of or need for the creation of new Departments and the amalgamation or abolition of existing Departments; and

(iii) the co-ordination of the activities of Departments.

b) To review the efficiency, effectiveness, and economy of each Department, including the discharge by the chief executive of his or her functions. . . . (State Sector Act 1988, s. 6).

This act was passed at speed and was the subject of considerable controversy, largely because it removed permanent tenure from public service staff and removed from the State Services Commission the function of employing all departmental staff (Walsh, 1991). That controversy should not allow the importance of the State Services Commission's review function to be overlooked. The Treasury (1984) had argued the importance of a centralised review function, both review of departmental management and review of the functions and operations of departments (p. 290), in particular, for establishment of a review process that would allow the "functions and objectives of each department" to be aligned with government policy (p. 291—292).

The State Sector Act did leave some employment functions with the Commissioner. This was the responsibility for the employment and assessment of departmental chief executives. The State Services Commissioner, with Ministerial input, appoints chief executives for five year terms which are renewable, again with Ministerial input, depending on performance as assessed by the Commissioner. Performance assessment covers all requirements imposed on the chief executive and may extend beyond the scope of the State Sector Act 1988 (s. 43).

The chief executive of a government department is responsible for the employment, employment conditions, motivation, and assessment of departmental staff. The chief executive is free to operate the department within the general constraints imposed by legislation and regulations, but that freedom is constrained by an accountability relationship with the minister responsible for the department. Performance and performance assessment are important to that relationship (Treasury, FE/89/203, 26 April 1989, documentation on Public Finance Act 1989;

Walsh, 1991). That accountability relationship underwent significant development with the financial management reforms.

Financial management reform: the Public Finance Act 1989

The Public Finance Act 1989 builds on the principles of public finance contained in the Constitution Act 1986 (s. 22) which states that it is unlawful for the Crown, except by or under an Act of Parliament:

a) To levy a tax; or

b) To raise a loan or to receive any money as a loan from any person; or

c) To spend any public money.

The Public Finance Act was designed around three conceptual dyads (Scott *et al*, 1997, p. 363). Two of these, ideas about accountability and controls, and the distinction between outputs and outcomes, were drawn from public sector financial management literature, while the third, the distinction between the government's purchaser and owner interests, "emerged from the finance literature in conjunction with consideration of appropriate governance arrangements for the state's commercial activities". The third dyad created a limitation of government structure (Savas, 1982) applied to the core functions of government (Scott *et al*, 1997, p. 366).[10] It was controversial because it drew an artificial distinction between the Crown and its departments.

The Constitution Act does not state what is meant by the Crown, implying that the Crown is the "Sovereign in right of New Zealand" by referring to the "demise of the Crown" as the death of that Sovereign (s. 2, 5). The Public Finance Act refers to "Her Majesty" as an alternative term for the Crown and then extends the idea of the Crown by interpreting both terms to mean, "Her Majesty the Queen in right of New Zealand; and includes all Ministers of the Crown and all departments" (Public Finance Act 1989, s. 2). The Act interprets a department as "any department or instrument of the Government, or any branch or division thereof; but does not include a body corporate or other legal entity that has the power to contract . . . ", and identifies capital contributions to departments as "the

amount of money to be provided to increase the Crown's net asset holding in a department" (s. 2, 4), thus suggesting a relationship between the Crown and its departments in the nature of a financial investment.

The Legislative Advisory Committee considers whether proposed legislation will give effect to the stated policy and makes submissions on all bills. In its submission on the Public Finance Bill of 1989, this committee argued that the idea of the Crown owning a department's net assets in the manner of an investment and making capital contributions to departments misrepresents the nature of the relationship. This was because "departments are part of the Crown. The public legal relationship between them is not one of investment" (Legislative Advisory Committee, submission on Public Finance Bill, 1989, Parliamentary Library).

This limitation of government structure allowed the government to be portrayed as a purchaser of outputs on behalf of individuals, with those outputs intended to achieve the government's desired outcomes. Ministers, acting on behalf of the government, would be responsible for the "quantity, quality and cost" of the outputs purchased and would, therefore, decide which outputs to purchase in order to achieve their desired outcomes; and where to purchase the outputs from, bearing in mind that government departments might not be the best source of supply (Scott and Gorringe, 1989, p. 84; see also, Scott *et al*, 1990; McCulloch and Ball, 1992; Pallot and Ball, 1996, p. 530). This implied that both output specifications and costs should be comparable, and this could be achieved by making "output definitions resemble goods or services which could be purchased in the private sector", and using accrual accounting to "compare the costs in each case. Previously, the differences in the accounting, regulatory and tax regimes have precluded meaningful cost comparisons" (Treasury, 1990, p. 85-86). Parliamentary scrutiny and control could focus on outputs, the "goods and services supplied outside the organisation, and not on the goods and services consumed within a department in the production of those outputs" (Bushnell, 1989, p. 416).

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[10] This is the closest reference to Savas's influence and neither his work, nor the finance literature sources, receive acknowledgment in Scott et al's references.

The Treasury (1984) had proposed a review process for both new and existing expenditure programmes. This involved a series of questions such as (p. 204):

> a) Is it necessary for the Government to carry out this activity . . . ;
>
> b) What are the objectives of the activity and what are the policy options to achieve these objectives? . . .
>
> c) In the case of new policy, will the Government receive value for money spent? For existing policy, is the Government currently getting value for money? . . .
>
> d) What is the priority of the activity in relation to other policy objectives in related areas?

Although this review process was obviously resource intensive, and only a few reviews could be conducted each year, slow procedures were not a problem because the time involved would allow public support to be secured (p. 204-205). Key reformers suggested that adoption of a purchasing focus would support this process because the purchase focus would assist with decisions: to stop purchasing particular outputs; to redirect available resources to the purchase of higher priority outputs; to require users, instead of taxpayers, to pay for some outputs or for part of the cost of those outputs. The purchase focus could also disconnect input costs from output prices, allowing efficiency dividends to be extracted by requiring price reductions (Scott and Gorringe, 1989, p. 86; Scott *et al*, 1990; Dale, 1992; McCulloch and Ball, 1992; McCulloch, 1993, p. 29; Scott *et al*, 1997).

The idea that the government owned departments required consideration of longer-term issues. The minister assigned responsibility for a department would consider the department's long-term strategy and decide on the level of investment sufficient to prevent deterioration of any assets required for longer term capacity, but there would be no expansion into new service areas (Scott and Gorringe, 1989, p. 87; Scott *et al*, 1997). Within that level of investment, the department's chief executive would be responsible for the department's personnel, cash, and other assets, and free to determine the most efficient production configuration. (Scott and Ball, 1993; Scott *et al*, 1997). This freedom would include the "power to buy and sell assets within the department's level of capital, without appropriation", facing restrictions only if a capital contribution were required to provide additional finance (Ball, 1995, p. 10, see also, McCulloch, 1993, p. 29). Departments would be prohibited from borrowing or investing, and accrual

accounting would assist the ownership focus by allowing profitability assessments of departmental performance (Scott and Gorringe, 1989, p. 86; Scott *et al*, 1990, p. 9-10, 25).

With the government viewed as both the owner of a department, and the purchaser of its outputs, there was an obvious tension between these different interests:

> Buyers generally want to pay as little as possible for goods of the required quality. If it was prepared to incur a loss on the production side, the government could achieve a 'price' as low as it desired. Yet lower prices reduce the rate of return. As owner, however, the government desires the best return possible from the resources tied up in the department. If the government cannot achieve a rate of return with the resources in the department equivalent to the level they would have earned in private ownership then public production lowers the wealth of society. (Scott *et al*., 1990, p. 21).

Resolution of the tension would be achieved by requiring departments to set their prices to cover but not exceed full costs, including the cost of capital, and paying departments no more than a fair market price for outputs (Scott *et al*, 1990; Ball, 1993c). Expectations were that the competitive pressures generated would make unnecessary the "hands-on approach that UK ministers have needed to take at times to ensure that contracting was considered" (Scott *et al*., 1990, p. 160). With ministers free to purchase outputs from other sources, chief executives were likely to pursue all possible efficiencies in output production, including out-sourcing (Treasury, 1984, p. 276; Scott and Gorringe, 1989, p. 87; Dale, 1992; Ball, 1995).

Stated objectives of the Public Finance Act 1989

Although the limitation of government structure is crucial to understanding the Public Finance Act, the Act's stated objectives suggest that its focus is more conventional. According to the long title of the Act, it was enacted to:

> a) Provide a framework for Parliamentary scrutiny of the Government's management of the Crown's assets and liabilities, including expenditure proposals; and
>
> b) Establish lines of responsibility for the use of public financial resources; and
>
> c) Establish financial management incentives to encourage effective and efficient use of financial resources in departments and Crown entities; and
>
> d) Specify the minimum financial reporting obligations of the Crown, departments and Crown entities; and

> e) Safeguard public assets by providing statutory authority and control for the raising of loans, issuing of securities, giving of guarantees, operation of bank accounts, and investment of funds.

This Act varies principles (b) and (c) of s. 22 of the Constitution Act by introducing several new terms. The raising of loans is included within the broader concept of issuing public securities, while the spending of public money is included within the broader concept of management of Crown resources (s. 2, 4, 55).

Identification and interpretation of public securities and resources

The Public Finance Act interprets public security, as including any securities issued by the Minister in respect of any loan raised under s. 53 of the Public Finance Act or any other act, but it also includes "any loan or credit agreement, guarantee, indemnity, bond, note, debenture, bill of exchange, Treasury bill, Government stock, and any other security representing part of the public debt of New Zealand" (s. 2).[11] Taxpayers are responsible for the obligations arising from all public securities which are a "charge upon and payable out of the revenues of the Crown equally and rateably with all other general loan obligations of the Crown" (s. 55).

Controls over the issue of public securities vary according to the nature of the security. The Act identifies and interprets three broad types of public security: loans, commitments, and contingent liabilities, although it is not clear that these three broad types capture all of what is intended by the interpretation of public security. Raising a loan includes borrowing, entering into hire purchase or finance lease agreements, and accepting debt on assignment from other persons. Specifically excluded from either the Public Finance Act's, or the Constitution Act's interpretation of raising a loan is:

> the purchase of goods or services or the obtaining of an advance by the Crown through the use of a credit card or by a supplier supplying credit for the purchase of goods or services, for a period of 90 days or less from the date the credit card is used or the credit is supplied. (s. 49).

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[11] The Minister is the minister assigned responsibility for administration of the Act.

Because these arrangements are obviously credit agreements, they are included within the concept of public security and they would, therefore, be the taxpayers' responsibility. They seem to be classed as commitments, which are "future expenses and liabilities to be incurred on contracts that have been entered into at balance date". The third broad type of public security is a contingent liability, which is "a liability that by reason of something done by a person, will necessarily arise or come into being in relation to that person if one or more certain events occur or do not occur" (s. 2). The third schedule of the Act contains a list of items specifically excluded from the interpretation of contingent liabilities — for example, any guarantee or indemnity contained in any overseas loan agreement — but, again, not necessarily excluded from the concept of public securities.

The Public Finance Act 1989 refers to but provides no interpretation of Crown resources. Presumably, the term is intended broadly and would therefore include, but not be limited to, public money which is "all money received by the Crown", except for trust money. The Act specifies that all "public money is the property of the Crown" and must be lodged in either a Crown or departmental bank account (s. 20).

Identity and responsibilities of those involved in management of the Crown's activities

In addition to the Crown, the Public Finance Act 1989 identifies and distinguishes between several other parties involved in public management. For the purpose of this thesis, the key parties are: the minister responsible for administration of the Public Finance Act; the Secretary to the Treasury; and departmental chief executives, and departments. Others identified are the executive government; responsible ministers; ministers responsible for votes; and the Governor-General.

Consistent with the Constitution Act 1986, the Crown is prohibited from issuing securities, raising a loan or issuing guarantees without an Act of Parliament (s. 46, 52A, 58A). An appropriation by Act of Parliament is also required for the Crown to spend public money, and to incur any expenses and liabilities (s. 4).

The minister responsible for administration of the Public Finance Act is referred to throughout the Act as the Minister who is most likely to be, but is not necessarily, the Minister of Finance, while ministers responsible for other functions are referred to in relation to those functions. The Public Finance Act delegates to the Minister the power to raise loans, and issue securities and guarantees and indemnities, and states that all loans and securities issued will be deemed lawfully raised. If any guarantee or indemnity exceeds $10 million the fact of that guarantee or indemnity must be published in the Gazette and a statement laid before Parliament (Constitution Act 1986, s. 22; Public Finance Act 1989 s. 46, 47, 49, 52A, 53, 56, 57, 58A, 59, 62).

The Minister may lend money and has extensive powers over the banking and investment of public money, which must be held in either the "principal bank account of the Crown", known as the Crown bank account, or in departmental bank accounts. The Minister may decide on the bank or banks at which the Crown bank account and departmental bank accounts will be operated, while either the Minister or the Treasury may direct the terms and conditions under which those bank accounts operate, obtain information, issue instructions regarding the public money held and transfer money between these accounts. No money may be paid out of the Crown bank account without Audit Office certification of a supporting appropriation or authority and the Governor-General's signature (s. 18-19, 21).

The Act interprets the Secretary to the Treasury as the chief executive of the Treasury and requires that any reference to the Treasury be taken to refer to the Secretary. The Treasury is authorised to invest any public money, including that held in departmental bank accounts. Any interest earned from these investing activities must be paid into the Crown bank account (s. 23).

Both the Treasury and the Governor-General by order-in-council may issue instructions to departments. The Treasury may also request from chief executives information about a department's "financial management, financial performance, or banking activities", and issue instructions for any of the following purposes: for obtaining information to enable the Treasury to fulfil any functions imposed on it by the Government or any Act; for prescribing the accounting policies to be adopted by departments; for regulating the management of public money; or for

regulating the "accounting and financial management and control procedures relating to contracts of the Crown" and the "custody and control by the Crown of public securities". Treasury instructions, however, are subject to the provisions of the Public Finance Act and to any other regulations made under the act (s. 79-81).

A department's chief executive is the head of the department responsible to the responsible minister for the financial management and financial performance of that department. The chief executive must comply with the financial reporting requirements of the Public Finance Act 1989 and any other act, and comply with any lawful instructions given by the Minister, the minister responsible for the department, the Governor-General and the Treasury (s 33(2), 33(3), 37, 79, 80).

All money paid to a department by the Treasury and all departmental receipts for revenue and for the disposal of fixed assets must be paid into that department's bank account. Departments must not invest money or raise loans but may purchase goods or services on credit. The Minister or the Treasury may direct the use of money in the department's bank account or, after consultation with the responsible minister, transfer it to another Crown or departmental bank account (s. 20, 21, 49).

Of the other parties involved in public management, the executive government is the government; and a responsible minister is the minister allocated responsibility for a particular department (s. 2).

Specification of what must be subjected to Parliamentary scrutiny

Parliamentary scrutiny and control is achieved through the tabling in Parliament of various reports, especially the Estimates of appropriations and the audited financial reports.

The Estimates of appropriations is a “statement of the proposed expenses and liabilities to be incurred by the Crown or the Crown’s proposed expenditure of public money” (s. 2). The Minister must table the Estimates with departments' forecast financial reports which are reconciled to the appropriations sought in the estimates, while departments' audited annual financial reports are tabled separately (s. 9, 34A, 35, 38 and 39). The broad content of the financial reports is

briefly considered here before explaining the estimates requirements in more detail.

Departments' financial reports must be presented in accordance with generally accepted accounting practice (GAAP), which means compliance with approved financial reporting standards to the extent that those standards apply. If there is no standard and no applicable rule of law, the accounting policies adopted must be appropriate and have authoritative support (s. 2). The forecast and annual financial reports must include: a statement of financial position, an operating statement, and a statement of cash flows, all accompanied by comparative figures so that actual figures may be compared with forecast and prior year figures; a statement of accounting policies; and any other statements necessary. The forecast financial statements must also include a statement of objectives providing details of forecast revenues and expenses for each output class, as well as the forecast financial performance and these must be re-presented in the annual financial statements together with a statement of service performance showing the actual performance of each class of output as compared with that forecast (s 34A(3)(d)). The annual financial statements must include a statement of commitments, a statement of contingent liabilities, a statement of unappropriated expenditure, and a statement reporting actual expenditure against each appropriation.

The estimates are compiled from more detailed information about each Vote. A vote is interpreted as an appropriation or grouping of appropriations, which is the responsibility of one minister and is administered by one department (s. 2). The estimates must identify the minister responsible for each vote and state whether that vote minister is also the minister responsible for the department administering the vote. Within each Vote the amounts to be charged to each appropriation must be shown and, for each class of output, the estimates must identify separately the costs to be incurred and the expenses to be incurred where those classes of output are to be supplied by others, while comparative figures must show budgeted and estimated actual appropriations for the previous appropriation period and for the previous financial year as well as comparative actual figures for the four financial years before that (s. 9).

The idea of the vote minister's responsibility for a vote, suggested that a department may "produce outputs for several different Ministers", that "one Minister may purchase outputs from more than one department", and that "different Ministers 'purchase' outputs from the same department" (Treasury, Tsy/2, 1989, "Summary for departments", documentation on Public Finance Act 1989, Parliamentary library). This means that the votes trace to Ministers, but the lines of responsibility for public resources and for safeguarding public assets trace to departments. This distinction between Votes and departmental responsibilities prompted the Legislative Advisory Committee to comment in 1989 that:

> The Bill would be improved if Treasury were to focus on what it envisages the estimates and the Appropriation Acts will look like after its passing. In some respects these documents should be the starting place of the legislation given that it is through them that Parliament is expected to scrutinise financial management and performance. (Legislative Advisory Committee, submission on Public Finance Bill, p. 6).

Appropriations are not interpreted in any Act but an important feature of the Public Finance Act was the change from cash appropriations to appropriations that are either cash or accrual. Section 4 refers to both of these, specifies the items for which appropriations is required, and restricts the use of any appropriation:

> (1) No expenditure of public money shall be made other than in accordance with an appropriation by an Act of Parliament.
>
> (2) No expense or liability shall be incurred by the Crown in relation to any transaction for which expenses or liabilities are required to be appropriated under subsection (3) of this section other than in accordance with an appropriation by an Act of Parliament.
>
> (3) A separate appropriation shall be made for (a) each class of outputs. . . (b) each category of benefits or other unrequited expenses . . . (c) each category of borrowing expenses . . . (d) each category of other expenses . . . (e) each capital contribution. . . . (f) each purchase or development of capital assets contained in the Estimates . . . and (g) each repayment of debt . . .
>
> (4) Any money or expenses or liabilities appropriated under subsection (3) of this section may be incurred only in relation to that appropriations and for no other purpose. (Public Finance Act 1989, s. 4).

The appropriations of most relevance to departmental management are appropriations for classes of outputs, other expenses and capital contributions. Outputs are goods or services produced by a department and measured by their full production cost including the allocation of overhead and non-cash costs such as depreciation, while a class of outputs is a grouping of similar outputs (s. 2, 4). Mode B output appropriations authorise a department to incur the costs necessary

to produce the outputs, while Mode C output appropriations authorise a department to incur the expenses necessary to produce the outputs.[12]

Departments may sell outputs to entities other than the Crown and require authorisation to incur the cost of producing those outputs. Trading revenue is that revenue departments earn from the sale of goods and services over which the department does not have a monopoly (s. 2). Under Mode B output appropriations, a permanent appropriation is provided for departments to spend up to the amount of the expected trading revenue from particular outputs on the cost of those outputs, provided that there is an appropriation act for that class of outputs and the Minister agrees (s. 10). This is known as Mode B net appropriations.

Other expenses are those expenses that are not part of the cost of outputs (s. 2, 4) and these require a separate appropriation. This category of expenses was added to the Public Finance Act 1989 in 1992. The Treasury, when proposing this amendment to the Minister, explained that these other expenses are:

> . . . costs associated with ownership. They include costs such as writing down the book value of fixed assets, loss on sale of fixed assets and restructuring costs. . . . Such ownership costs will normally reduce the level of taxpayers' funds in a department. In cases where the operating surplus achieved by a department in the supply of outputs is large enough, ownership costs will reduce but not eliminate the operating surplus and thus will not reduce taxpayers' funds. (Treasury, T91/4462, 8 October 1991, Richardson files 750).

Section 11 of the Act provides a permanent appropriation allowing change in the composition of a department's balance sheet. This section allows for the proceeds from sale of assets, and any working capital of a department to be used to purchase other assets or to pay any liabilities. The department's net assets at the end of the year must not be increased as a result of such transactions.[13]

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[12] Mode A output appropriations were cash-based and applied to departments until they converted to accrual accounting. This Mode was deleted after all departments had converted to accrual accounting. Until 1994, Mode C output appropriations meant "an appropriation of public money for acquiring a specified class of outputs required by the Crown" and this was interpreted as an appropriation for the price rather than for costs or expenses. Mode C output appropriations have never been used, contrary to Jones and Thomson's (2000) suggestion that they have.

[13] The section allows departments to change the composition of their assets and liabilities and the proviso seems unnecessary. It has been used to develop the repayment of operating surplus rule covered later in this chapter.

An appropriation act, for example the Appropriation (1997/98 Estimates) Act, which suggests cash appropriations in s. 3 and accrual appropriations in S 4 and 5, shows the form of parliamentary approval:

> **3. Appropriations of public money –** (1) Public money may be spent in relation to–
> (a) The capital contributions by the Crown to . . .
> (b) the repayment of debt set out . . .
> (2) The amounts of public money to which subsection (1) relates are separately appropriated . . .
>
> **4. Appropriations for expenses to be incurred –** (1) Expenses may be incurred in relation to –
> (a) the classes of outputs set out . . .
> (d) the categories of other expenses set out . . .
> (2) Public money . . . may be spent for the purpose of meeting expenses
>
> **5. Appropriations for liabilities to be incurred –** (1). Liabilities may be incurred in relation to –
> (2) Public money . . . may be spent for the purpose of meeting liabilities incurred under the authority of subsection (1).

When accrual appropriations were first proposed in the Public Finance Bill issued in 1989 they were limited to appropriations for outputs. From the Treasury's perspective, the concept of accrual appropriations for outputs was consistent with shifting controls away from inputs. Arguably, fully costed outputs, with depreciation expense included in those full costs, would generate tight output appropriations. This would allow external reporting obligations to replace the parliament's ex ante controls (Treasury, November 1989, FMPG8, Treasury files). The Legislative Advisory Committee queried these accrual appropriations:

> How can you say that there will be no depreciation of assets except by appropriation of Parliament? Certainly Parliament might wish to know of such a depreciation - but how can it allow it? Doesn't it just happen? (Legislative Advisory Committee, submission on Public Finance Bill 1989, p. 6).

Evidently, the government agreed that some form of ex ante control was still required and, although the appropriations were for expenses (output costs), the disbursement of cash from the Crown bank account was viewed as a proxy ex ante control for the purposes of the controller function (see Appropriation (1997/98 Estimates Act) above, sections 4(2) and 5(2)). Later, when the concept of accrual appropriations was extended, the Legislative Advisory Committee argued that the reformed financial "reporting regime should not be confused with the annual appropriation legislation", and questioned the point at which the prospect of incurring an expense would require Parliament to:

> approve in advance not just the spending of public money but also the incurring of expenses. Consider the decision of the Crown to enter into a contract, say, to buy frigates over the next 20 years. Would it now have to be based on prior statutory authority? Is not the Crown by entering into that contract 'incurring expenses'? If so, [this] would reverse the long established principle that the power of the Crown to enter into a contract is unaffected by the distinct need repeated in the Constitution Act for Parliamentary appropriation of the money to be paid under the contract. (Legislative Advisory Committee, submission on Public Finance Amendment Bill No 3, 1992).

The Legislative Advisory Committee's comment was interpreted as a concern that the appropriations requirements might inhibit the Crown from entering into long term contracts (Treasury, T/2 "Further comment on issues identified in paper of 6 October", Public Finance Amendment Bill (No, 3), Parliamentary Library). In an effort to prevent such inhibitions, expenses were interpreted as related to one financial year but not beyond that year; and the interpretation of commitments was changed from "future payments and expenditure to be incurred on contracts that have been entered into at a balance date" to "future expenses and liabilities to be incurred on contracts that have been entered into at balance date" (Public Finance Act 1989, s. 2). Commitments are, therefore, omitted from appropriations requirements.

Financial management incentives

Although the Public Finance Act 1989 states in its objectives the intention to establish financial management incentives, there is no other specific mention of incentives in the Act. The broad economics interpretation of incentives suggests that the Act itself establishes incentives, but there were early intentions to develop incentives based on the Treasury's (1984, p. 283-288) ideas of market and non-market activities and the appropriate ways to manage those activities.

The Public Finance Bill contained more extensive reference to mode B and mode C appropriations than merely the output appropriations that now appear in the Act. Initially, mode C output appropriations were intended as payment of an output price for the production of outputs, while mode B output appropriations represented the full accrual cost of outputs (Scott *et al*, 1990). The implications of the proposed types of appropriations were that a department could be classified as either a mode B (non-commercial activities and treated as a cost centre) or mode C (commercial activities and treated as a profit centre) department and this was the idea suggested in the Public Finance Bill (Table 4.1).

Table 4.1 Public Finance Bill: departmental appropriation modes and interest earning proposal

Mode B	Mode C
Output appropriation: for output costs (cl. 2).	Output appropriation: of public money for acquiring outputs (cl. 2).
Capital contribution: appropriation of public money for acquisition of goods and services of a capital nature (cl. 2).	Capital contribution: appropriation of public money to adjust level of Crown's investment in department (cl. 2).
Any increase or decrease in a department's accumulated capital contribution requires an appropriation (cl. 13(1)).	Any increase or decrease in a department's accumulated capital contribution requires an appropriation (cl. 13(1)).
No retention of operating surplus (cl. 13 (2)).	Silent for mode C.
Interest or dividends may be payable on accumulated capital contribution (cl. 13(3)).	Interest or dividends may be payable on accumulated capital contribution (cl. 13(3)).
The Treasury invests all surplus money, including that held by departments, and interest earned paid to the Crown (cl. 21).	The Treasury invests all surplus money, including that held by departments, and interest earned paid to the Crown (cl. 21).

Evidently the mode B appropriations, as proposed in the Bill, imposed tighter controls than the mode C appropriations by limiting output appropriations to the incurrence of costs for production of outputs, prohibiting retention of any operating surplus, limiting the amount of cash held by departments by separating the output appropriations from the amount of cash passed on to departments, and requiring a capital contribution appropriation for all fixed asset purchases (Public Finance Bill, 1989; The Treasury, 24 October 1990, An overview of Mode C, Treasury files). Those departments that responded to the Public Finance Bill did so at short notice and generally responded negatively (submissions on the Public Finance Bill, 1989, Parliamentary Library).

The proposed distinctions between mode B and mode C departments were impractical because departments could, feasibly, supply both mode B and mode C outputs:

> Where an organisation has more than one set of outputs, this clause [cl 6(4) requiring outputs to be classified into appropriation modes] has the effect of enabling that organisation to operate under more than one mode at the same time. This would appear to be in conflict with the reporting clauses in the Bill, all of which would require the department to be operating under either Mode A, Mode B or Mode C, but not under more than one mode concurrently. (Deloitte Haskins and Sells, submission on the Public Finance Bill, 2 May 1989, FE/89/164, Parliamentary library).[14]

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[14] Deloitte Haskins and Sells included in their submission the information that they had been involved with Treasury in developing the reforming legislation.

Further, the interpretation of the capital contribution appropriation proposed for mode B seemed to derive from some confusion over accounting ideas:

> The controls on capital appropriations contained in the Bill appear to confuse the concept of equity, the shareholders investment in an enterprise, with capital equipment purchases, by assuming, incorrectly, that the two are equivalent. No firm would tag revenue from its operations in order to refrain from purchasing capital items with those funds. The idea of investment monies being used just for capital purchases and revenue monies only being available for operations is nonsensical. Further, these provisions ignore the continuing substitution between capital, labour and other inputs which is an integral part, in this modern age, of the decision-making and planning process of any organisation that is not technologically moribund. (Department of Statistics, submission on the Public Finance Bill 1989, Parliamentary library).

Some of the distinctions between modes were removed from the Act (Table 4.2).

Table 4.2 Public Finance Act 1989: departmental appropriation modes and interest earning proposal

Mode B	Mode C
Output appropriation for output costs (s. 2)	Output appropriation of public money for acquiring outputs (s.2)
Capital contribution: appropriation of public money to increase the amount of the Crown's net asset holding in a department (s. 2)	Capital contribution: appropriation of public money to increase the amount of the Crown's net asset holding in a department (s. 2)
A department may use the proceeds of the sale or disposal of capital assets, together with any working capital to purchase or develop other capital assets, provided there is no increase in net assets as a consequence (s. 11)	A department may use the proceeds of the sale or disposal of capital assets, together with any working capital to purchase or develop other capital assets, provided there is no increase in net assets as a consequence (s. 11)
No retention of operating surplus (s. 14 (1))	The department shall pay to the Crown a return of an amount determined by the Minister (s. 14(2))
The Treasury invests all surplus money, including that held by departments, and interest earned paid to the Crown (s. 23)	The Treasury invests all surplus money, including that held by departments, and interest earned paid to the Crown (s. 23)

The changes made the capital contribution appropriation the same for both modes and allowed all departments to purchase fixed assets within the scope of resources held. The requirement to pay interest or dividends to the Crown was removed from mode B, and the requirement that any increase or decrease in a department's accumulated capital contribution be appropriated was removed from both. This meant that departments receiving mode B output appropriations, which represented approval to incur costs, were unable to retain any operating surplus, while departments receiving mode C appropriations of public money, presumably for the price of outputs, were required to pay a return to the Crown but not prohibited from operating surplus retention. The Act interprets operating surplus

as the "amount by which departmental revenue exceeds the expenses of a department". Departmental revenue is the revenue resulting from the supply of "goods, services, rights, or money to other parties, including the Crown", while expenses, which include the cost of outputs, are "expenses measured in accordance with generally accepted accounting practice" (s. 2, 14).

The Act assumed that a department would operate under only one mode. The idea of these modes was that mode B departments would receive only the cash needed for operations instead of the full amount appropriated because cash would be held centrally, while extensive developmental work was required to achieve mode C output appropriations because contracts would be needed to specify the "quantity, quality, time and place of delivery, and price" of departments outputs, and this information would be publicly reported (Scott *et al*., 1990, p. 20; McCulloch and Ball, 1992, p. 10). In 1990, however, the Treasury questioned whether government departments should even operate commercial activities, arguing that "the SOE form appears better suited for some activities currently performed by government departments" (Treasury, 1990, p. 91, 93).

Following a pilot trial of a capital charge and interest payment regime, its application to all departments was recommended (Treasury, 1990). The capital charge, imposed on all departments from mid-1991, was explained as analogous to a company's dividends, interest and taxes. This charge is calculated by multiplying the department's reported net assets by a particular rate. Its imposition was considered desirable to provide a rate of return to the Crown similar to that which could reasonably be expected from similar investments in the private sector; make clear the full costs of a department's goods and services; give departments incentives for efficient management of the Crown's investment, with this incentive including the disposal of fixed assets; and act as a disincentive to seeking capital contributions (Gilling, 1991; Lally, 1991; McCulloch, 1991; Dale, 1992; Ball, 1995; Scott, 1996). The capital charge regime is considered in more depth in later chapters. It was credited with prompting improved cash management systems within departments but was considered too low because departments' balance sheets excluded human resources and some intangibles (McCulloch, 1991; 1993; Ball, 1993; Scott *et al*, 1997).

Embedding the financial management reforms

The Financial Reporting Act 1993 is not normally mentioned in the context of the public sector reforming legislation but the requirement in the Public Finance Act that all financial reports be presented in accordance with generally accepted accounting practice (GAAP) links the reporting requirements to a separate regulatory process established by the Financial Reporting Act. This Act brought both the public sector and the private sector under the same financial reporting requirements, compliance with GAAP, and established a Crown entity, the Accounting Standards Review Board (ASRB), to decide exactly what is GAAP in New Zealand (s. 3, 24).

The Financial Reporting Bill proposed this regulatory process for most of the business sector, a proposal that the Treasury initially opposed (T91/3516, 12 August 1991, Richardson files 721; T91/3587, 16 August 1991, Richardson files 723). Almost two years passed before the bill was read in parliament for the second time, still without any suggestion that it should apply to the public sector. Much of the parliamentary debate at that time concerned the constitutional implications of delegating "to an outside body, to be called the Accounting Standards Review Board, the power to make binding rules. In many respects we are being asked to delegate the power to legislate — our own principal power" (Caygill, 4 May 1993, Debate on Financial Reporting Bill second reading, 15071). In July 1993 the Treasury recommended extending the Financial Reporting Act to encompass the public sector, partly to:

> enhance the credibility of state sector reporting by having an independent body approve standard accounting practice for state sector financial statements. This should reduce the scope for charges of political manipulation of state sector financial reporting, thus strengthening the impact of the fiscal transparency initiatives. (T93/1792, 12 July 1993, Richardson files 909).

This extension was made by supplementary order followed, a week later, by the third reading and enactment. In the brief debate on that third reading the extension to include the public sector received no mention.

Fiscal policy

Both macro-level fiscal policy reform and micro-level financial management reforms were proposed in 1984 but the legislation for the macro-level fiscal policy

developed only after implementation of the Public Finance Act 1989. The Fiscal Responsibility Act 1994 establishes a framework within which a government must define and report on its overall fiscal strategy.

The Treasury (1984) had proposed the publication of fiscal targets and the adoption of fiscal balance as a general rule. It again recommended the adoption of "aggregate expenditure limits or targets" in 1990, and its favoured target seemed to be expenditure as a percentage of GDP (Treasury, BR No. 62, 20 May 1992, Richardson files 295; Treasury, T93/671, 25 March 1993, Richardson files 815). There was no formal development of fiscal policy and by 1993, when net public debt was 47.9% of GDP, fiscal policy was a big challenge, and debt reduction was proposed by "closing the deficit over the next three years, and then run[ning] fiscal surpluses" (Treasury, 1993, p. 94).

The Fiscal Responsibility Act 1994 was regarded as a logical addition to NZ's financial management reforms because it would increase the credibility of fiscal policy, "integrate macro and micro" approaches, and link "the information systems for budgeting with those of reporting the government's finances (Scott, 1995, p. 10-12). Surprisingly, when the Fiscal Responsibility Bill tabled in parliament shortly before the 1993 general election, it omitted any proposal for fiscal targets.[15] A set of five principles intended to provide fiscal targets was added to the Bill following what may have been an orchestrated response to it, and those principles were adopted in the Act (Fiscal Responsibility Act 1994 submissions, Parliamentary library).

a) that Crown debt should be reduced to "prudent" levels by achieving operating surpluses every year until that level has been achieved;
b) that Crown debt should then be held at a prudent level by ensuring that Crown operating expenses are not more than Crown operating revenue;
c) that Crown net worth should be maintained at a level sufficient to provide a buffer against adverse events;
d) that the Crown's fiscal risks be managed prudently; and

[15] In 1978, James Buchanan co-edited a book titled *Fiscal Responsibility in a Constitutional Democracy*. Buchanan was a strong advocate of governments adopting constitutional norms including a balanced budget constraint (see also, Chapter 3).

e) that these policies be pursued in such a manner that the level and stability of future tax rates is predictable (FRA, 1994, s. 4A)

The first two of the principles supposedly adapt the earlier fiscal balance proposal to New Zealand's "almost unique internationally and highly desirable" accrual accounting regime (Scott, 1995, p. 5). In an accrual accounting environment, however, there is no necessary connection between reported operating surpluses (that is, revenue minus expenses) and debt reduction, but the Treasury's explanation of those principles shows no sign of awareness that the first two principles are nonsensical (www.treasury.govt.nz/legislation/fra/explanation/details1.asp):

> The principles of responsible fiscal management, as set out in the Act, are:
>
> a) Reducing Crown debt to prudent levels, so as to provide a buffer against future adverse events, by achieving operating surpluses every year until prudent levels of debt have been achieved; ie., the Government is to spend less than it receives in revenue until public debt is reduced to prudent levels.
>
> . . . The principle is a two-tiered test; debt must be reduced and this must be achieved by running operating surpluses. This prevents governments from achieving prudent debt levels simply by selling assets.
>
> b) Maintaining total Crown debt at prudent levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; ie., the Government is to keep debt at prudent levels by living within its means.
>
> The second principle implies that once prudent levels of debt have been achieved, a government should not expect to borrow to "pay for the groceries" on an ongoing basis. This principle is a medium- to long-term one. In the short term, cyclical factors may well result in temporary, and desirable operating surpluses or deficits.

The Fiscal Responsibility Act requires regular reports on the government's fiscal policy and the consistency of that policy with the principles. By 31 March each year, approximately two to three months prior to presentation of the annual budget, a budget policy statement must be published stating the government's long term fiscal policy in relation to the Crown's operating revenues, operating expenses, operating balance, Crown total debt and net worth (s. 5A). The targets for these variables must be compared with the principles of fiscal responsibility. A half yearly economic and fiscal update and a pre-election update must also be published (s. 12, 13).

Chapter Summary

New Zealand's public sector reforms commenced with a strong focus on privatisation and the legislation enacted is consistent with that focus. Preceded by a financial crisis, possibly engineered, and economic restructuring as readying procedures, the reforms soon moved on to the corporatisation and privatisation of SOEs (see Chapter 1) and, with the Reserve Bank Act 1989 and the Fiscal Responsibility Act 1994, the adoption of constitutional norms (see Buchanan and Wagner (1978) and previous chapters).

Although to this point, New Zealand might have provided a text book example of the type of reforms advocated by the Washington consensus, its reforms to the core public sector took an extreme privatisation stance (Osborne and Plaistrik, 1997) which has some consistencies with Savas's (1982) four privatising strategies (see Chapter 3). Key reformers have stated that the Public Finance Act and the State Sector Act interlock (for example, Scott *et al*, 1990), with that interlocking largely explained in the context of principal-agent theory and monitoring: "The State Sector Act is only part of the picture because, while it enables ministers to take action on the results of monitoring, it does not establish the criteria for that monitoring. That task is addressed by the financial management reforms in the Public Finance Act 1989" (Scott *et al*, 1990, p. 155). The obvious key to the Public Finance Act is the implementation of a limitation of government structure, which is one of the four privatising strategies Savas (1982) proposed, and that Act follows through with Savas's proposals for contracting by interpreting outputs as measured by their full costs. It might, therefore, be suggested that the key to the State Sector Act is the State Services Commissioner's review function which could operate as another of Savas's proposed privatising strategies: a systematic load-shedding device (Savas, 1982, p. 123). While this represents only two of Savas's proposed strategies, promotion of the other two is also apparent. Since 1984 the Treasury had proposed fiscal balance, the need for expenditure reductions and control, while the Treasury (1987) proposed the implementation of user charges.

The possibility that these proposals may be linked with Savas (and Buchanan for the principles of fiscal responsibility) is not intended to imply that there is no

merit in the proposals, but merely to show the consistency between those proposals and the privatisation movement and, with those ideas applied to the core public sector, the reason that New Zealand's public sector reforms are viewed as extreme. Questions of merit do arise when examining the practicality of some aspects of the legislation and the implications of that legislation. Just two examples that are consistent with the influential literature reviewed in Chapter 3 but of questionable merit in application are the limitation of government structure and the nature of accounting. First, although the limitation of government structure is the key to understanding the Public Finance Act, the Legislative Advisory Committee's advice that this structure misrepresents the nature of the relationship between the Crown and its departments suggests that the Public Finance Act is constructed upon shaky foundations, but there is no evidence that the advice was considered. Secondly, the Public Finance Act required adoption of accrual accounting, but the principles of fiscal responsibility in the Fiscal Responsibility Act were drawn from cash-based accounting, and obviously were not well-translated into accrual accounting terms.

A financial crisis prompted New Zealand's economic and public sector reforms, and given that this financial crisis was attributed to the high level of debt incurred by the government without effective scrutiny, the failure to address this issue in the Public Finance Act seems surprising. The Treasury's early arguments against cash accounting, which included the observation that it ignored future commitments, suggested that the adoption of accrual accounting would at least allow prior parliamentary scrutiny but the Public Finance Act continues to omit commitments from prior parliamentary scrutiny. With the more recent development of financing arrangements constructed as the purchase of goods and services, and Savas's (2000) advocacy of public-private partnerships (PPPs) which frequently involve very large amounts of money, this loophole in the Public Finance Act increases taxpayers' vulnerability. Given the stated objectives of the Public Finance Act it also seems surprising that nowhere is there any interpretation of what is meant by appropriations, and it is not clear that the two forms of appropriation devised either capture all that seems to be contemplated by the Constitution Act, or are mutually exclusive.

Finally, the powers delegated by the Public Finance Act must be noted. The Minister still has the power to issue all forms of public security, evidently without prior parliamentary scrutiny, while the power to enter into contracts for the supply of goods and services is widely delegated, including to all departments. In addition, the Treasury's delegated powers relate to both the handling of public money and the issue of instructions to departments and, as institutional theorists would recognise, these powers, and the effects that may be achieved with them, should not be under-estimated. The focus of this thesis is the financial management system as it affects departments and that system has been developed through the use of delegated powers. Until this point, most of the comment about New Zealand's public sector reforms and its financial management system in particular is drawn from publicly available sources. With the legislation in place, however, the financial management system underwent considerable development, and much of that development occurred under a National government which, for at least the first three years of its term, strengthened the reform agenda. That government's strategies are the subject of the next chapter before considering the detailed development of the financial management system in Chapters 6 to 9.

5 Executive government: structure and strategy

The State Sector Act 1988 and the Public Finance Act 1989 required the chief executive of each government department to take responsibility for staff employment and conditions, and for the development of an accrual accounting system. Departments were required to complete the transition to accrual accounting by 30 June 1991 and so when the government changed in late 1990, departments were still in the transition stage. Because accrual accounting merely provides a base for the development of NPFM techniques, it was under the 1990 National government that key NPFM developments occurred.

This chapter briefly outlines the developments planned for the financial management system at the time, the structure adopted by the government, and its fiscal and policy strategies. It suggests that those strategies were incorporated in the financial management system and provides an introduction to the subsequent four chapters which explain the ongoing developments to the financial management system. This chapter includes illustrative boxes showing how the National party's 1990 election manifesto commitments to involve the private sector in the justice system were translated into financial issues for pursuit through the operation of the financial management system.

The financial management system and its development

Shortly after taking office, the Minister of Finance received advice about the nature, general intent and state of development of the financial management system. The system devised was a management system controlled by outputs. It required explicit agreement over what is to be produced and how it is evaluated, and the removal of most input controls to allow departments to determine for themselves the appropriate input mix. The requirements for full costing would allow comparison of departments' outputs with those from other sources (T90/N12, 7 November 1990, Richardson files 758). The government's ownership interest in a department would require decisions about a department's particular line of business, the level of investment in a department, whether the return on

investment by the department is satisfactory, and the management practices to be observed (T90/N13, 8 November 1990, Richardson files 758). Chief executives were crucial to this system and accountable for both personal results achieved and those of the department. With employment conditions in the reformed public sector changed to base part of a chief executive's remuneration on results achieved, the relationship between a responsible minister and departmental chief executive required formal specification of expected performance and the basis for assessment of that performance in a written performance agreement (T90/N14, 7 November 1990, Richardson files 758).

At the time, considerable development of the financial management system was intended. A set of incentives projects, which resulted "from a desire by departmental managers to earn interest on the cash balances generated through better cash management and to retain any resultant operating surpluses", was planned and the previous Labour Cabinet had endorsed these projects in principle. The incentives projects were planned for implementation in several phases and phase 1, the development of a general incentives model and announcement to departments had been completed. Phase 2, incentives to "encourage efficient use of both fixed and working capital", was in the process of implementation, while subsequent phases were yet to be implemented. Phase 3 was "incentives to supply the outputs required by the Government", and phase 4 was "incentives to encourage chief executives' performance" (T90/N17, 7 November 1990; Richardson files 758). The phase 3 incentives were important to the development of the output management system and included (T90/N12, 7 November 1990, Richardson files 758, p. 5):

- Mechanisms to bring about better specification and costing of outputs;
- Mechanisms by which Ministers can better monitor whether the outputs have been delivered;
- Mechanisms for independent output pricing;
- Procedures which allow the Crown to pay for outputs when they are delivered rather than when costs are incurred in their production;
- Options for supporting Ministers in the detailed output negotiations and monitoring;
- Potential benefits resulting from consumer based monitoring rather than ministerial monitoring.

Implementation of phase 2, which was a capital charge and interest payment regime for application to all departments, was to be completed by 1 July 1991. Capital charge rates "appropriate to each department" had not been determined. A process had been devised for determining default rates for application in the absence of private sector counterparts or in the event of failure to determine an appropriate rate (TC1990/13, 25 October 1990, p. 3-4, Treasury files). Individual departmental rates had not yet been devised and, as a transitional measure, the application of default rates to all departments was proposed and agreed. The default rates were very high, and generated a negative response which prompted the Minister of State Services to propose an evaluation of the state sector reforms.[16] He proposed to review the "changes to the structure, accountability relationships, operations and financing of the public sector resulting from the introduction of the State Owned Enterprises Act, the State Sector Act and the Public Finance Act", with the review supervised by a group publicly-perceived as having no vested interests in the reforms, while the project work itself would be conducted by officials (STA(91)45, 29 April 1991, Richardson files 1032).

Treasury officials advised the Minister of Finance that the review should protect "existing and potential benefits" of the reforms while proposing improvements in "implementation or design" and any other necessary changes. The proposed terms of reference for the review should, therefore, be narrowed, the time period of the review extended, and the critical importance of the "quality" of those appointed to the steering committee for the review be recognised (T91/1716, 30 April 1991, Richardson files 669). Correspondence between Treasury officials and the Minister of Finance at the time and during the course of the review suggest that the Treasury input influenced the terms of reference, the selection of some personnel, and the eventual report (T91/2142, 24 May 1991, Richardson files 682; T91/2212, 28 May 1991, Richardson files 684; STA(91)M18/6, 19 June 1991, Richardson files 934; T91/3666, 20 August 1991, Richardson files 726; T91/3944, 6 September 1991, Richardson files 734; T91/5246, 3 December 1991,

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[16] The development of the capital charge regime is significant and it will be considered in greater detail Chapters 6, 7 and 8. At the time, the idea was that two default rates would be devised with the difference between them related to different levels of risk. The default rates proposed were 20.5% and 17.8% whereas the 5-year government bond rate on which they were based was 12%.

Richardson files 834). The report, known as the Logan Report, largely endorsed the reforms, making a number of recommendations for their further development and represented a consensus view of the steering committee (Interview, former departmental chief executive, June 2001). It also commented on the 1991 budget process, the first budget prepared using the reformed financial management system, and noted confusion about “both the direction of the reforms and the roles and responsibilities of central agencies in facilitating reform”, as well as concern over the fact that “there is no common view on what will constitute the endpoint of the reforms and how far away that is” (Logan, 1991, p. 11). Following the Logan review, the reforms continued and, if anything, strengthened (Scott *et al.*, 1997).

Structure and strategy within executive government

The Treasury's 1990 briefing to the incoming government recommended commercialisation and expenditure reduction and, consistent with its election manifesto, the incoming National government adopted both. The Treasury (1990) proposed the adoption of fiscal targets in addition to two processes for achieving expenditure reduction: controlling the amount of resources available and establishing criteria to be satisfied for spending proposals to receive approval; and making use of information from the new financial management system to determine how to spend those resources (1990, p. 80-81). Advice to the Minister of Finance of the incoming National government in 1990 explained the need to align the government's fiscal strategy with its chosen policy strategy (Treasury, 1990; Treasury, 30 October 1990, T90/4152, Richardson files 1171).

The government viewed privatisation as a "natural corollary to commercialisation", and a "natural part of the Government's management of the Crown's . . . business interests". According to the Treasury’s subsequent advice, privatisation was an "important part of the Government's overall economic and financial policy mix", and should be "presented as the last step in a broadly based more business-like approach to efficient management in the public sector. The performance gains that can arise from commercialising Government activities would be the main focus of Government strategy, with sale being one of the

options open to the Government" (Treasury, 16 December 1991, T91/5496, Richardson files 834).

Shortly after the election, the Prime Minister announced the government's goal to "control, reduce and eliminate the deficit in our first term" without raising taxes. Reducing low priority expenditure and improving value-for-money in high priority expenditure areas would achieve the expenditure reductions (Richardson, 21 November 1990, "Spending review announcement" Richardson files 1029; Bolger, CSC (91)2, 12 February 1991, Richardson files 989; T91/1737, 1 May 1991, Richardson files 670).

The Prime Minister was advised that the large size of any Cabinet inhibits effective decision-making and that, typically, a small group of senior ministers would make strategic decisions informally and then seek Cabinet endorsement. The proposal to formalise such an arrangement included recommended committee titles and terms of reference. It resulted in a multi-tiered cabinet sub-committee structure, largely consistent with the recommendations, with the Cabinet Strategy Committee (CSC) at the top, specialist committees such as the Cabinet Expenditure Control Committee (ECC), the Cabinet State Sector Committee (STA) and the Cabinet Committee on Enterprise, Growth and Employment (CEG) at a level lower, and portfolio-holding ministers, possibly grouped into sector sub-committees at a level lower still (Treasury, 30 October 1990, T90/4152, Richardson files 1171; Bolger, 9 November 1990, Richardson files 1171). There was considerable overlap in membership of these committees.

Evidently the government's chosen strategies determined the roles of the Cabinet sub-committees. The CSC's role was to set strategic goals, establish priorities and monitor progress, and thus "provide the clear framework within which detailed policy decisions can be developed by the other Cabinet Committees" (Bolger, 9 November 1990, p. 1, Richardson files 1171). The CSC sought the promotion of growth and employment, and expenditure reductions of approximately $2 billion in relation to the budget projections prepared according to the Treasury's instructions shortly before the 1990 election (CSC, 9 May 1991, Richardson files 989; CSC(91)2, 12 February 1991, Richardson files 989;

CSC(91)29, 14 May 1991, Richardson files 989; CAB(92)M3/3d, 3 February 1992, Richardson files 837).[17]

The roles devised for the second tier committees supported these strategies and drew on the framework provided by the Public Finance Act and the State Sector Act. The ECC's role was to identify how to achieve savings "without injury to essential services from Government departments and agencies, and how we increase the value for money that is spent"; the STA's role was to review government operations "in order to identify activities which could be better undertaken by State Owned Enterprises or by the private sector, and . . . promote and oversee their formation"; and the CEG's role was to "develop and coordinate policies relating to industry and commerce, trade, transport, and employment to foster an enterprise culture" (Bolger, 13 November 1990; Committee Terms of Reference, Richardson files 1171). These committees would, therefore, act in accordance with the policy strategy to influence the operation of individual portfolios. In its 1990 election manifesto, the privatising intent was evident but, following the outcome of a public referendum in 1992 on alternative electoral systems, which was conducted as a preliminary step for a promised binding referendum on New Zealand's electoral system, the overt intent softened (Box 5.1).[18] This type of hierarchical committee structure, albeit with different committee titles and different terms of reference, remains in operation today (see for example, www.dpmc.govt.nz/cabinet/committees). State sector issues are incorporated within the terms of reference of the Government expenditure and administration committee which is also concerned with expenditure control.

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[17] The Minister of Finance explained the alignment between these policy and fiscal strategies. The government's manifesto commitment to reduce government expenditure would "reduce pressure on interest rates, stimulate economic growth and create more job opportunities" (Richardson, 21 November 1990, "Spending review announcements" Richardson files 1029).

[18] The binding referendum resulted in a Mixed Member Proportional representation electoral system which tends to result in loosely bound government. (Pallot, 1998). The Fiscal Responsibility Act 1994 and the Financial Reporting Act 1993 both seemed to be an attempt to embed the reforms in anticipation of this changed electoral system.

Box 5.1 Policy strategy and the Department of Justice

In its election manifesto, the National Party promised both expenditure reductions and that it would increase police numbers by 900. In addition, it promised that, "The role of the private sector in the prison system will also be increased, particularly in the areas of prison escorts and remand facilities". This promise was consistent with a Strategos report, issued in July 1989 following a review of the Department of Justice, which proposed privately-owned and operated prisons and commercialisation of the department's registry functions.

In early 1991, the Minister of Finance requested a briefing from the Minister of Justice on the case for privatisation of prisons and "your intentions in respect of our manifesto commitment to establish a Department of Corrective Services." The Officials Working Party on the Regulatory Environment for Foreign Investment in New Zealand, formed to remove barriers to foreign investment and to promote foreign investment in New Zealand, was extended to include Department of Justice representatives.

Three Department of Justice functions were classified as role of the state issues: contracting for custodial services, in particular the use of the private sector for prison construction and management; computerisation of public registries; and prisoner escort and court-related custodial services. In late 1992, however, when the level of public disapproval of privatising initiatives was evident, the manifesto commitment was explained as intended "to provide an opportunity for new and innovative approaches to be introduced . . . with a long term view of reducing re-offending; . . . the possibility of achieving savings in the high costs of operating prisons; . . . [and] to enable public prisons to measure themselves against non-state operators, which should encourage a higher standard of performance in both sectors, as well as providing evidence of the relative merits of state and non-state operation of prisons in the New Zealand context." (Letter, R. Richardson to D. Graham, 10 January 1991, Richardson files 104; T91/500, 19 February 1991, Richardson files 631; CAB(91)M16/2a, 29 April 1991, Richardson files 868 ECC(92)96C, 7 April 1992, Richardson files 836; ECC(92)M12/2, 8 April 1992, Richardson files 1101; CSC(92)153, 13 October 1992, Richardson files 1105; CSC(92)M52/5, 28 October 1992. Richardson files 1105).

Adoption of strategy: informal

The Logan report noted that the reformed financial management system assumes a centralised direction-setting process with specification of both fiscal and policy strategy. It recommended formal statements of these strategies (Logan, 1991, Recommendations 4 and 5, p. 46-52). For 1992 and 1993, strategy specification remained relatively informal: the growth and employment strategy continued for those two years, while the fiscal strategy, which was not publicly announced, was to achieve a trend of reducing government expenditure as a percentage of gross domestic product (GDP) for 1992, and then to contain 1993 expenditure at or below the projected level for 1992 (ECC(91)345, 10 December 1991, Richardson files 876; Treasury BR No: 62; 20 May 1992, Richardson files 295; CAB(92)M20/43, 25 May 1992, Richardson files 840; CAB(92)M46/9, 9 November 1992, Richardson files 874). Although the strategies adopted helped to develop the understanding and shared commitment of ministers and to guide resource allocation, they were not widely understood (CAB(92)M46/9, 9 November 1992, Richardson files 874). With the policy and fiscal strategies

aligned, it appears that the developments planned under policy strategies could also be pursued under the expenditure reduction strategy. Events affecting the Department of Justice demonstrated that whichever strategy dominates determines which higher level committee and which advisers are involved (Box 5.2).

Box 5.2 Strategy predominance: commercialisation or expenditure reduction?

The government's election manifesto commitment to increase front line police numbers by 900, together with proposals to strengthen bail laws implied increased costs throughout both the police and the justice systems. The Department of Justice already faced difficulties "accommodating the existing prison population" and sought additional funding. A search commenced for alternative strategies to reduce costs, including the possibility of contracting out periodic detention centre management, remand institutions, transport of offenders and inmates, private security guards at courts, enforcement of fines, and the execution of warrants and documents. According to Treasury advice, US experience of private prisons brought efficiencies of 15%.

In 1991, a scoping study of the Police and the Department of Justice examined both "machinery of government and expenditure control issues with a view to identifying substantial savings." It proposed decisive action to slow expenditure growth but recognised the considerable time, effort, and enabling legislation required. The Treasury advised that developments in the Justice portfolio should not be viewed simply as a "cost containing exercise", but proposed that progress would be assured by maintaining "a strong fiscal focus, which emphasises its importance and gives Treasury and State Services Commission a rationale for continued involvement". The adoption of a fiscal focus meant "it might be preferable for Strategy Committee to have Expenditure Control Committee take overall responsibility for the further work".

After Cabinet "approved in principle the introduction of private sector contracting into the provision of the full range of prison services, including the management and operation of prisons", the Minister of Justice argued that "the introduction of private sector contracting into the prison system is a major development which was commenced in accordance with government policy and independent of the Police/Justice scoping study". He proposed that the previously-established reporting process to Cabinet through the Cabinet Social and Family Policy Committee be continued, with a copy of reports to the ECC. Following representation from Treasury to the Minister of Finance, which included documentation showing Cabinet sub-committee membership, the ECC directed the involvement of the Officials Committee on Expenditure Control and required "that future reports on private sector contracting in the prison system should be submitted to the Cabinet Strategy Committee, not the Cabinet Social and Family Policy Committee". (ECC(90)1, 19 November 1990, Richardson files 1029; Letter, P. East, Acting Minister of Justice to R. Richardson, 14 June 1991, Richardson files 104; CAB(91)M23/28h, 17 June 1991, Richardson files 869; ECC(91)302, 12 November 1991, Richardson files 1027; ECC(91)319, 18 November 1991, Richardson files 1020; ECC(91)312, 18 November 1991, Richardson files 1027; T91/5197, 29 November 1991, Richardson files 345; ECC(92)201, 25 May 1992, Richardson files 1052; ECC(92)M28/7, 26 May 1992, Richardson files 1101; T92/3228, 20 October 1992, Richardson files 345).

Adoption of strategy: formal

In 1993, the government issued a broad vision document which formalised a goal of economic growth and social cohesion, while the Fiscal Responsibility Act 1994 with its principles of fiscal responsibility and requirements for any government to link its fiscal strategy with those principles formalised the government's approach to fiscal strategy and, in effect, required subsequent governments to adopt a similar approach.

Strategic results areas / key result areas

From 1994 and 1995, the government's policy strategies were linked to government departments and their activities by identifying progressively lower level and more detailed targets to be met in pursuit of those strategies. Strategic result areas (SRAs) were developed to link the government's strategies with the contribution required from departments over a three to five year period; key result areas (KRAs) were devised to provide a shorter term focus for departments in striving to meet the SRAs and, at a lower level still, were milestones on the way to achieving the KRAs (State Services Commission, 1994).

In 1999, a set of over-arching priorities was set above the SRAs and, following the 1999 election and a change of government, the SRAs were changed to key government goals. Regardless of changes in terminology or the different levels, the process of devising government strategy and then developing progressively lower level targets for departments to meet in pursuit of the strategy has continued. Given the 1990 election manifesto commitment and the view that aspects of prison operations were role of state issues, that private sector contracting for prison services was part of policy strategy rather than merely a cost savings development has long been evident (Box 5.3).

Box 5.3 Privatisation and policy strategy

In 1996, the strategic goals adopted by the newly-formed Department of Corrections included the "development of a contracting framework", and the "establishment of a contract-managed remand facility", but strategic goals were omitted from the 1997 annual report. From 1998, the department identified the Government's strategic result area relating to safer communities and included in its nine key results areas: KRA1, systems to ensure the security of offenders held in custody; KRA5 which "concerns the construction and management of the new Auckland Central Remand facility" for which the government had recently announced that its management and operation would be tendered; and KRA9, the implementation of a contracting framework. The strategic goals for 2001/2002, the first full year under the Labour-Alliance coalition government contain no references to contracting. (Department of Corrections, Annual reports years ended 30 June 1996 - 30 June 2000; Statement of Intent 1 July 2001-30 June 2002).

Fiscal strategy

The Treasury's advice that the government adopt fiscal targets required recognition that while the fiscal targets should be simple, and easily understood and monitored, the narrow focus of such targets could impede decisions that make good policy sense. Alternative policy options, for example, could be fiscally neutral but, because the aggregate target focuses on a particular item, such as

expense, one policy alternative could affect the target while another does not, and this could distort decisions. Similarly, governmental control over some items may be minimal but could have a major impact on the aggregate target. The fiscal targets might, therefore, require some adjustment by excluding fiscally neutral items from counting against the targets and focusing on discretionary items instead of all items. At the same time, the need for "flexibility and minimising the damage done to credibility by missing a target" also required consideration (Treasury, BR No 62, 20 May 1992, Richardson files 295).

Following implementation of the Fiscal Responsibility Act 1994, the fiscal targets adopted by the National government were the reduction of government operating expenses below 30% of GDP and the reduction of net debt below 20% of GDP, with that figure later reduced to 15% of GDP (Birch, 1995; Peters, 1998; Birch, 1999). In 1999, the Treasury noted that there was no "consensus amongst economists about the appropriate long-term objectives for net public debt and spending", but argued that high public debt levels were risky (Treasury, 1999, p.22-26). The Labour coalition government elected in late 1999 adopted fiscal targets for operating expenses to average 35% of GDP and for net debt to fall below 20% of GDP (Cullen, 2001).

Summary

This chapter notes that incentives developments to the financial management system were planned but not implemented when the National government took office in 1990. Those developments proceeded and, after the review of the state sector reforms, which acknowledged confusion over the direction and intent of the reforms, those developments strengthened.

The incoming National government adopted the expenditure reduction and commercialisation strategies. It also structured its Cabinet sub-committees and devised their terms of reference largely in accordance with Treasury recommendations. The terms of reference of some committees immediately below the CSC supported the general privatising thrust suggested by the Chapter 4, with the STA's responsibility for review providing scope for a systematic means of load-shedding, the ECC responsible for achieving expense reductions, while the

CEG was responsible for encouraging private sector development. Savas acknowledges that privatisation has more to do with politics than with economics, but he, and others, recognise public opposition to it as a role of government issue while privatisation for pragmatic reasons, such as efficiency and enhanced services, encounters less opposition (see Chapter 3). The examples drawn from the justice developments suggest that as overt privatising objectives foundered in New Zealand, they were translated into objectives that appear more pragmatic (Box 5.1) and pursued through the financial management system.

The financial management system assumes a centralised direction-setting process, and the general approach to strategy became incorporated in the Fiscal Responsibility Act, which requires specification of particular fiscal targets and comparison of those targets with the specified principles of fiscal responsibility, and in the manner in which strategies adopted are taken to lower levels with strategic goals and key results areas. Although this may suggest that each government may set its own direction and that the financial management system will accommodate that direction, this thesis argues that the expenditure reduction and commercialisation strategies, both of which are consistent with Savas's strategies for achieving privatisation, are designed into the financial management system and that ongoing developments to the system are largely consistent with those strategies. The manner in which those strategies have been designed into the system will be explained in more depth in Chapters 7-9. First, however, Chapter 6 provides an overview of those ongoing developments as pursued through incentives projects.

6 Incentives projects

The State Sector Act makes the State Services Commissioner responsible for the review of government departments and their operations, while the Public Finance Act makes the Treasury responsible for developing the financial management system which provides information used in such reviews and, therefore, provides monitoring criteria (Scott *et al*, 1990). The Public Finance Act merely provided a basic structure and an accrual accounting base for subsequent developments, and those developments commenced shortly after the passage of the Public Finance Act 1989 in a joint effort between the Treasury and the State Services Commission. These departments commissioned a report, *Report on Departmental Incentives,* which analysed and discussed incentives for application to departments (Treasury and SSC, 1989, Treasury files). That report seems to have provided a foundation on which several subsequent projects to incorporate incentives in the financial management system have drawn. This chapter outlines the contents of the *Report on Departmental Incentives* and then provides an overview of the ongoing set of incentives projects conducted to develop the financial management system, with those projects typically drawn together under a particular theme.

Report on Departmental Incentives, 1989

The *Report on Departmental Incentives* was a compilation of five project reports on different aspects of the new financial management system: a capital charge; output pricing, monitoring and payment; risk assignment for government purchases; accounting measures and issues; and incentives for chief executives. A sixth project, Project 0, attempted to understand departments' negative reactions when responding to the Public Finance Bill.[19] A different team, each working under considerable time pressure, was responsible for each of the six projects (Treasury and SSC, 1989, Treasury files, p. 1, 12-28).

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[19] Some project reports contain multiple sub-reports, only some of which are page numbered. The full report contains no page numbering but it consists of 253 pages. For referencing purposes, the pages have been counted from the beginning of the report and page numbers added.

The overview of this report proposed a "set of sanctions and incentives" which would allow delegated decision-making, but would, at the same time, ensure that agents (departmental chief executives) make decisions that are in the principal's interests. This required identifying the desired performance and devising the appropriate combination of sanctions and incentives to prompt that performance. The Treasury sought incentives to "encourage efficient use of resources", while the State Services Commission sought, in addition, to determine the purpose of performance reviews and to identify key performance measures (Treasury and State Services Commission, 1989, Treasury files, p. 13-17). The commercialisation of departments' activities was important and expectations were that the increasing "ability to specify and monitor both financial performance and the delivery of outputs" would support changes in pricing and payment practices away from the "arbitrary rules and restrictions" for mode B appropriations, to market conditions for mode C appropriations (p. 4-6). The reported findings of each project are presented in a composite table (Table 6.1) on p. 112.

Project 0: Departmental problems with incentives

Project 0 (p. 29-44) attempted to develop central agency understanding of departments' negative responses to the Public Finance Bill and to the eventual Act (p. 31). Some departments had argued that the Public Finance Bill contained disincentives for effective and efficient use of resources rather than incentives. The Public Finance Bill's proposal that all departments should pay a return to the Crown, that they could not earn interest on their surplus funds, and that mode B departments not be allowed to retain any operating surplus exemplified the concerns about disincentives (Submissions on Public Finance Bill, 1989, Parliamentary library).[20]

This project report contained a schedule of 31 concerns identified by consulting a few departments, and comments on each of those concerns together with, when relevant, identification of which incentives project would address

[20] Some time prior to promulgation of this bill, an arrangement had been made whereby departments were allowed to retain, or carry forward, underspending against appropriations. Evidently some viewed the

those concerns. An additional schedule reviewed the negative responses to the Public Finance Bill. The difference between departmental views and those of the project team was marked.

Some departments saw a contrast between the Public Finance Act and the State Sector Act's "spirit of freedom" for chief executives and departments. This was regarded as departmental failure to understand the role and responsibilities of a departmental chief executive as opposed to those of a minister and parliament. Some departments argued that allowing them to retain interest earned from improved cash management, or savings generated by providing outputs at a cost less than the amount paid would be an incentive for improved management. This was regarded as an "attitude problem" because any savings should accrue to the departments' owner, the Crown, and not to the departments. "Good performance should not be rewarded by increased purchase of outputs or increased capital contributions." Departments would have incentives to compete for contracts (Treasury and SSC, 1989, Treasury files, p. 36-37, 43).

Project 1: A capital charge for government departments

Project 1 (p. 45-88) viewed capital as the government's ownership interest in a department and sought recognition of that interest by including an ownership contract in each department's corporate plan. It also sought to include in a department's operating costs, the costs related to that ownership interest by imposing on all departments a cost of capital (p. 50-53, 63).

Two consultants advised on this project. One consultant had been asked to advise on a capital charge for government departments. He proposed that in the absence of market prices, output prices should be based on full costs including depreciation, tax and a capital charge, and that the capital charge should prompt "optimal investment and divestment" decisions (p. 76). He also advised that departments' asset valuations required consideration because those valuations would affect both the capital charge and the amount of depreciation, with both affecting the full costs of outputs. He argued that the capital charge would prompt

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prohibition on retention of operating surplus as a step backwards (Interview with former chief executive,

"optimal divestment decisions" if assets were revalued regularly to the greater of present value or sale value or, if neither of those is available, to replacement cost as a proxy for those values (p. 76).

The other consultant had been asked about capital charge rates for mode B departments, which have an "objective function of cost minimisation rather than profit maximisation, since the department does not have a revenue function but has costs of production" (p. 57). He advised that there is no conceptual justification for imposing a capital charge on departments that lack external revenue streams and depend on government funding decisions. The goal to be achieved by imposing the capital charge would therefore help to determine the capital charge rates imposed (p. 71-85).

Although the first consultant commented on optimal divestment decisions, both consultants assumed a goal of competitive neutrality and proposed that the cost of capital should equate to that of a private sector firm with comparable operations and with an "appropriate degree of financial leverage" (p. 72).

The project report proposed a capital charge and, for consistency, interest charging or payment on bank account balances.[21] It sought realistic valuations for long-lived assets, arguing that the capital charge would provide an incentive for departments to return surplus cash to the Crown (p. 64).

The project report argued that the capital charge would allow a "more full costing of outputs" and the amounts paid to departments for output production should be increased by the amount of the capital charge (p. 50 - 60). Because the amounts paid for outputs would cover all expenses, departments would be able to accumulate cash approximately equivalent to the depreciation component of the output prices (p. 62). Chief executives should have discretion over minor asset purchases and routine replacements but not over expenditure "which affects the

June 2001).

[21] Project 0, which seemed to be an afterthought, noted this recommendation for payment of interest. It pointed out that the Public Finance Act would require amendment for departments to be able to spend that interest, or that a capital injection appropriation would be required to allow departments to retain it. Alternatively, output appropriations could be reduced to offset the expected interest income (p. 36).

ability of a department to deliver outputs, or which may restrict future options" (p. 62).

For mode C departments, the capital charge would allow assessment of departmental and management performance, and, assuming that pricing of outputs is based on full costs, help to ensure that "pricing was competitively neutral with private sector industry participants". The capital charge for a mode C department should, therefore, equate to that for an analogous private sector firm. For mode B departments, the report proposed adopting the pragmatic recommendations of the second consultant assuming 50% debt and a beta of 1 (The Treasury and SSC, 1989, Treasury files, p. 50).

Project 2: Output pricing, monitoring and payment

The authors of project 2 (p. 89-153) expected that the funding of outputs and the administration of regulations would become increasingly important forms of intervention while policy advice and service delivery would become less important. Government-funded outputs could be either private or public goods, both of which could be supplied under either contestable or non-contestable conditions. The outputs could be specified at three general levels: output type, output class, and output component (p. 97). The project report therefore identified the funding of outputs as "one of the two major types of intervention open to the government", and output specification as "central to the new system of financial management in the public sector".

According to the project report, the financial management system hinged on ministers' ability to specify purchase decisions in terms of the "quantity, quality, source and recipients of outputs" and departmental chief executives' responsibility to deliver those outputs "which are to be supplied by departments". This implied that the government requires unit prices of outputs to decide which outputs to purchase, and to assess departmental operations. Departmental chief executives could be required to demonstrate that their prices are lower, or no higher, than those of alternative suppliers, thus placing "the onus on departments to prove that they offered value-for-money" (p. 102). The unit price information would also allow others to consider offering the same outputs at a lower price (p. 101).

The intended budget process would involve departments and their Vote Ministers proposing to the Cabinet the outputs they think the government should purchase (p. 131). Central agencies could advise by recommending prices and, where the price is non-contestable, efficiency dividends, with the eventual arrangement recorded in an output agreement between the department and purchasing ministers. This agreement would specify outputs in more detail than output classes (p. 133-134). Those departments making payments on behalf of the Crown (POBOCs) would also specify those payments by output class (p. 140).[22] Departments would develop corporate plans consistent with, but more detailed than the government's budget and estimates, with those plans containing the output agreement and a statement of ownership requirements (p. 98-100, 130).

Parliamentary appropriations for outputs were regarded as "authorizations to the Executive to spend up to that limit for purchasing the output class identified" (p. 124). The level of contestability would dictate the pricing methods but, irrespective of the pricing methods used, detailed costing systems would be required to avoid limiting performance assessments to the "crude" measure provided by overall financial performance (p. 101, 144, 146).

Opening markets to external suppliers or developing an internal market within government would allow the separation of output costs from prices and development of contestable, or market, prices (p. 102-106). Clear and detailed output specifications would be necessary to ensure price comparability and, because higher prices are unacceptable in competitive markets, this would motivate departmental efficiency improvements (p. 102-103).

Most departmental outputs were considered non-contestable, but simple cost reimbursement was unacceptable. Instead, prospective pricing rules were proposed, with these devised by using benchmark prices, by applying a margin over the variable costs of a department's contestable outputs, or by using expected standard costs (p. 104-106-109). These pricing rules were to be applied in conjunction with enforcement of output delivery and the extraction of efficiency

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[22] Initially POBOCs were separately identified, but not by output class. The 1992 amendment to the Public Finance Act changed this to require identification by output class.

dividends to prompt productivity improvements (p. 105). The possibility of squeezing prices too hard was noted, as was the need periodically to check pricing rules against performance audits (p. 104, 106).

Project 2 envisaged a transition from block funding in advance to output purchase arrangements with payment in arrears depending on output delivery. This required clear specification of outputs, quantities, quality, and prices (p. 135). If funding were directed to consumers for them to purchase their own services, then they could determine for themselves the quality of services. This would allow administrative evaluation of output delivery to be minimised, with only the minimum information necessary to determine output delivery required (p. 93, p. 134).

Central agency judgements of departmental performance would focus on a department's financial performance with performance penalties "directed against the financial position of the department" to avoid penalisation of the beneficiaries of government-supplied outputs. These penalties would be connected to the incentives affecting the department's chief executive (p. 110, 126).

Project 3: Risk assignment for government purchases

The risk assignment project (p. 154-162) viewed the budgeting process as establishing the money available for output production. Because, from a departmental perspective, the budget sets both the maximum revenue and the maximum expenses a department may incur in output production, this project considered who should bear the risk of budget underestimations. The artificiality of allocating risks between the Crown and its departments was recognised. The Crown as purchaser, could increase the output appropriations paid to a department or, as owner, it could let the department incur a loss. The manner in which the cost is borne was considered likely to affect the amount of the cost involved. The report concluded that whichever party is best able to minimise the costs should bear the risk. The department was thought best able to bear all costs except for changes in output requirements which would be the purchaser's risk (p. 156-159).

Project 4: Accounting measures and valuation

Project 4 (p. 163-214) identified the setting of accounting standards as "central to accounting developments affecting government departments" (p. 177). It included advice from consultants who considered the Public Finance Act's requirement for government financial reporting practices to be in accordance with generally accepted accounting practices (GAAP) recognised in New Zealand as appropriate for the public sector (p. 181).[23] They urged attention to those practices and particularly to the public sector accounting concepts that had been developed in New Zealand two years earlier (p. 182-187). The concepts proposed different accounting treatments for those government entities undertaking commercial activities and those undertaking non-commercial, service-oriented activities. The consultants argued that the distinction between commercial and non-commercial activities was "conjectural" because the act intended a businesslike approach to all government activities, and therefore viewed all government activities as commercial (p. 184).

The project report recognised that performance assessments in the newly-decentralised environment would rely on financial reports, that financial reports are a function of the particular accounting policies adopted, and that without some restriction on the range of accounting policies available to departments, chief executives would select policies to benefit themselves (p. 188, p. 199-200). Accounting policies should, therefore, be restricted, and monitoring and auditing included in the assessment process (p. 202).

Particular performance indicators were also considered. There was "no doubt" that "at least marginal efficiency savings can be made cumulatively and progressively, each year, for a considerable time". Arguably, such savings should be rewarded instead of imposing the traditional budget cuts, and it was proposed that departments be offered an incentive to produce a surplus (p. 168). The amount and state of fixed assets and the optimal use of working capital were

[23] This was prior to the Financial Reporting Act 1993.

thought likely to help with performance assessment from the owner's perspective (p. 164-169).

Project 5: Incentives for chief executives

The question of how to motivate a chief executive was the topic of project 5 which recognised that chief executives' commitment to a particular service objective could mean that performance-linked compensation packages would not necessarily motivate them (p. 215-253). Such compensation was considered acceptable for chief executives in commercially-oriented departments where the financial objective was considered appropriate, but counter-productive for those in the non-commercially-oriented departments where services and ethics were important (p. 241). Three pre-conditions for linking chief executives' performance with their compensation were: that the performance be measurable; that the performance be under the control of the person concerned; and that the process of assessment and pay variation be perceived as legitimate (p. 224-227).

Senior managers' review of the *Report on Departmental Incentives*

Shortly after completion of the *Report on Departmental Incentives*, senior managers within Treasury met to consider the report's implications for system developments. The early intention for Mode B departments was that they would not receive the full amount of output appropriations, and that cash would be held centrally, but this was "partway between input controls and incentives on outputs". Movement in one direction or the other was considered necessary, with a preference for movement towards incentives on outputs (Treasury, "Minutes of meeting of senior managers, 10-30am Wednesday 22 November 1989", Treasury files).

Output-contestability was considered desirable but it required detailed output specifications, pricing developments and a capital charge. At some distant point in the future, further specification detail would not be warranted, and it was noted that any technique, including accrual accounting, should not be pushed beyond its usefulness at an acceptable cost. Departments had already been required to absorb the cost of conversion to new systems and a recent increase in goods and services tax (GST), and they suspected that introduction of a capital charge would impose

further costs. Because the financial management system developments needed to be politically acceptable, departments had been told that they would soon receive proposals on incentives, and that interest would be included. The early introduction of the capital charge was desirable but, to avoid imposing excessive pressure, the other incentives would be introduced more slowly (Treasury, "Minutes of meeting of senior managers, 10-30am Wednesday 22 November 1989", Treasury files).

Surplus retention was a relatively minor issue because extraction of the capital charge amounted to a pre-determined dividend. Well-defined and appropriately priced outputs would limit any reported surplus to super-profits which would be small. A large reported surplus would reveal excessive prices which might, otherwise, remain invisible and allowing surplus retention would provide an incentive to reveal surpluses (Treasury, "Minutes of meeting of senior managers, 10-30am Wednesday 22 November 1989", Treasury files).

Table 6.1 Summarised findings of projects

Project 1: Capital charge
1.1 Capital charge
1.2 Realistic asset valuations
1.3 Interest payments
1.4 Output prices adjusted to include capital charge
1.5 Use of departmental cash flows for minor and replacement asset purchases
1.6 Detailed ownership contract to form part of departmental corporate plan
Project 2: Output pricing, monitoring, payment
Output definition
2.1 Output types: policy advice, administration of regulations, administration of funding, service delivery
2.2 Outputs specified in detail, unit prices and quantities, attributes, standards, performance measures
Output pricing
2.3 Price and cost separation ideally with contestable output pricing. Project 2.2 essential to this.
2.4 Pricing rule when non-contestable: benchmarks, margin over variable costs, expected standard costs, efficiency dividends. Project 2.9 essential
2.5 Regular performance audits to check pricing rules
2.6 Detailed costing systems a priority
2.7 Departments bear risk of controllable costs, ie most risks except government policy changes
2.8 Long term contracts, multi-year appropriations where transaction-specific assets involved
Contract enforcement
2.9 Enforcement of output delivery
2.10 Payment on delivery for amount of output delivered. Project 2.2 essential to this
2.11. Departments and CEs penalised for failures rather than beneficiaries
Budgeting processes and monitoring
2.12 Department, vote ministers propose output purchases, provide disaggregated information
2.13 Decentralised evaluation of outputs where possible, including self-monitoring
2.14 POBOCs presented in estimates by output class
2.15 Corp. plan consistent with budget, output agreement, ownership contract, business plan
Project 3 Risk assignment for purchases
3.1 Departments as providers bear risk of controllable costs
3.2 Government as purchaser bears cost of changes in output requirements
Project 4 Accounting measures
4.1 Restrict accounting policies
4.2 Incentives to produce a surplus
4.3 Ownership measures: Encourage optimal use of working capital, information about amount and state of fixed assets, productive efficiency, eg return on investment
4.4 Auditing and monitoring
4.5 Rejection of distinction between commercial and non-commercial activities
Project 5 Incentives for chief executives
5.1 Performance-pay link for chief executives appropriate in commercially oriented departments.
5.2 Preconditions: unbiased performance measures without significant measurement error; performance under control of person concerned; legitimate assessment, pay variation processes

Particular incentives projects

Evidently, the *Report on Departmental Incentives* provided ideas for subsequent incentives projects but not for a recent project led by the State Services Commission. Four major Treasury-led incentives overviews drew together under a particular title, or theme, a series of ongoing smaller projects. These overviews indicate the general intent and role of the smaller projects.

The "incentives for departmental performance" theme (1989-1991)

The project reports in the *Report on Departmental Incentives* link directly to the projects contained under the "incentives for departmental performance" theme. The individual projects were to be implemented in five phases, the first of which was development of the general incentives model, government approval, and its announcement to chief executives in December 1989. Apparently, the announcement proposed that "departments should be able to choose whether to retain any net surplus" and advised of the implementation phases, suggesting that surplus retention would be included in phase two (The Treasury, TC1990/13, 25 October 1990, p. 4, p. 14).

Phase two: interest payment/capital charge regime

Phase two developed the interest payment and capital charge regimes, and reconsidered the retention of surplus. A project report was produced in April 1990 and the proposed implementation of these incentives was announced in October 1990, shortly before the general election. According to the project report, the financial management reforms implied that departments could hold money on which they might earn interest, but the Crown was a net borrower rather than a net investor. Unless the Crown had access to all public money, it would be forced to borrow while departments held cash reserves. The centralised cash management system therefore regarded "all the cash as the Crown's rather than a department's", but it was recognised that payment to departments of a "working capital bonus" would provide an incentive to departments and contribute towards competitive neutrality conditions because of private sector counterparts' ability to earn interest. The amount of any such working capital bonus would be an "administrative cost of FMR" (Treasury, 10 April 1990, Incentives project phase 2: capital charge/interest regime, position paper 4, p. 2, Treasury files). Departments were advised that they would receive interest on their surplus cash and reminded that if they wanted to spend that interest on outputs an appropriation would be required (TC 1990/13, 25 October 1990, Treasury files).

Any capital charge rate was preferable to no capital charge, but there were three options for determining the capital charge rates. These ranged from a

different rate for each investment, which was the ideal, through a rate specific to each department, to a single rate applying to all departments. Competitive neutrality and comparability were important where competition was possible, but not an issue for "long term Mode B departments", those departments providing policy advice, administering transfers and government regulations.

Competitive neutrality principles required consideration of the appropriate asset base on which the capital charge should be levied. Under generally accepted accounting practices (GAAP), reliance on historical cost reporting was noted, as was controversy over intangible assets. Although logic dictated that departments should report all assets, including intangible assets, at market values, such a valuation requirement imposed on departments would breach GAAP, prevent comparability with the private sector, and, potentially, bring the financial management reforms into disrepute. Implementation of the capital charge on a historical cost basis was proposed with later reconsideration of asset values (Treasury, 10 April 1990, Incentives project phase 2: capital charge/interest regime, position papers 1-3, Treasury files).

Departments were advised that the capital charge for all departments would be imposed at a rate "appropriate to each department", the rate of a "private sector counterpart". They were also advised that they would be "funded for the full price of outputs supplied to the Crown, rather than only for the cash required to produce their outputs" (TC 1990/13, 25 October 1990, p. 7, 15, Treasury files).

From the Crown's perspective, the capital charge would represent "the return available from an alternative investment of similar risk". After a capital charge, any operating surplus would be small but that too belonged to the owner, the Crown. If withdrawn automatically, managers might not report a surplus, whereas if reinvested in the department it would not prompt inefficient output production because "by definition retained surpluses are an investment by the owner and therefore must stay on the balance sheet (be used for working capital or fixed asset purchases)". The benefit of allowing surplus retention would be the positive behavioural response prompted but delaying surplus retention would be more beneficial by providing departments with an incentive to cooperate with phase three. The Treasury sought reassurance about the validity of any reported

operating surplus, arguing that the prices and costs of outputs should be separated before allowing departments to retain any operating surplus (Treasury, 10 April 1990, Incentives project phase 2: capital charge/interest regime, position paper 6, p. 2, Treasury files). Departments were advised that allowing surplus retention as part of phase two was inappropriate because of the need to separate costs and prices (TC 1990/13, 25 October 1990, Treasury files).

With the implementation of accrual accounting and the introduction of appropriations for outputs, all departments received mode B output appropriations for all outputs. The project report proposed that departments could adopt the capital charge and interest regime quickly, but that any department using the default rate should not be allowed to progress to mode C appropriations. Intentions were that departments could not shift from mode B appropriations to mode C until their operations met several criteria, including detailed specification of outputs, a determinable date of delivery of outputs to establish both revenue recognition and payment date, a rigorous cost accounting system, and output prices which allow a department to achieve breakeven after the capital charge, but stated on a unit price basis (Treasury, 24 October 1990, An overview of Mode C, Treasury files).

The announcement of the phase two development contained advice that phase three, which was underway, was the separation of the price and cost of outputs, departments paid the price on delivery, instead of being advanced amounts with which to incur costs, and detailed output specifications. In addition, subject to Ministerial agreement, departments would be allowed to retain surpluses. The fourth and fifth phases were incentives to reward chief executives and their staff for good financial performance, and incentives for the good management of transactions on behalf of the Crown, such as payment of benefits (TC1990/13, 25 October 1990, Treasury files). Table 6.2 summarises the projects contained within the incentives for departmental performance theme, with the numbers referring to the numbers in the Table 6.1 summary of the *Report on departmental incentives*.

Table 6.2 Projects contained within the Incentives for Departmental Performance Theme

Phase 2: Capital charge and interest regime
1.1 Capital charge
1.2 Realistic asset valuations if necessary
1.3 Interest payments
1.4 Full price of outputs to be paid to departments
Phases 3, 4, 5
2.2 Outputs specified in more detail than output class, including quantities, attributes, standards, performance measures
2.3-2.4 Separation of output price and cost
2.10 Payment on delivery for amount of output delivered,
4.2 Incentives to produce a surplus (retention of surplus with agreement of responsible minister)
5.1 Performance pay link for all chief executives
New: Incentives related to receipts, payments, assets and liabilities managed by departments on behalf of the Crown

Change of government, review of reforms and a new incentives project

Following the 1991 review of the State Sector reforms, the Logan report made 40 recommendations about the reformed public sector, some of which related to the incentives projects. These included strategic aspects such as the need for centralised direction-setting in the newly de-centralised environment (recommendations 4 and 5); suggestions for developing the contractual relationships between ministers and department chief executives through formal performance agreements, departmental operations agreements containing the output agreement and ownership agreement, and some way of recognising the collective interest (recommendations 6 and 8).

Recommendations about the capital charge regime and the budgeting process covered concerns about implementation of the capital charge regime and the method used to calculate the charge (recommendation 31); and the need for coordination of the budget process, including criteria and standards for assessment of departmental expenditure, a resource allocation process for the government's capital investment decisions, and guidelines for departments on their capital expenditure decisions (recommendation 29).

The Logan report noted disputes between departments and the Treasury over specifications of outputs and output classes.[24] Departments sought a clearer process involving the chief executive and minister. The report recommended that the Treasury convene a working party, which would include some chief executives, to establish the principles for "defining output classes at an appropriate level of aggregation, developing associated performance attributes and specifying outputs at lower levels of aggregation". It also recommended the development of guidelines for the "process of negotiating the output specifications, particularly the negotiation of changes to output class structures and associated attributes" (recommendation 28). The report also recommended further, faster development to departments' cost allocation systems (recommendation 30), and the delay of further changes to the existing incentives, such as allowing departments to retain operating surpluses, until completion of the work on output specifications and pricing (recommendation 32). Table 6.3 summarises the relevant projects contained within the Logan report, with the numbers referring to the numbers in the Table 6.1 summary of the *Report on departmental incentives*.

Table 6.3 Logan report recommendations

Logan committee recommendations
1.1 Capital charge (implementation and calculation concerns)
1.5 Guidelines for departments on capital expenditure decisions
1.6 Statement of departmental intent containing output agreement and detailed ownership contract as part of departmental corporate plan
2.2 Output specification - clarification of output and output class definitions and processes to change them
2.6 Detailed costing systems: faster development
2.12 Coordination of budget process
4.2 Incentives to produce a surplus (withheld until completion of output definitions and price and cost separation
5.1: Chief executive performance agreements
New Recognition of collective interests
New: Centralised direction setting, including collective interest

Following the Logan report, reference to incentives for departmental performance ceased, as did reference to financial management reforms. The Treasury, the State Services Commission and the Department of the Prime Minister and Cabinet, in their response to the Logan report's findings, adopted a

24 This dispute was noted earlier. The Treasury viewed its role as negotiating “correct technical specification of output classes”, while departments opposed the Treasury’s attempts to obtain information at a sub-class

"forward looking" stance, seeking to "put Ministers back in the picture of what departmental management under the new public sector framework is all about". They presented the ongoing work as change management, and used the term departmental management in preference to financial management reforms (Treasury, "Strategy for refinement of departmental management", 19 October 1992, p. 2, Treasury files). The ongoing collection of incentives projects, together with additional tasks recommended by the Logan report, became known as "departmental management initiatives" (Treasury, "Strategy for refinement of departmental management", 19 October 1992, Treasury files; T92/3696, 4 December 1992, Richardson files 804).

Departmental management initiatives (1992-1994)

The departmental management initiatives report explained that the reformed public sector management system was still developing. It identified several projects being developed jointly by the Treasury, the State Services Commission, and the Department of the Prime Minister and Cabinet. Particular work intended to assist with that development and in progress at the time included (Treasury, T92/3696, 4 December 1992, Richardson files 804):

- output specification (and pricing) particularly the use of purchase agreements;
- purchase advisors to provide support to Ministers;
- improved CE performance specification and assessment process for departmental management;
- management development programme;
- cost allocation;
- capital expenditure review;
- capital charge refinements; and
- treatment of surpluses and deficits.

All of these projects were important and interrelated but two, the development of output specifications and pricing, and the chief executive performance specification and assessment, were particular priorities, while accelerated progress on cost allocation was also necessary.

The prioritised tasks were progressing. Output specification improvements and the introduction of purchase agreements were intended for the 1993 budget round. Improvements in pricing, or the ability to compare costs, would complement those

level (T90/N12, 7 November 1990, Richardson files 758, p. 4).

developments. The improved information would allow inter-organisational comparisons of similar outputs, or application of pricing formulae. A pilot project to review the specification and pricing of policy advice was recommended (Treasury, T92/3696, 4 December 1992, Richardson files 804).

Specification and assessment of chief executives' performance would enhance chief executives' motivation to produce the required quantity and quality of outputs at the least cost, while the refinement of cost allocation systems would help to integrate this new system of departmental management. Recent Audit Office comment about departments' costing systems was considered to provide support for the development of standardised cost accounting in the public sector.

Proposed programme

The report on departmental management initiatives recommended that the overall work programme be noted, but that "robust output specification and pricing and an improved chief executive performance assessment process" be prioritised. These priorities would be advanced by restricting the focus on output pricing to phasing in "on a case by case basis where this represents a cost effective opportunity for getting better value from purchasing for Government" and then developing during the 1993/94 budget round a "recommended approach for pricing policy advice outputs"; devising specification and assessment procedures for chief executive performance; and undertaking a work programme on standardisation of cost accounting practices, aiming for full implementation in June 1994 (Treasury T92/3696, 4 December 1992, Richardson files 804; STA (92)258, 8 December 1992, Richardson files 1013; STA(92)M42/3, 9 December 1992, Richardson files 1011; ECC(92) 428, 11 December 1992, Richardson files 955; ECC(92)M55/19, 15 December 1992, Richardson files 956; CAB(92)M52/16q, 21 December 1992, Richardson files 875). Table 6.4 summarises the projects contained in the departmental management initiatives summary, with the numbers referring to the numbers in the Table 6.1 summary of the *Report on departmental incentives*.

Table 6.4 Departmental management initiatives project summary

Departmental management initiatives
1.1 Capital charge (refinements, including pilot of department-specific rates)
1.5 Use of departmental cash flows for asset purchases
2.1 -New Purchase advisers (part of policy advice, as described)
2.2 Output specification - detailed - **priority**
2.3-2.4 Output pricing - pilot project on policy advice - **priority**
2.6 Detailed costing systems: standardisation - **priority**
2.15 Use of purchase agreements
4.2 Incentives to produce a surplus (treatment of surpluses and deficits)
Project 5 Incentives for chief executives: performance specification and assessment: **priority**
New Management development programme

Financial management initiatives - next steps (1994-1995), and efficiency and innovation (1995-96)

Following a close general election result in 1993, Ruth Richardson was replaced as Minister of Finance and the government softened its earlier approach to privatisation as a role of government issue. That approach had been associated with her (Scott, 2001). Several months prior to that election, the Treasury had proposed developing a "more sophisticated approach" to its advice on expenditure and departmental performance (T93/233, 10 February 1993, Richardson files 1093). Arguing that "achieving the Government's economic and fiscal strategy requires both macro stability and a competitive enterprise economy" (p. 1), the Treasury argued that the Government needed to focus on (p. 1):

> Improving the continuing serious fiscal situation;
>
> Improving public sector performance, including the quality of expenditure and services provided by the public sector;
>
> Improving the effectiveness of expenditure control and improving decision-making about expenditure priorities; and
>
> Managing fiscal risks through the use of the financial management tools that have been developed.

Although the achievements of the financial management developments to date were considerable (p. 2):

> regardless of the fiscal situation, there is an ongoing need to ensure high quality government expenditure. This will require improving the quality of public sector expenditure decisions and ensuring departments deliver the services demanded by the public at significantly reduced costs. Achieving both of these objectives will require increasingly sophisticated analysis and argument by both the Treasury to the Ministers and by the Minister of Finance within Cabinet.

The Treasury argued that the minister's ability to impose fiscal restraint required more a more sophisticated strategic approach to the Treasury's vote analysis function which the Treasury argued was core business for any finance

advisory ministry. This proposed development, which was "at the forefront of public sector management" did not imply a "return to centralised input controls, though we may need to examine inputs in our analysis" (p. 5). Although departments' chief executives were responsible for decisions about departmental management, the Treasury's advisory function was defended as within the Treasury's mandate with the argument that the Treasury is "in the business of providing a <u>second opinion</u> to the Minister of Finance, Ministers collectively, and sometimes to the Responsible Minister, on the options put forward by the chief executive and his or her performance" (p. 6, emphasis in original). A common vocabulary was required for this development (p. 6).

Incentives projects around this time seemed to be centred within the Treasury and conducted at a less formal level, without the announcements to departments that characterised the earlier projects. The developments of 1994-1996 under the financial management initiatives theme exemplify this. The Crown financial reports for the year ended 30 June 1994 reported a surplus for the first time. One of the project papers under this theme commented that until then, attention had been focused on expenditure control achieved by imposing across-the-board expenditure cuts and financing any new initiatives by reprioritising existing expenditure. The reported surplus brought "suggestions that the focus should shift" away from cost reduction and revealed differing views within Treasury about the nature of the financial management system and appropriate developments (Treasury, 30 November 1994, Surplus retention, FM/2/19, Treasury files; Gorringe, 1995a; 1995b). (This opposing view is considered in more depth in Chapter 8).

The view which predominated "postulated" that the financial management system was intended to impose "downward pressure on spending", to prompt the identification of expenditure priorities thus allowing existing expenditure to be reallocated to high priority areas, and to protect the Crown's ownership interests (Treasury, 30 November 1994, Surplus retention, FM/2/19, Treasury files). Continued pursuit of these intentions while the Crown reports operating surpluses required retention of the existing controls and incentives, and four improvements to the "Government's managerial leverage" (p. 3): improved purchase decisions; more focused monitoring; enhanced chief executive performance contracting; and

surplus retention (Treasury, 30 November 1994, Surplus retention, FM/2/19, Treasury files).

Improved purchase decisions

"Better output specification and more reliable departmental costing systems" would improve both purchase decisions and performance assessment, while the introduction of pricing and payment for outputs only on proof of delivery would further improve the system. By devising "standard specifications for particular generic outputs at the lowest level of detail", which is the "activity", or "intermediate output" level, increased "purchase pressure between ministers and departments" could be achieved. These detailed specifications would support cost benchmarking and competitive bidding, thus driving "efficiency from within the department" and allowing reductions in "intrusive" central agency monitoring (Treasury, 09/95, "Coopers & Lybrand 1995 review of costing systems and user charges", p. 8, Treasury files; Treasury, 30 October 1995, Financial management initiatives - the next steps FM/21, p. 2-3).

The proposal to introduce pricing for application to both final outputs (ministers' purchases) and intermediate outputs required the use of departments' cost information in price negotiations between the Treasury and departments (Treasury, 12 November 1993, FM/2/13, Treasury files; Treasury, 24 October 1995, FM7/4, Treasury files). Because all departments received mode B output appropriations for costs, the proposed price negotiations conducted within the appropriations implied that prices could not exceed costs but could be less than costs. A pilot pricing project with the Customs department was under way, and further pricing/benchmarking pilots conducted over two or three years, and focused on large scale processing-type transactions and investigatory work such as auditing and surveillance, were recommended (Treasury, 30 October 1995, FM/21, p. 2-3; Treasury files).[25] Payment on delivery was also tested with some target departments and the recommendation made that all government departments be paid in arrears (Treasury, 30 November 1994, Surplus retention, p.

[25] Evidently the pilot project stalled, with fractious relationships developing between those involved (Treasury, Output pricing/baseline reviews, Treasury files).

4-5, Treasury files; Treasury, 21 November 1995; Vote analysis: priorities over the next two years, Treasury files).

Actual competition, demonstrating a credible intention to award contracts to the most efficient supplier, was proposed. This would be easiest for standard services, and practical, but more difficult, for professional services. Success in this development required preventing departments from defining or grouping outputs in ways likely to discourage alternative suppliers, and prompting ministers and departments to purchase from the cheapest source. This development would raise ownership issues because loss of contracts would cause financial problems for departments, and reduce their future ability to perform those functions (Treasury, 24 October 1995, Efficiency and innovation in the public sector, FM/7/4, p. 5, 20, Treasury files).

Enhanced chief executive performance agreements

Chief executive cooperation with this purchasing development would be obtained through "more powerful, and more effective, rewards and sanctions" for chief executives, including increased financial rewards, together with more comprehensive Treasury input into chief executives' performance assessments. Despite acknowledgment of the questionable political acceptability of personal financial incentives, this was proposed as further work for the State Services Commission (The Treasury, 30 November 1994, Surplus retention, p. 6, Treasury files).

More focused monitoring

The 1993 proposal for more focused and more sophisticated monitoring sought strategic assessments, purchase agreement assessments, including ministers' purchase options, and ex-post assessments of departments' performance in relation to purchase, ownership and financial management obligations, thus allowing more comprehensive Treasury input into chief executive performance assessments. Arguably, the improved monitoring and assessment would generate savings but it required ministerial support because of departmental opposition to intrusive monitoring and to the Treasury's involvement "in issues where we have no mandate" (T93/663, 24 March 1993, Richardson files 815).

The 1994 and 1995 proposals for more focused monitoring again promised savings, with maximum leverage achieved by shifting the "burden of proof" onto departments. Purchase-related monitoring would include benchmarking and checking alignment between departments' key result areas and the government's strategic result areas. Ownership monitoring would focus on the "long term demand for departmental outputs; the overall level of Government investment in each department; the organisational structure of departments; management capability; long term resource requirements; and ownership risks" (Treasury, 30 November 1994, Surplus retention, p. 5, Treasury files). This monitoring would be "enhanced by the use of internal bench-marking practices" (p. 5). Special project teams within Treasury would target large balance sheet departments and focus on the "management efficiency of assets", "examine the risks of owning departmental assets, and minimising that risk where possible . . . [thus providing] vote teams better levers to move a number of these risks outside of the Crown" (Treasury, 21 November 1995, Vote analysis priorities over the next two years, Treasury files, p. 3-4).

These proposals caused some concerns because the Treasury lacked sufficient skilled analytical staff. This left monitoring and analysis to the Treasury's relatively junior, unskilled vote analysis staff who were difficult to retain. Despite recognition that the "legislative framework and existing systems/products provide a number of tools and a considerable amount of information", departmental financial managers were "increasingly sophisticated" while the Treasury's vote analysis credibility was doubtful. Consequently, the key issue was the Treasury's ability to use the information available from the financial management system. Once again, the recruitment of more experienced staff, and creation of a project team to "update the financial profile and analysis of each vote and establish a regular and probing monitoring regime based around agreed key indicators" was proposed (Treasury, 12 December 1995, Vote Analysis: a strategy for lifting our game, p. 2-4, Treasury files).

Retention of surplus

Partial surplus retention was proposed to help the Crown "achieve advantages it would not achieve through the continued use of existing management tools"

(Treasury, 30 November 1994, Surplus retention, p. 8, Treasury files). Those departments receiving payment for their outputs either on delivery or in arrears could retain a portion of interest earned.[26] This would require reducing their budget baselines by the amount of their forecast interest and allowing the difference between forecast and actual interest, whether positive or negative, to remain with those departments. Departments might also retain a percentage of their reported surplus, with the "surplus eligible for retention" excluding "other expenses and ownership gains" but including "interest income, profits on sale of fixed assets and realised revaluation gains" (Treasury, 23 February 1995, Surplus management, p. 6-7, Treasury files).

Internal Treasury consultation revealed scepticism about this surplus retention scheme in the absence of "significant improvements in output specification and performance monitoring". Some portion of a department's surplus could reward departmental staff but preconditions for surplus retention were "adequate specification of outputs, monitoring of delivery of outputs (including payment on delivery), and demonstration of value for money in the pricing of outputs". Treasury senior management were not convinced that these preconditions could be met by all departments and required system developments to focus on incentives for chief executives and other enhancements to the existing system (Treasury, 7 December 1994; Surplus management, Treasury files; Treasury, Surplus management, 23 February 1995, Treasury files; Treasury, 27 February 1995, Minutes of senior management meeting, Treasury files). Table 6.5 summarises the projects contained in the financial management initiatives summary, with the numbers referring to the numbers in the Table 6.1 summary of the *Report on departmental incentives*.

[26] At the time of this proposal, only four departments received payment on delivery or in arrears. Although all departments received interest on surplus cash as part of the 1991 capital charge development, at the end of each financial year they were required to repay to the Crown the full amount of any interest revenue. This is explained in Chapter 9.

Table 6.5 Financial management initiatives summary

Financial management initiatives - next steps
2.2 Output specifications: further improvements
2.3 Separation of price and cost: contestable output pricing through competitive tendering.
2.4 Controls over departments' access to resources (via efficiency dividends)
2.4 Pricing rule for non-contestable pricing, price separated from cost, benchmarks
2.10 Payment on delivery for amount of output delivered
2.15 Use of purchase agreements (for benchmarking, prioritisation)
2.15 ownership requirements
4.2 Incentives to produce a surplus (allow departments to retain if achieved advantages for Crown)
Project 5 Incentives for chief executives: chief executives and assessment
New Tailored monitoring: alignment of KRAs and SRAs
New: Focus on management accounting information

CAP project (1998-)

The State Services Commission-led CAP (Capability, Accountability and Performance) project resulted from concerns expressed by the State Services Commission about departments' reducing capability, and the desire of the Minister of State Services for a balanced appraisal of departments. It involved the State Services Commission as the lead agency, working jointly with the other two central agencies, the Treasury and the Department of the Prime Minister and Cabinet.

The Minister of State Services argued that the attention paid to purchase interests left an institutional gap in relation to the ownership interests: ministers did not understand their ownership responsibilities and lacked analytical support; departments were subjected to continuous extraction of efficiencies without any assessment of expected future demand or their capability requirements; and there was no "coherent ownership strategy for the core state, but a tendency to tinker at the margin without really knowing the implications for organisational capability" (T98C/2349, 17 July 1998, Treasury files; STR(99)153, 13 July 1999, FM/2/12/8, Treasury files; STR(99)M17/12, 14 July 1999; Treasury files; CAB(99)M20/15, 23 August 1999; Treasury files).

This development led to the debate over capability and the financial management system which prompted this research (see Chapter 1). The Treasury's contribution to the debate argued that the "basic public sector management framework is sound, but there need to be some major changes in the way that it is implemented". According to the Treasury, the perceived problems result from

misperceptions of the system and may be addressed by "adopting a more sophisticated or flexible view" of how the system should operate (Treasury, 30 March 2000, "It's information Jim, but not as we want it!" p. 4, Treasury files). The State Services Commission, however, was dissatisfied with the system's operation. The introduction of output price reviews in 1996 brought the State Services Commissioner's role to review the machinery of government into the financial management system but, by late 1998, the Commission argued that the output price review process, although "used as a means for intensive assessment and remedy of critical ownership risks within departments", generally resulted in recommendations to reduce business scope, reduce low priority outputs, and divest physical assets to allow funding of investments in human resources and business infrastructure. The Commission argued that options presented to ministers should not necessarily require such reductions (State Services Commission, 11 December 1998, "Future Application of output pricing reviews: incentives, options and strategies" Treasury files).

The State Services Commission also disagreed with the Treasury's view that the basic system is sound, arguing instead that the system provides only weak support for goal-setting; is focused on prior, overly-detailed specification of outputs; and focused on financial performance issues with little attention to whether non-financial performance, that is, effective delivery of outputs occurs. In summary, the system is over-wired because "changes have been built onto what is current, and very little has been taken down", thus obscuring and weakening "the essential architecture", and it may contain "deeply inherent flaws" (State Services Commission, 2000, "Response to the Treasury working paper of 30 March 2000: "It's information Jim, but not as we want it!" p. 3, State Services Commission files).[27] Acknowledging a growing awareness that the Treasury's "starting point for analysis" differed from its own, the State Services Commission disputed the principal-agent model, which expects unprincipled behaviour in a system that should promote principled behaviour.

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[27] Stated examples of the flaws in the system included the focus on outputs, the preoccupation with prior specification of contracts and inattention to delivery, excessive detail and excessive focus on financial matters, and connotations of the language such as apparent indiscriminate use of cost, expense and price, with price, which "supports the 'free market' analogy" predominating.

The State Services Commission proposed re-interpreting the system, partly by changing the language to make it "comparatively neutral", and by realigning the biases currently favouring outputs and purchasing, quantifiable information, short-term imperatives and documentation. Shifting the emphasis would unravel the owner-purchaser distinction, allowing its replacement with a plain English temporal one, viz. the current and capability distinctions proposed by the Controller and Auditor-General in 1999 (State Services Commission, 2000, "Response to the Treasury working paper of 30 March 2000: "It's information Jim, but not as we want it!" p. 9, State Services Commission files).

The CAP project attempted to develop an alternative "high level analytical framework" within which "the interaction of [departmental] strategy, capability and performance" is the central concern. It seemed to focus on changing the documentary and reporting processes to reduce "the clutter and cost of the present accountability system" and, following the findings of a report it commissioned on capability problems and the budget system, the State Services Commission agreed that the "CAP project does not need to seek modifications to the Budget process". This was because the budget system contains processes to inject capability, including "output price reviews, capital bids, or other capability-based resource bids" (STR(99)242, 4 October 1999, FM/2/12/8, Treasury files; State Services Commission, 29 February 2000, The ownership interests of ministers, and the State Services Commission's role, FM/2/12/8, Treasury files; State Services Commission, 7 December 2000, CAP Analytical Framework; State Services Commission files; Ferguson, 28 June 2001, "Capability problems and the budget system", State Services Commission files; State Services Commission, August 2001, "State Services Commission view on capability problems and the budget system, State Services Commission files).

Earlier differences between the two central agencies over the financial management system appear to have been reconciled. In late 2001, the chief executives of all three central agencies — the Treasury, the State Services Commission, and the Department of the Prime Minister and Cabinet — reassured the government that the public management system "as it stands today provides a reasonable platform to work from" for the government to achieve its objective of maintaining and strengthening the public sector (Advisory Group, 2001. p. 4, 10).

Value-for-money (1998-)

The Treasury's current incentives development also seems to have commenced in 1998 when the government devised a set of over-arching goals to which it sought to align its strategic results areas (SRAs). One of those SRAs related directly to the financial management system, aiming to "encourage the contestable supply of resources and services in areas of public sector responsibilities". This SRA required the development of principles to guide public sector decisions and open opportunities for private sector supply", and "pricing policies for public sector". The decision to encourage the contestable supply of services required the development of principles of competitive neutrality and the idea of price competition between sectors (T99C/305, 23 February 1999, Treasury files).

When the government changed in late 1999, the Treasury outlined its involvement in projects, all of which were intended to improve value-for-money in the public sector. In this context, value-for-money was explained as a function of four key dimensions: efficient cost management focusing on least cost production; effective purchasing of outputs intended to achieve the government's aims; robust capability to continue producing the most effective outputs; and innovation through new outputs and new ways of delivering them (T99/61, 20 December 1999, Treasury files). Within this value-for money theme the earlier criticism of the system was acknowledged:

> In our view the key issue is not whether the system needs another round of fundamental reform. We do not think it does. More progress is necessary, but will go further and faster if it builds on the solid foundation provided by the current system. The key issue is what needs to be done within the current framework to ensure sustained improvements in performance. (T99/61, 20 December 1999, p. 5, Treasury files).

Ten projects were listed: a review of accountability documentation; a crown entity initiative; shared services/ outsourcing/ smart purchasing; E-government; Public Audit Bill; capability pilots (with the State Services Commission); competitive neutrality; efficiency and effectiveness initiative; budget process design; and a review of departmental incentives. The last five of those are considered here.

The Treasury argued that notwithstanding acknowledged measurement difficulties, "maintaining capability is a core responsibility of every Chief

Executive. Capability is a function of management performance as much as it may also be a function of output prices and resourcing" (T99/61, 20 December 1999, p. 7, Treasury files).

Competitive neutrality, the efficiency and effectiveness initiative and budget process design may be viewed as part of the budgeting/purchasing process. The Treasury proposed re-orienting competitive neutrality towards value-for-money and explained the other two projects as initiatives intended to enhance value-for-money. The budget process design would provide "incentives and opportunities for ministers to consider the value-for-money in the use of both existing and new resources". This would involve a limit on new resources through a counting framework, and collective review mechanisms designed into the budget process. The efficiency and effectiveness initiative seemed to represent the nature of the collective review mechanisms. This initiative sought to put "the onus of proof on departments rather than central agencies in resourcing disputes" and to develop techniques for "departments to better quantify and evaluate the value of the outputs they produce". Collaborative work between the Treasury and pilot departments was in process (T99/61, 20 December 1999, Treasury files).

The Treasury acknowledged the need for alignment of the incentives designed into the financial management system with the system's "external objectives" and sought to refine the existing incentives (T99/61, 20 December 1999, Treasury files). This review project was eventually called the departmental incentives for good financial management project. The overview of this project explained that only the first phase of the 1989/90 incentives for departmental performance set of projects was ever implemented. Development stopped because "the quality of departmental output specification, pricing and monitoring of delivery never reached the standards contemplated by the general incentives model. Notwithstanding this, many departments still regard this, and particularly the lack of a surplus retention policy, as unfinished Treasury business" (p. 9). Lack of progress with surplus retention resulted from the difficulty of differentiating "between genuine efficiency gains and under-delivery or cost-shifting. There were also concerns that any surplus would tend to be put to low value uses" (p. 9).

The overview also explained that the range of rules which limit the amount and use of resources available to departments are intended to help the Crown protect its financial interests. Many of those rules are "relatively blunt instruments" and potentially dysfunctional (The Treasury, 30 June 2000, T2000/1361, p. 2). Examples of dysfunctional behaviour prompted by the rules included departments' tendencies to spend available resources at the end of the financial year, to hold more capital than necessary, and to over-recover costs from third parties (p. 5). That dysfunctional behaviour may be reduced by reconsidering the surplus retention policy, revising the capital charge, allowing departments to offset their capital charge with interest earned, increasing the use of multi-year appropriations, allowing some form of overdraft or early access to funds to resolve timing issues, and reconsidering the manner in which cost over- and under-recoveries operate. Work on this aspect of the departmental incentives project is ongoing. The surplus retention and interest proposal are similar to those of 1995: identification of a portion of reported operating surplus that may be retained subject to conditions on use; and a deduction from departments' budget baselines of a normalised level of interest earnings, and subsequent adjustment of any difference between that normalised interest and the actual interest adjusted against the capital charge (Treasury, 11/00, "Better working capital management consultation document", Treasury files). Table 6.6 summarises the projects contained under the value-for-money theme, with the numbers referring to the numbers in the Table 6.1 summary of the *Report on departmental incentives*.

Table 6.6 Value-for-money summary

1.1 Revision to capital charge
1.3 Reconsideration of interest: use to offset capital charge
2.8 Multi-year appropriations
2.15 Development of earlier ownership requirements through cost effectiveness and capability dimensions
4.2 Incentives to produce a surplus
New Overdraft or early access to funds to address timing issues.
New Cost over- and under-recoveries
New Budget process design

Chapter summary

This chapter has outlined the contents of an ongoing series of incentives projects conducted either jointly by Treasury and the State Services Commission, with the involvement of the Department of the Prime Minister and Cabinet, or separately by the Treasury or the State Services Commission. In the early stages

of the reforms the work was clearly joint, deriving from the jointly-commissioned *Report on Departmental Incentives* and leading to the projects encompassed under the incentives for departmental performance theme and the departmental management initiatives theme with the addition in the latter theme of some developments proposed by the Logan report.

In 1993, the Treasury seemed to be working alone in seeking to adopt a “more sophisticated” approach to its work, particularly its analytical work and second opinion advice function. This analytical work was expected to result in negative reactions from departments and could, conceivably, be perceived as encroaching on the State Services Commission’s review function. The timing of this development, however, is interesting because it occurred when it became obvious that the electoral system would change, thus resulting in more loosely bound governments, and the unpopularity of the privatisation agenda pursued since 1984 could no longer be ignored.

The projects under the "financial management initiatives - next steps" and "efficiency and innovation" themes of 1994-1996 seemed to be largely concentrated within Treasury and seemed to be unannounced, even though the ownership monitoring and chief executive performance aspects of this work clearly traced into the State Services Commission’s review function and implied some joint work with the State Services Commission. At its commencement, the State Services Commission-led CAP project seemed opposed to the Treasury’s views about the soundness of the financial management system but, by late 2001 had reversed that position, while the Treasury's value-for-money projects have proceeded on the basis that the system is basically sound. Today, these two central agencies seem agreed that the system is sound.

Although when the government changed in 1990, the incentives projects were said to result from the desire of departmental managers for departments to be allowed to earn interest and retain operating surpluses, (see Chapter 5), that aspect of the incentives projects is minor and as revealed in the latest value-for-money project overview has never been developed. Instead the major focus of these ongoing incentives projects has been the development in the financial management system of a commercialised approach to departmental operations

and, in particular, the development of the idea of the Crown purchasing outputs from departments, with departments' output costs determined on the basis of full costs including both depreciation and a capital charge. From 1994, that idea was taken to a lower level with the proposals for costing and benchmarking output components, and the idea that chief executives should make increased efforts to achieve efficiencies. As was evident from comments about departments encountering financial difficulties, the use of full costing and the treatment of output costs as if they are fully variable seems likely to have negative financial effects on departments at both the output purchase level and the output component level.

The various reports of these projects indicate intentions but they are merely discussion and proposals. They have little or no effect unless traced through into the rules and procedures actually applied to departments and it is the actual rules and procedures developed that are the subject of the next three chapters.

7 Expenditure reduction and budget baselines

The Treasury's briefing to the incoming government of 1990 had recommended two processes to reduce expenditure, both of which were used for the 1991/92 budget process. The first drew on more traditional budget allocation mechanisms to control the amount of resources available, while the second used the information derived from the new financial management system, in particular the information about outputs, to decide how those resources should be used (Treasury, 1990, p. 80 - 81). This chapter focuses on the first process, budget allocation, beginning with the 1991/92 budget and the government's fiscal strategy. It then explains the development of that process into a budget baselines management regime, and the manner in which macro-level fiscal strategy has since been aligned with that regime. Examples drawn from the Department of Statistics, the Inland Revenue Department and the Department of Corrections illustrate particular points.

Fiscal strategy 1991/92: expenditure reductions

Shortly before the 1990 general elections, departments were instructed to prepare forecasts for the 1991/92 financial year on the basis of the true costs of their services. The result of this exercise was forecasts which projected massive cost increases, and a "loaded gun" passed to the incoming Minister of Finance of the new National government. The extent to which the budget was re-balanced with reductions to social services was at least partly concealed by the size of the budget cuts subsequently made (Interview with former chief executive, June 2001).

For the 1991/92 budget, the CSC sought expenditure reductions of approximately $2 billion in relation to those earlier budget projections, and required the ECC to identify expenditure-reducing changes in policies, structures and outputs and, in consultation with vote Ministers, to review their use of resources and scrutinise departmental outputs to ensure value-for-money. The ECC's first step was to use budget allocation mechanisms to set the amount of

resources available for departmental operations. It devised a set of relatively simple rules with which departments were required to comply.

Departments were required to begin with the budget projections, but to re-set all non-demand-driven outputs at "the lower of their 1990/91 appropriation or estimated outturn"; to update demand-driven outputs noting that they would be subject to close scrutiny in the review of budgets; to do the same for payments on behalf of the Crown (POBOCs), except where the level of payment had been pre-determined by contract or by government decision; to assume no capital injections unless specified exceptional circumstances applied; and to fund any new policy through budget reallocations. After these adjustments, the total amount remaining set the upper limit of the amounts that each department could spend on the production of outputs, and this upper limit was known as a baseline. With the introduction of the capital charge regime, the baselines were increased for the capital charge content in outputs supplied to the Crown (November 1990, Terms of Reference of Committees, Richardson files 1171; CSC(91)3, 12 February 1991, Terms of Reference, Cabinet Strategy Committee, Richardson files 989; CAB(90)M8/12, 4 March 1991, Richardson files 867; ECC(91)M15/9,10, 16 April 1991, Richardson files 1190; CSC (91) M 10/1, 2, 3, 17 April 1991, Richardson files 988). After the establishment of these baselines, the expenditure reduction process changed to adopt the purchasing focus which is considered in more depth Chapter 8.

Locking-in the expenditure reductions

The procedures adopted for the 1991/92 budget process were judged a success, especially given the involvement and commitment of senior ministers in the process, and the comprehensiveness of the budgeting process which dealt with all votes. The Treasury recommended that continuation of that approach into future budget rounds would lock-in the reduced expenditure (ECC(91)212, 15 August 1991, Richardson files 999). A further attraction of the budget baselines process was that it would reverse previous biases against expenditure restraint by forcing departments and their responsible Ministers, when seeking additional resources, to demonstrate the unreasonableness of the budget baseline. Not only would a tough line towards arguments for baseline increases prevent expenditure creep, the use

of baselines would allow across-the-board savings to be made by extracting efficiency dividends from those baselines (T91/3479, 8 August 1991, Richardson files 719).

For the 1992/93 budgeting round, the ECC required departments' 1992/93 expenditure forecasts that had been produced as part of the 1991/92 budget process to be assessed, modified as necessary by the Officials Committee on Expenditure Control (OCEC), and to have two percent deducted as an efficiency dividend. Any department unable to achieve the required efficiencies was required to provide detailed output specifications for review by the OCEC and the ECC, and those committees would recommend savings options to the vote minister concerned (CAB(92)M23/12, 15 June 1992, Richardson files 840; Treasury, Unreferenced letter to the Minister of Finance, 30 November 1992, Richardson files 305).

The budget baselines were then extended to cover three years, the budget year and the following two years, and thus to create a rolling budget baselines system. The baselines were subjected to cuts of between 1% and 5% each year, with the cuts continuing through to the 1995/96 year following which nominal dollar budget baselines were maintained. Even nominal dollar baselines, however, achieved savings because they forced "real saving in departmental spending each year equivalent to the rate of inflation" (Barnes and Leith, 2000, p. 2; see also ECC(91)M64/3, 11 December 1991, Richardson files 1024; Treasury BR No: 9, 9 October 1992, Richardson files 305; CAB(92)M51/21; 14 December 1992, Richardson files 306; Treasury, FM/2/19, 6 July 1995).

In effect, the budget baselines gradually reduced departmental expenditure, forcing a continued process of re-allocating expenditure to stated priorities (Treasury, FM/2/19, 6 July 1995) (Box 7.1). According to Cullen (2001) after the change of government in late 1999 the new government committed significant amounts to restore some baselines.

Box 7.1 Expenditure reductions and the growth and employment strategy

The Department of Statistics is required under the Statistics Act 1975 to produce a range of statistical information "required by the Executive Government of New Zealand, Government departments, local authorities and businesses for the purpose of making policy decisions and to facilitate the appreciation of economic, social, demographic, and other matters of interest to the said Government, government departments, local authorities, businesses and to the general public." In 1989, a machinery-of-government review of the department concluded that the role and function of the department was appropriate and that restructuring was unnecessary. Instead, imposition of financial and management discipline was proposed by requiring the department to earn third party revenue sufficient to cover 25 percent of its operating costs.

For the 1991/92 budget process, the first using the new financial management system, after determination of the department's budget baseline, attention turned to the use to be made of the budget baseline resources. Deregulation of the economy had affected, and in some cases removed, data sources for the department and the need for improvements in official statistics was recognised as was the increased costs involved. Treasury advice to the Minister of Finance concentrated on macro-economic statistics, the need to improve them, and the resource implications for the department. Treasury argued that the improvements could be made without additional taxpayer funding by requiring the department to increase its charging for other existing services and to make savings by reducing the costs of statistical series other than macroeconomic statistics and through productivity improvements.

Following ECC review, savings were made by reducing purchase prices and reducing or ceasing altogether the production of some statistical series: the inter-industry study changed from five yearly to seven yearly and the agricultural census from yearly to biennially; the quarterly hire purchase survey, collection of justice statistics, the monthly retail trade and overseas orders surveys were all discontinued; the size of the household labour force survey was reduced; and the funding of a Maori statistics unit rejected. For the 1991/92 financial year, these changes saved $700,000, with $640,000 of that re-allocated to improve the macroeconomic statistics. Commenting on the discontinued justice statistics, the Government Statistician argued that, "In most other developed countries, such statistics are viewed as fundamental social indicators, essential for monitoring the health of the nation and the performance of the justice system" (T91/819 12 February 1991, Richardson files 640; ECC(91)M27/7, 22 May 1991, Richardson files 1189; T91/2306, 2 June 1991, Richardson files 688; ECC(91)156, 4 June 1991, Richardson files 1199; ECC(91)M32/4, 5 June 1991, Richardson files 1188; CAB(91)M23/28n, 17 June 1991, Richardson files 869; CAB(91)M24/5x, 24 June 1991, Richardson files 870; Report of the Government Statistician for the years ended 30 June 1990, 1991, 1992).

Budget baselines guidelines

The budget baselines rules devised in 1991/92 and 1992/93 eventually were formalised in guidelines which have been revised regularly. These guidelines describe the objectives of the baseline management regime and the requirements for scrutiny of baseline changes, particularly for baseline increases (BR No 62, 20 May 1992, Richardson files 295, p. 3; CAB(92)M22/8a, 8 June 1992, Richardson files 840; CAB(92)M40/10, 5 October 1992, Richardson files 843; ECC(93)224, 17 May 1993, Richardson files 972; CAB(93)336, 21 May 1993, Richardson files 890; CO(93)11, 27 August 1993, Richardson files 1005).

The budget baselines management regime aims to "ensure that each vote and department remain within the baselines", and to minimise expenditure proposals outside the main budgeting process. By providing a fast-track minimal scrutiny or

no scrutiny approval process for those budgets which comply with the baselines, the budget baselines regime encourages departments and vote ministers to refrain from requesting additional resources. Early versions of the guidelines for the budget baselines management regime stated that the baselines allow:

> Vote Ministers, advised by Chief Executives, to reprioritise within the baselines approved in each Budget baseline update (consistent with the overall strategy adopted for that Budget), on the basis that this reprioritisation is consistent with the Government's broad policy objectives and **will not run down the Crown's assets or increase its liabilities in any one year or over time**. (CAB(94)M44/11, 14 November 1994, Treasury files; CO(95)10, 15 September 1995, Treasury files) (emphasis added).

Later versions of the guidelines reveal some changes to the stated objectives. In 1998, the prohibition on running down assets or increasing liabilities when reprioritising expenditure was replaced with a requirement that repriorisation "provide better value for money" (CO(98)17, 24 November 1998). More recently, following the 1999 change in government, the budget baselines guidelines are less explicit about the objectives, commenting that the guidelines are "a critical part of the Government's overall financial management framework” (CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars). The baselines ease decision-making by providing a common process and allowing Cabinet to prioritise. They have also been integrated with fiscal policy to assist with maintenance of overall fiscal control.

Integration of fiscal targets with budget baselines

By 1994, after three years of this budget baselines regime, pressure from departments for increased resources was evident (Treasury, 30 November 1994, Surplus retention, FM/2/19, Treasury files). The Fiscal Responsibility Act and the idea of fiscal targets provided scope to apply top-down counter-pressure to that growing bottom-up pressure for expenditure increases (Treasury, 1996, p. 128). The Treasury proposed a three-year budget strategy, with three-year plans for key indicators such as overall spending, revenue and operating balance, but achieving the required counter pressure required some means of integrating the fiscal targets with the budget process. A "system of three-year fiscal limits, with associated rules for counting to these limits" was devised to do this (Barnes and Leith, 2000).

The fiscal limits, or provisions, are determined by beginning with the fiscal targets adopted, in this case operating expenses and debt expressed as a

percentage of GDP. Applying the desired percentages against the projections for GDP allows dollar amounts to be estimated for maximum total operating expenses and total debt. The amounts available for new expenses and debt may then be deduced. This results in provisions, one of which is for new expenses and is known as the expense provision, while the other is for new debt, and is known as a capital provision. These provisions cap the amount of money available for the three-year term of government. The provisions were recommended to 1999's incoming government as a "tool for managing individual decisions so that they match aggregate intentions" (TC1997/2, 14 February 1997, BU/2/4/1, Treasury files; Treasury, 1999, p. 22-23).

Associated with the provisions is a set of rules intended to link the provisions with the government's budgeting decisions. This set of rules is known as the counting framework, and it tracks the expenses and capital expenditure balances remaining available. More recently, the budget baselines guidelines have been revised to show how the counting framework rules translate into the budget baselines guidelines. The budget baseline guidelines, however, remain based on earlier principles. Although the provisions are derived from GDP projections, and they therefore change with changes in inflation, departments' budget baselines remain fixed and nominal. In addition, although the counting framework allows some expense and capital expenditure items without them counting against the provisions, allowing such items to adjust a department's baseline does not mean that the department will receive additional resources. Instead, the principle is that departments should be forced to "bid for any compensation for the loss in real resources" because that will allow any bid for compensation to be scrutinised in light of current and new budget initiatives (Barnes and Leith, 2000, p. 4). Although the fast track minimal scrutiny process for budgeting encourages compliance with the budget baselines regime, that regime is also intended to force full reviews when departments can no longer cope with the resources provided.

Counting framework rules for operating expenses

The counting framework rules for operating expenses update the expense provision "for all changes to the operating balance resulting from Government decisions to introduce a new policy initiative or change the fiscal cost of existing

initiatives". Those rules currently ignore "forecasting changes, the recognition of existing liabilities, and costs arising from natural disasters and civil emergencies" or for changes in the capital charge, expense transfers that are fiscally neutral between periods, or changes in carrying values, including gains or losses on sale of assets (CO(98)17, 24 November 1998; TC2000/2, 24 February 2000, Treasury files; CO(00)12, 23 November 2000; Barnes and Leith, 2000, p. 12).

The distinction between policy changes (which do count) and forecasting changes (which do not count) is acknowledged as unclear (Barnes and Leith, 2000, p. 12). The explanation of these changes is that forecasting changes arise from government policies which require an automatic change in funding in response to changes in the general environment. Examples given of forecasting changes include changes in debt servicing costs when interest rates change or changes in the payment of benefits indexed to the consumers' price index (CPI). They involve no change in the policy itself and Cabinet approval is merely a rubber-stamping exercise. In effect, the manner in which a policy is stated would determine whether a change in expenses is a policy change or a forecasting change. For example, a policy decision to accept costs of a particular dollar amount would mean that acceptance of any cost changes amounts to a policy change, while a policy decision to accept costs determined in accordance with a particular formula or index would mean that any cost changes are forecasting changes.

The commentary on the recognition of existing liabilities suggests that the existence of these liabilities may have been acknowledged, perhaps in the statement of commitments or the statement of contingent liabilities, but that they had not been recognised in the financial reports as liabilities. The recognition point for liabilities is, therefore, the key and any liabilities incurred, but which do not have to be recognised immediately, do not count against the provisions.

The commentary on changes in carrying values states that the only changes in carrying values that count are those that result from a specific government decision, such as a decision to introduce competition and reduce prices. All other changes in carrying values, including revaluations and gains or losses on sale of assets, do not count because "they are a direct function of the carrying value,

which could vary substantially depending upon factors such as accounting policies, revaluation policies and timing of cyclical revaluations. Accordingly, the gain or loss may be considered subjective (and potentially manipulable)".[28]

The focus of attention in this counting framework is on what may be controlled in the short-term, while accepting that "the wider fiscal balance will be influenced by cyclical variations and valuation changes" (Barnes and Leith, 2000, p. 12).

The budget baselines guidelines classify proposed baseline changes into technical changes that do not count against the fiscal provisions and therefore require only minimal scrutiny, and substantive proposals that do count against the fiscal provisions or have policy implications and therefore require close scrutiny and must jump the high hurdle of a separate spending initiatives process. As noted above, however, the budget baselines guidelines remain based on earlier principles that departments should not automatically receive compensation for any losses in real resources, but should be forced to bid in order to recover such losses (Barnes and Leith, 2000; CAB(91)1129, 13 December 1991, Richardson files 876; ECC(91)360, 10 December 1991, Richardson files 876; CAB(96)M46/17; CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Budget baseline changes for which scrutiny may be minimised

The budget baselines guidelines identify a variety of technical changes which "generally result in no additional resources being required and, in particular, do not reduce resources available within the fiscal provisions". Provided these technical changes do not count against the provisions, raise no significant policy issues and involve no transfers between different types of output class (such as between departmental and non-departmental outputs), then the baseline changes may be approved by the relevant vote Minister and the Minister of Finance if they agree on those changes. These technical changes, which change the baseline but not the amount of money provided to a department, consist of expense and/or

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[28] It seems that increased depreciation expense following revaluations does "count" even though the amount of depreciation reported is a "direct function of the carrying value" which is well known for varying "substantially depending upon factors such as accounting policies, revaluation policies and timing of cyclical revaluations".

capital transfers, fiscally neutral adjustments, forecasting changes, recognition of existing Crown liabilities, return of savings to the Crown (which may increase the resources available within the provisions), and technical accounting adjustments.

Expense and/or capital transfers

Expense and/or capital transfers arise when the delivery of outputs or capital projects either cannot be achieved within the timeframe of the appropriations, or when the vote minister decides to defer the expenditure concerned. The resources may be transferred from the current financial year to the next financial year "with no change in the output purchased, or the fiscal provisions." Initially, these transfers did not extend to bringing forward projected expense or capital items from future years, and the current wording still implies that this is the case.[29] Expense or capital transfers are not used to carry forward under-expenditure. They apply either under circumstances beyond the department's control or following a vote minister's decision (CO(98)17, 24 November 1998; CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Fiscally neutral adjustments

Fiscally neutral adjustments involve a "reallocation of resources within a single financial year with no impact on the fiscal provisions." They are fiscally neutral because the adjustments must have "no overall impact on the Crown's accrual operating balance, Crown balance (net worth) or net cashflows from operating and investing". Fiscally neutral adjustments may be made either within a department's baseline, between departments, or between departments and the Crown.

The major focus of adjustments within a baseline relates to the concept of a Minister as a purchaser of outputs which implies some freedom for the Minister to decide what to purchase. The hierarchical arrangement of Cabinet sub-committees means that just a few senior ministers determine the total amount of a budget baseline, a decision over which particular vote ministers may have little or no influence. The vote minister, however, may influence decisions on the use of

resources available. Ministers' reprioritisation decisions must be consistent with the government's policy objectives, but a minister may choose to stop purchasing lower priority outputs and purchase instead higher priority outputs consistent with the government's strategy.

Another form of adjustment within a department's baseline relates to the revenue expected from selling outputs to third parties. Departments must include in their budget baselines an amount for any such revenue. If third party revenue is less than budgeted, departments must make fiscally neutral adjustments to ensure that financial results fall within the budget baseline. In other words the department must reduce expenses to offset the revenue shortfall (CAB(92)M40/10, 5 October 1992, Richardson files 843; CO(92)16, 23 October 1992, Richardson files 1005; CO(93)11, 27 August 1993, Richardson files 1005; CO(95)10, 15 September 1995, Treasury files). The Department of Statistics' experience reveals that although these adjustments are fiscally neutral for the Crown, they may have significant financial implications for a department (Box 7.2).

Box 7.2 Fiscally neutral adjustments and third party revenue

The 1989 machinery of government review of the Department of Statistics concluded that the department did not require restructuring but that financial and management discipline would be imposed by requiring the department to generate from third parties sufficient revenue to cover 25 per cent of its gross expenses. The 1991/92 budget process increased the direct funding for macro-economic statistics but discontinued the direct funding of some statistics used by other government departments. The departments concerned were expected to purchase the statistics they required from within their own baselines, but those other departments were also under pressure to reduce costs.

The Department of Statistics restructured and developed an information marketing unit. Businesses were "receptive to the concept of increasing their use of statistical information" but the department encountered increased staffing difficulties as staff moved to higher paid positions mainly in other, less financially-constrained government departments. Delivery "delays for business datasets resulted in as many as one in four customer orders being cancelled." The department engaged in several interdepartmental initiatives to improve or expand the range of official statistics but failed to generate sufficient third party revenue to meet the revenue targets and was forced to make offsetting expense savings.

From 1993, the third party revenue targets were reduced following Treasury acknowledgment that those targets were "arbitrary, being set without market analysis and any actual experience", but the budget baseline remained unchanged and the department was still required to make offsetting expense reductions to stay within that baseline. In 1991/92 it saved $2.5 million by reducing expenditure on the 5-yearly population census statistics but the cost-cutting measures also affected the quality of outputs and impaired the department's ability to "maintain the statistical systems". It received capital injections as partial compensation for that revenue shortfall because

[29] Treasury advise that expenditure for future years may now be brought into the current year under some circumstances (email, Treasury to S. Newberry, 2 November 2001).

Treasury advised that it was "inappropriate for shortfalls in third party revenue to impact on outputs supplied to the Crown".

Year	Revenue shortfall	Capital injection
1991/92	$2.725 million	Nil
1992/93	$2.736 million	$2 million
1993/94	$2.592 million	$2.592 million
1994/95	$2.908 million	$1.573 million
1995/96	$1.193 million	Nil

In 1996 the Government Statistician reported that, "Despite continued efforts, Statistics New Zealand has been unable to achieve the very high third-party revenue targets set by government. This has impacted on working capital, and requires periodic injections of capital to adjust for the resultant deficits. The department is struggling with the current revenue to continue producing existing core official statistics. Efforts to find acceptable output cuts and reductions have now reached a point where there would be significant impact for major policy advisory agencies". In 1997, following the first output price review, a "major change" noted was the "recognition that third-party revenue targets had been unrealistic and were creating perverse incentives for the department". (T91/819, 12 February, 1991, Richardson files 640; T91/1223, 28 March 1991, Richardson files 652; T91/2306, 2 June 1991, Richardson files 688; ECC(92)M16/8, 5 May 1992, Richardson files 1101; CAB(92)M21/10aa, 2 June 1992, Richardson files 840; T92/3683, 3 December 1992, Richardson files 804; ; T92/3762, 10 December 1992, Richardson files 805; ECC(92)432, 14 December 1992, Richardson files 955; ECC(93)M2/2, 16 February 1993, Richardson files 912; CAB(93)M5/6b, 22 February 1993, Richardson files 910; Report of the Government Statistician for the years ended 30 June 1990, 1991, 1992, 1993, 1994, 1995, 1996,1997).

Fiscally neutral adjustments between a department and the Crown involve off-setting arrangements and currently the most prominent of these relates to the capital charge regime. On implementation of that regime in 1991, departments received increased output appropriations and money to compensate for their increased expense in relation to the outputs provided to the Crown (see also Chapter 6 and the senior managers' review of the *Report on Departmental Incentives*).[30] They were advised that irrespective of changes in the capital charge rate, "the appropriation would not be reduced other than to reflect changes in the quantity or quality of outputs, or to reflect efficiency gains in their production." An increased capital charge would force departments to reduce other costs and therefore represent cost savings to the Crown, while a decreased capital charge implied either that departments would report an operating surplus, or that they could increase other output expenses while remaining within their output appropriations. A decreased capital charge therefore represented potentially

[30] They received no compensation in relation to third party outputs. They were required either to increase their prices to the third parties or to absorb the increased expense but prohibited from offsetting losses from competitive supplies against other gains (CAB(91)M20/8, 27 May 1991, Richardson files 868). This limited absorption of the expense to reductions in taxpayers' funds, and the possibility of recovering the loss by charging higher prices on competitive outputs in future years (T92/2618, 25 August 1992, Richardson files 794; STA(92)190, 8 September 1992, Richardson files 963).

increased costs to the Crown and after the first year of operation, a recommended reduction in the capital charge was declined (STA(91)68, 21 May 1991, Richardson files 1033; STA(91)M15/6, 22 May 1991, Richardson files 988; CAB(91)M20/8, 27 May 1991, p. 1, Richardson files 868; TC1991/4, 7 June 1991, p. 3, Richardson files; STA(91)172, 1 October 1991, Richardson files 1036; STA(91)M33/10, 2 October 1991, Richardson files 934; T92/520, 21 February 1992, Richardson files 809; T92/611, 28 February 1992, Richardson files 809; Treasury, 28 February 1992, FM2/2, Treasury files; STA(92)35, 10 March 1992, Richardson files 958; CAB(92)M10/10, 23 March 1992, Richardson files 837; Correspondence 8 May, 1992, 27 May 1992, Treasury files; T92/2618, 25 August 1992, Richardson files 794; STA(92)190, 8 September 1992, Richardson files 963; CAB(92)M38/7f, 21 September 1992, Richardson files 843).

The following year, interest rates on which the capital charge is based had fallen further. The proposed reduction to the capital charge implied increased costs for the Crown of $205 million, and the previously-announced policy that appropriations would not change to offset changes in the capital charge rate was reversed because the windfall gain to departments was an "inappropriate incentive to managers". Following advice that the government should not be exposed to such a financial risk, the new policy adopted was that "revenue Crown paid to departments will be increased or decreased consistent with increases or decreases in capital charge rates." Changes in the capital charge were, therefore, brought within the scope of fiscally neutral adjustments (CAB(92)M43/12, 27 October 1992, Richardson files 874; The Treasury, T92/3467, 13 November 1992, Richardson files 802; ECC(92)451, 14 December 1992, Richardson files 955; ECC(92)M55/13 15 December 1992, Richardson files 956; CAB(92)M52/36, 21 December 1992, Richardson files 875; CAB(94)M44/11, 14 November 1994, Treasury files).

The policy for changes in the capital charge is about to change again (EXG(00)M20/1, 13 December 2000, Treasury files; CAB(00)M42/11, 18 December 2000, Treasury files; TC2000/16, 21 December 2000, Treasury files). From 2002/03 onwards (TC2000/16, 21 December 2000, p. 2, Treasury files):

> for most departments, the presumption will be that baselines will **not** change as a result of changes in the capital charge but, if warranted, the department or Treasury can seek a baseline change through the normal budget process; and
>
> For a small number of capital-intensive departments meeting specified criteria, Treasury will support an automatic baseline change to reflect future changes in capital charge payable (emphasis in original).

As was evident from the initial policy, if a department's baseline is not adjusted to offset any change in the capital charge, then the change in the charge is not fiscally neutral. An increase in the charge represents cost increases to departments and savings to the Crown, while a decrease represents the reverse. The procedures proposed to obtain a baseline change differ for the capital-intensive departments as compared with the others. Consistent with the intent of the budget baselines regime, that departments must bid for any increase in real resources and undergo close scrutiny, the capital-intensive departments must satisfy Treasury that their use of inputs in the production of outputs is efficient, and this will require evidence that the departments are conducting "an active and well-managed programme of identifying and selling surplus assets and ongoing self assessment of the level of fixed assets required" (p. 8). The other departments must make a case to ministers demonstrating their efficient use of inputs and, as part of this process Treasury will assess: how their existing baselines were set; whether offsetting savings may be made elsewhere; whether the assets underlying the capital charge are integral to the department and could be rationalised; evidence that the department has implemented an asset management and review plan; whether less expensive alternative options such as leasing are available; and whether the baseline is reasonable against price benchmarks. Further, any baseline changes sought will be considered as part of the collective initiatives phase of budgeting and will therefore be "assessed against other competing priorities within the department and the Government as a whole" (p. 9). Clearly, changes in the capital charge will no longer necessarily be fiscally neutral and will fall into the category of change requiring close scrutiny should departments seek a baseline change and resources to compensate.[31] The type of scrutiny involved is covered in

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[31] One of the justifications for undertaking the latest changes to the capital charge regime was that departments had incentives to hold more capital than necessary (Treasury, 30 June 2000, T2000/1361, Treasury files). The possibility of adjusting appropriations for rate decreases but not for rate increases was considered earlier. Possible rationalisations for such a policy included, “Appropriations should be reduced when the rate

more detail in the explanation of the output price review process in Chapter 9 (CO(00)12, 23 November 2000, dpmc web-site; TC2000/16, 21 December 2000, Treasury files).

Forecasting changes

The changing policy towards the capital charge regime as outlined above illustrates the lack of clarity noted earlier about the distinction between forecasting and policy changes. The implications of the pending changes to the capital charge regime are that a reduction in the capital charge rate indicates a forecasting change while an increase in the rate indicates a policy change. If a budget baseline change results from a forecasting change then it is viewed as a technical adjustment (CO(00)12, 23 November 2000; Barnes and Leith, 2000).

The budget baselines management regime began with tightly defined requirements for acceptable changes. Unavoidable and uncontrollable expenses were defined as those costs that could not be contained within the total appropriations by altering the "quality, quantity or cost of the outputs in the current year" (CO(92)16, 23 October 1992, Richardson files 1005). These unavoidable and uncontrollable expenses included the costs arising from natural disasters and civil emergencies, but later they were extended to include expenses linked to particular indices such as the consumer price index, interest rates or foreign exchange movements where exposure is unavoidable, and became known as forecasting changes. Although the budget baselines may be changed to incorporate forecasting changes, close examination is required to consider whether the costs involved may be accommodated, even partially, by making savings elsewhere ECC(92)M55/13, 15 December 1992, Richardson files 956; CO(95(10), 15 September 1995, Treasury files; CO(98)17, 24 November 1998; CO(00)12, 23 November 2000, www.dpmc.govt.nz/).

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falls to avoid 'windfall gains' to departments. However, if there is a rate increase then a relative price change has occurred, ie capital is more expensive relative to other inputs. In this event appropriations should not be increased, to induce a cash 'crisis' which provides the incentive for departments to substitute away from capital" (Treasury, 1992?, Lally: Adjusting appropriations for capital charge rate changes, p. 3).

Recognition of existing Crown liabilities

Existing Crown liabilities must be recognised because "the Crown has no option but to recognise its liabilities *when they arise*" (emphasis in original). These pre-existing liabilities were initially included in the category of unavoidable and uncontrollable expenses which are now viewed as forecasting changes. Although the need to recognise the liabilities is noted, meeting those obligations will not necessarily result in a baseline increase or a resource increase because Ministers must first consider whether offsetting savings may be found in other areas of the vote concerned (CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Return of savings to the Crown

The budget baselines guidelines try to restrict the budget process to one time of the year but savings may be returned to the Crown at any time. These savings, such as the return of a portion of a department's capital, count positively against the provisions (CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Technical accounting adjustments

The idea of technical accounting adjustments was foreshadowed following the speedy implementation of accrual accounting, when departments were encouraged to adjust their opening balance sheets if, for example, initial asset valuations were subsequently found incorrect. These valuation adjustments required baseline adjustments and appropriations but they had no current year cash effect. Although, since the 1993/94 financial year these particular adjustments have been excluded from the list of acceptable baseline adjustments, the idea seems to have given rise to technical accounting adjustments which have no current year cash impact, such as downward revaluations and accounting policy changes. Departments are required if possible to contain the amount of the adjustment within existing appropriations by reducing other costs. If an appropriation is necessary, it is tagged to ensure that it cannot be used for other output expenses if the full amount of the appropriation is not taken up. Such an appropriation does not result in any increase in money provided to a department, that is, there is no increase in a

department's revenue Crown (CO(98)17, 24 November 1998; CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Appropriations for other expenses

Until 1995, and the issue of a Treasury circular which limited the category, departments reported a number of costs as other expenses including all losses on realisation of assets. Now, following that circular, other expenses include restructuring expenses, losses arising from the write-down or sale of surplus assets when those assets are not related to current production, and extraordinary items as defined by GAAP (Treasury, T91/4462, 8 October 1991, Richardson files 750; TC1995/8, 9 August 1995).

Other expenses may involve cash payments, for example redundancy payments, or they may be accrual adjustments, for example the write down of assets purchased earlier. Shortly after the establishment of the other expenses appropriation, specific funding was sometimes provided to departments but, from 1994, when rules for capital contributions were devised and added to the budget baselines guidelines, the policy adopted for other expense appropriations was that departments must use their own resources to cover other expenses. A department seeking specific funding for an other expense must, in addition to the other expense appropriation, apply for a capital contribution appropriation which will be assessed on the criteria normally applied to capital contribution requests (TC1995/8, 9 August 1995). Restructuring expenses and the recognition of pre-existing liabilities are significant examples of other expenses, and provide some idea of the costs departments must absorb (Table 7.1).

Table 7.1 Other expenses

Year	Nature of other expenses	Department of Statistics $'000	IRD $'000
1993	Restructuring	1,150	
1994	Implement taxpayer audit review		4,585
	Organisational review		1,424
1995	Revaluation losses	187	
	Establish retirement provision	428	
	Implement taxpayer audit review		1,480
	Organisational review		3,943
1996	Implement taxpayer audit review		557
	Organisational review		42,381
1999	Discounted net present cost of long service leave	1,979	590
	Total	**3,744**	**54,960**

Budget baseline changes involving close scrutiny

The fast-track minimal scrutiny process applies provided no funding increase is sought, and allows ongoing funding amounts without reconsideration of the need for the particular outputs. The fast-track process has built into it resource-eroding tendencies because baseline increases approved do not carry with them increased funding, and the extent of that resource erosion is apparent from the fiscally neutral adjustments required of the Department of Statistics and the other expenses incurred by both the Department of Statistics and the Inland Revenue Department. Clearly, the intention of this fast track process is not only to encourage departments to accept gradual resource erosion (described by one departmental interviewee as creeping death), but also eventually to force departments to bid for increased resources simply to continue current operations and a bid for a baseline increase will require close scrutiny. Budget baseline changes may also count against the provisions or imply significant policy change and these, too would require close scrutiny.

The bidding process provides an opportunity to scrutinise the outputs produced within the baseline and to reassess those outputs against the government's strategy and new budget initiatives (Barnes and Leith, 2000; Cullen, 2001). Since 1996, two processes have been established to review baselines. The first process was an output price review which could be prompted either by the Treasury or a vote minister, or by a department's chief executive who believes that the department can no longer manage the cost of output production from within the department's budget baseline. For an output price review (OPR), the Cabinet decides on the

scope, timing, and any resource issues related to the review (CO(98)17, 24 November 1998; CO(00) 12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars). The second process, endorsed by Cabinet in 2000, is a value-for-money (VFM) review which examines the existing spending and any opportunities available to re-prioritise that spending. Departments conduct a VFM review, while the Treasury provides a second opinion. Both forms of review scrutinise the outputs produced, consider the need for continued production of those outputs, and consider whether departments should produce those outputs. A similar process, but on a smaller scale, applies to new or expanded activities requiring increased funding. Ministers and departments must submit a proposal which explains the financial effects of the proposal, identifies the output reductions to be made if the proposal were to be funded from within the baseline, and be justified "in terms of the guidelines for changes to baselines". The proposal is assessed by the Minister and Treasury. These baseline reviews will be considered in more detail when considering the processes of monitoring and review in Chapter 9 (CO(98)17, 24 November 1998; CO(00)12, 23 November 2000, www.dpmc.govt.nz/cabinet/circulars).

Counting framework rules for the capital provision

The capital provision is derived from a calculation which determines the amount available for new debt. According to the Treasury, at a macroeconomic level, the “level of new capital investment does impact on the Government’s borrowing programme. It also provides signals of future Government spending intentions and the likely future role of the Government in the economy” (T99C/213, 11 February 1999, Treasury files, p. 3). At a public sector management level, however, the link implies that all capital expenditure increases debt and that debt is incurred only for the purpose of capital expenditure.[32]

The Treasury distinguishes between capital and operating expenditure, arguing that “investment commits resources now in the promise of future benefits. One of the key benefits of the shift from cash to accrual accounting was that it allowed

[32] Confusion over accounting concepts, especially in relation to concepts of capital, has been noted from the time of the Public Finance Bill (see Chapter 4 and Table 4.1).

discrimination between investment and current consumption" (T99C/213, 11 February 1999, Treasury files). The counting framework rules for the capital provision attempt to capture all such investment decisions by the government, including:

> all capital injections to departments and SOEs and Crown entities, purchase or development of capital assets by the Crown, and advances;
>
> [offset by] any new capital withdrawals, decisions to reduce existing baselines for purchase or development of capital assets by the Crown or reduce existing baselines for advances . . . (TC2000/2, 24 February 2000, Treasury files).

Three ideas underpin the capital provision and its associated counting rules. The provision imposes an overall limit on capital expenditure and so it is likely to encourage Ministers to prioritise capital expenditure proposals and to fund any capital expenditure either from within current budget baselines or from within departmental balance sheets. Secondly, the provision helps with management of capital expenditure to ensure its consistency with the Crown's policy goals; and thirdly, for risk management purposes, "it is sensible for there to be some overall management of capital investment to ensure the Crown is not unduly exposed to financial and operational risks" (p. 4).

With capital expenditure by the government capped through this provision, the Treasury advised of the availability in the private sector of alternative financing sources which it refers to as "private sector capital investment", thus suggesting that it cannot also be public sector capital investment. The use of funds raised from this financing source does not count as capital expenditure by the government: "Private financing can serve the dual purposes of reducing the borrowing requirements of the Crown and also introduce stronger monitoring disciplines on Crown agencies", although the considerable related risks are acknowledged (T99C/213, 11 February 1999, Treasury files).

The counting rules for the capital provision are recognised as not convincing for "assessing or controlling capital spending" (Barnes and Leith, 2000). One obvious problem is the idea that capital contributions to departments count as capital expenditure, while another obvious problem relates to exactly what is meant by debt.

Appropriations for capital contributions

The counting framework counts capital contributions to departments as capital expenditure. The 1991/92 budgeting round paid little attention to capital contribution appropriations. Departments were advised that capital contributions should not be assumed and would be provided only under specified exceptional circumstances. The Logan report recommended for the 1992/93 budget cycle some form of "resource allocation process for capital investment decisions by the Government" (1991, p. 101, recommendation 29(iv)). Evidently, the Logan report's recommendation was interpreted as departments' expenditure on assets (capital expenditure), rather than the Crown's capital injections to departments (ECC(92)39, 2 March 1992, Richardson files 836; ECC(92)M5/12, 3 March 1992, Richardson files 1101).

The permanent appropriation allowed to departments under s. 11 of the Public Finance Act 1989 is subject to a delegations limit originally set in 1989 by CO(89)22, and increased in 1998. Chief executives now have discretion up to $7 million ($5 million from 1989 to 1998), and responsible ministers have discretion up to $15 million ($10 million from 1989 to 1998) (ECC(92)39, 2 March 1992, Richardson files 836; ECC(92)M5/12, 3 March 1992, Richardson files 1101; CAB(98)M47/9D(4), 14 December 1998, Treasury files). Departments' proposed expenditure on assets (capital expenditure) for the 1992/93 financial year totalled approximately $620 million, but departments, apparently relying on section 11, sought from the budgeting cycle capital contributions for approximately $125 million. The scrutiny of capital expenditure applied to those departments operating within section 11 involved examination of the processes used to "develop and manage capital expenditure plans", and examination of all capital expenditure projects exceeding $5 million either uncompleted or planned up to the 1995/96 financial year. The information obtained from this scrutiny was thought likely to assist with capital expenditure management in future, and to provide an opportunity to discuss "links between the Government's priorities and capital expenditure plans". Development of an ownership phase involving budget scrutiny of "a number of long term elements of departmental management, of which one is capital expenditure" was proposed (CAB(92)M2/2, 27 January 1992, Richardson files 837; ECC(92)39, 2 March 1992, Richardson files 836;

ECC(92)M5/12, 3 March 1992, Richardson files 1101; ECC(92)304, 21 September 1992, Richardson files 1052; ECC(92)M45/2, 29 September 1992, Richardson files 1101).

The 1993/94 ownership phase included a review of capital expenditure in those departments with the largest capital expenditure budgets, and development of a "process for evaluating any requests for capital injections." Evidently, the assumption was that capital contributions to departments were for the purpose of capital expenditure because departments seeking capital contributions were "required to demonstrate adequate management of capital expenditure . . . and why it is in the Crown's interest to invest further in the department." This assumption continued into the subsequent budget baselines guidelines documents. Although the 1998 version of the budget baselines guidelines acknowledges that a capital contribution may be sought for purposes other than capital expenditure, for example, to restore depleted working capital, most discussion of capital contributions assumes that such a contribution enables a department to invest either in particular assets or in a project (ECC(92)304, 21 September 1992, Richardson files 1052; ECC(92)M45/2, 29 September 1992, Richardson files 1101; CAB(92)M40/9, 5 October 1992, Richardson files 843; CO(98)17, 24 November 1998; CO(00)12, 23 November 2000). In the very early stages of the financial management system, capital contributions made to the Department of Statistics and the Inland Revenue Department were for investment in fixed assets but subsequent capital contributions were provided for a variety of reasons (Table 7.2).

Table 7.2 Capital contributions

Year	Explanation of capital contribution	Department of Statistics $'000	IRD $'000
1991	Investment in fixed assets	1,984	62,906
1992	Investment in fixed assets		48,202
1993	Other expenses: (Restructuring)	1,150	
	Partial compensation for revision to 3rd party revenue	2,000	
	No explanation		1,300
1994	Compensation for expected operating deficit	263	
	Partial compensation for revision to 3rd party revenue	2,592	
	Remedy negative working capital of $3.2 m from 1989	2,000	
	Repayment of capital to Crown		-5,000
	No explanation		1,611
1995	Information technology upgrade	13,590	
	Partial funding for census of population and dwellings	75	
	Partial compensation for revision to 3rd party revenue	1,573	
	Establish retiring leave provision	428	
	No explanation		96
1996	Information technology upgrade	4,430	
	Partial funding for census of population and dwellings	377	
	Return of capital repaid to Crown		2,500
	No explanation		209
1997	Partial funding for census of population and dwellings	40	
	Restructure balance sheet	4,000	
	Return of capital repaid to Crown		2,500
1999	No explanation		120
2000	Repayment of capital to the Crown		-1061
	No explanation		277
	Total	**34,502**	**113,360**

The budget baselines guidelines were extended to include capital contributions in 1994. These guidelines state that a capital contribution from the Crown to a department will be provided only as the last resort source of finance after a department has exhausted other possible sources. Those other sources include any cash accumulated by a department, including that accumulated by receiving payment for the full cost of outputs when some of the output costs, such as depreciation, are non-cash expenses; the sale of existing assets; the use of operating leases instead of owning assets; and improved working capital management through improved debt collection and slowed creditor payments. (Scott, 1996, p. 65 citing ECR(94)162 and (94)M26/1 2 August 1994; Treasury, 1998, FM/2/4 Vol 4, Treasury files; CO(98)17, 24 November 1998; CO(00)12, 23 November 2000). The explanation of this use of cash requirement is that, "the provision of depreciation and pricing to cover this charge will generate free cash which may be used to finance other capital expenditure. . . . GAAP does not require that accumulated cash be attached to specific assets or accumulated in

sinking funds" (The Treasury, 1998, Capital contributions, FM/2/4 Vol4, p. 10, Treasury files).

In 1998, the stated objective of the capital contribution requirements was to ensure that departments' investments are consistent with the government's strategic direction. Consequently all capital contribution requests must be accompanied by a sound business case which is consistent with the department's longer term strategic business plan (CO(95)10, 15 September 1995; CO(98)17, 24 November 1998; The Treasury, 4 December 1998, T98C/4002, FM/2/4 Vol 4; EXG(98)190, 8 December 1998, Treasury files FM2/4; CO(00)12, 23 November 2000).

Capital contributions for 3rd party outputs

Over time the pricing of third party outputs has been the subject of considerable attention. Third party outputs may be supplied on a contestable basis, in which case the department receives Mode B net appropriations, or on a non-contestable basis, in which case the department receives Mode B gross appropriations. Mode B net appropriations provide departments with a permanent appropriation to spend up to the amount of trading revenue earned on the production of those contestable outputs.

Departments are required to price all outputs, including third party outputs, on the basis of full cost, and they are expected to neither overcharge (charge more than full cost), nor undercharge, nor subsidise losses on third party outputs (see for example, The Treasury 1999, Guidelines for setting charges in the public sector). Especially when the outputs are contestable, any losses on those contestable outputs must be borne by reductions in taxpayers' funds. Any recovery of those losses must come from higher prices in future years. Those departments providing outputs on a contestable basis are now required to operate notional memorandum accounts to ensure full cost recovery over time (Treasury, 28 February 1992, Report of the Officials Group to monitor the implementation of the capital charge, FM2/2, Treasury files; TC1995/10, 11 September 1995).

The operation of these notional memorandum accounts is independent of a department's formal accounting system and the recording of accumulated

surpluses or deficits in the notional accounts is simply the copying of information accumulated during each year in the department's formal general ledger and reported as part of its financial performance. The actual surplus or deficit on these outputs would therefore be incorporated each year in a department's reported financial results and dealt with under the repayment of surplus rules. The accumulated balances in the notional accounts, which are outside the general ledger system, provide the information required for long-run price setting to ensure cost recovery over time.

Until 2000, provided earlier over-recoveries had been earned on these outputs, deficits arising from the under-recovery of costs in any year could be funded by a capital contribution from the Crown. Departments were required, however, to meet all of the requirements for a capital contribution, evidently including the last resort requirement. Given the prioritisation process applied to all capital contribution appropriations, even if a department did meet all the requirements, it would not necessarily receive a capital contribution. From late 2000 the requirements were eased for situations where deficits followed earlier over-recovery of costs and the memorandum account contains a positive balance (TC2000/18, 21 December 2000, Treasury files).

What is meant by debt

The counting framework provision for capital expenditure is derived from a calculation which determines the amount available for new debt. One implication is that the nature of debt is known and settled. Although departments are prohibited from raising loans, they are required to exhaust other sources of funds before they can expect a capital contribution, and such alternative sources include the sale and leaseback of assets, and other operating leases. The Treasury extends this idea by recommending arrangements it refers to as private financing, but the idea of private *financing* must, surely, imply debt regardless of whether a private financing arrangement must be reported in the financial reports as a liability.[33]

[33] Under GAAP, there are no specific requirements to report these arrangements as liabilities on a balance sheet. Nevertheless, the obligations arising from such agreements are encompassed within the definition of

Evidently departments have increasingly used private financing in the form of operating leases and non-cancellable contracts for goods and services to obtain the use of assets and to contract out some services. With effect from 30 June 1999, the delegations limit for the purchase of fixed assets was extended to include operating leases for the use of fixed assets, implying that those operating leases are equivalent to capital expenditure (CAB(98)M47/9D(4); 14 December 1998, Treasury files; CO(99)7, 30 June 1999, www.dpmc.govt.nz/cabinet/circulars). Over time, both the Department of Statistics and the Inland Revenue Department have reduced their accommodation lease commitments and capital commitments and increased their entry into other non-cancellable leases and non-cancellable contracts for goods and services (Table 7.3).

Table 7.3 Commitments

	Department of Statistics			Inland Revenue Department		
Type of commitment	**1991**	**1995**	**2000**	**1991**	**1995**	**2000**
Accommodation leases	31,021	14,037	9,213	284,657	212,017	105,932
Other non-cancellable leases	0	592	533	1,981	81,870	60,700
Non-cancellable contracts for goods and services	0	1,374	2,387	1,627	1,045	6,105
Capital commitments	629	123	0	135,566	14,578	17,847
Total	**31,650**	**16,126**	**12,133**	**423,831**	**124,416**	**190,584**

The Treasury's explanation of capital expenditure, that it "commits resources now in the promise of future benefits" could equally be applied to commitments. Such trend changes in commitments raise questions whether the Treasury's advice that private financing reduces borrowing requirements and, therefore, does not count against the fiscal targets encourages decisions that fail to make good policy sense, especially because subsequent recognition of these arrangements as liabilities would not count either (see the counting framework requirements for recognition of existing liabilities, and Treasury, BR No 62, 20 May 1992, Richardson files 295). Some commitments involve sizeable amounts (Box 7.3).

liabilities as set out in the conceptual framework. They are not future liabilities, as suggested by the Act, they are existing liabilities for which settlement is in the future.

Box 7.3 Fiscal targets and commitments: operating expenses or debt?

From the time of its formation as a separate department, the Department of Corrections has engaged in commitments classed as operating commitments for an increasing range of goods and services.

1996	1997	1998	1999	2000
$52,119,000	$29,764,000	$44,889,000	$36,017,000	$146,464,000

In 1996, these commitments consisted of $27,958,000 for operating lease commitments which included "premises, computer equipment, telephone exchange systems, facsimile machines and photocopiers". In addition the department had entered "non-cancellable contracts for computer maintenance, building services and other contracts for services" which totalled $24,161,000. In 2000, the operating lease commitments included the same list of items subject to operating leases but did not separately itemise the amounts involved. In addition, the annual report explained that the department had entered into non-cancellable contracts and explained the increase in operating commitments as "largely due to a contract entered into with Australasian Correctional Management, who have obtained the management contract of Auckland Central Remand Prison". This contract, excluded from commitments in 1999, but reported as negotiated in that year, was for $102,000,000 over five years. Of that amount, $53,000,000 related to the provision of correctional services and the remainder was not explained. In the 1999/2000 financial year, a total of 99 contracts with external providers were negotiated, all of which exceeded $5,000. (Department of Corrections, Annual reports for years ended 30 June 1996, 1997, 1998, 1999, 2000).

Chapter summary

In 1991, the National government pursued its fiscal policy to achieve expenditure reductions by devising a budget baselines regime which subsequently was extended and institutionalised in budget baselines guidelines. The fast-track minimal or no scrutiny process is intended to act as an incentive for departments and vote ministers to comply with the resource restrictions of the budget baselines regime, although it seems contrary to the idea that expenditure should be targeted to align with the government's policy objectives. The extraction of efficiency dividends and then the maintenance of nominal dollar baselines which have a gradual and acknowledged resource-eroding effect force some examination of expenditure in order to re-prioritise, but other resource-eroding mechanisms have also been built into the budget baselines regime. These are all of the accepted budget baseline changes which departments are required to absorb by using departmental resources. Even if an appropriation is provided for some of these adjustments, that appropriation is not accompanied by money. To the extent that these appropriations are for outputs, this seems to be a departure from the policy announced earlier, that departments would be funded for the full price of outputs (TC1990/13, 25 October 1990, Treasury files).

That this resource-eroding effect is intended is acknowledged, as is the purpose of this process. The effect is that the expenditure reduction strategy adopted in

1990 was designed into the budget baselines regime, but with further developments to that regime, the resource-eroding effect has been accelerated. Eroding departments' resources forces them, eventually, to seek additional resources at which point the full amount of the budget baseline will be reviewed, raising the potential for this review process to function as an institutionalised clear the decks procedure of the type proposed by the Treasury (1984) (see Chapter 4). That this may be the case was suggested in Chapter 6 by the State Services Commission's comment on the output price review process. The capital contribution requirements implemented since 1994 suggest application of a similar review process of departments' assets. The policy that departments would receive capital contributions only as a last resort of finance after the use of all available cash contradicts the earlier idea that paying departments an output price to cover full costs allows them to accumulate sufficient cash to replace their assets. The nature and operation of the baseline review processes are considered in more depth in Chapter 9.

The development of the fiscal targets and provisions reinforces the budget baselines regime and also extends to all government expenditure, not merely to departments' budget baselines. Possibly, the muddled ideas evident from the fiscal targets and the counting framework are a result of the difficulties arising from a set of principles which failed to adapt to accrual accounting the cash-based ideas from which they are derived. The original cash-based expenditure targets, if applied to operating expenses and capital expenditure, might be thought to capture all that is intended. Regardless of the absurdity of the principles of fiscal responsibility, and some of the rules developed in the counting framework, both that and the budget baselines regime clearly impose considerable downward pressure on expenditure. Given this downward pressure, it might seem curious that the commitments loophole in the Public Finance Act, identified in Chapter 4, should be opened even wider with the counting framework, and even more curious that the means of escape from the expenditure constraints, through leasing, commitments and other private financing arrangements, would be highlighted and encouraged. Arguably, if the intent were to achieve the stated objectives of the Public Finance Act and, in particular, to safeguard public assets by controlling the issue of securities, this loophole would be closed rather than

advertised. The effect is to promote a particular form of debt financing arrangement which escapes the counting framework and escapes prior parliamentary scrutiny. This issue will be considered in more depth in Chapter 10.

The budget baselines regime merely determines the amount of resources to be made available to departments. The use of the resources supplied for the purchase of outputs is considered in the next chapter.

8 Commercialisation and purchasing

The budget baselines regime covers all appropriations affecting departments but, for output appropriations, the amount established as a department's budget baseline is only the first step of a two-step budgeting process. The second step, which is the subject of this chapter, is to determine exactly which outputs will be produced within the budget baseline (Treasury, 1990, p. 80-81). Just as the budget baselines regime has developed over the years since it was first implemented, so too has the commercialised output purchasing model developed over time.

This chapter explains the way in which the budget baseline resources made available are used to obtain outputs either from departments or from alternative providers. The National government of 1990 pursued a commercialisation strategy which supported this purchasing idea and the chapter begins by explaining the manner in which this commercialisation strategy affected the specification and costing requirements for outputs. This was expected to result in a competitive contracting environment in which price would determine which provider should be awarded a contract for output provision. When this intended competitive environment failed to achieve the results apparently anticipated, and when public opposition to the idea of privatisation was evident, this commercialised regime was taken down to a more detailed, but less visible, level. This development resulted in some controversy within the Treasury over the nature and appropriateness of the commercialised financial management system. The chapter includes illustrative boxes showing the effect of the commercialising process on the Department of Corrections and the Department of Statistics.

Policy strategy 1991/92: Commercialisation, growth and employment

Chapter 7 explained how, for the 1991/92 budgeting round, the ECC determined the amounts of departments' baselines. Once that first step was completed, the budgeting process changed to adopt a purchasing focus. The ECC required departments to specify clearly their intended outputs and the full cost of those outputs. At this point, recognition was required that those outputs could be

the responsibility of more than one vote minister. Departments' budgets therefore had to be analysed into the various votes, and the idea presented was that the budgeting process related to each vote's expenditure base. Vote ministers are cast as purchasers of departments' outputs and, provided those purchasers use the vote resources to pursue the government's strategy, their use of resources may reflect their own preferences. Departments' outputs were scrutinised, with the process changing to decisions about which outputs the government should purchase in light of the adopted strategy. Those outputs identified as low priority in relation to the growth and employment strategy were either reduced in quantity or eliminated (TC 1990/13, 25 October 1990, p. 15, Treasury files; ECC (91)212, 15 August 1991, Richardson files 999; Kidd, 30 July 1991, ECC Schedule of expenditure decisions, Richardson files 1157).

Although the budgeting process adopted for the 1991/92 budgets was judged a success, its weaknesses largely related to this second purchasing step which was intended to allow the specific targeting of expenditure. Those weaknesses included the difficulty of making decisions using broad output specifications, and, following decisions to save costs by not purchasing particular outputs, departments’ ability to defeat at least some of those savings by respreading their costs over other outputs. The specification and examination of outputs at a more detailed sub-output level was proposed (ECC(91)212, 15 August 1991, Richardson files 999; Treasury, BR No. 62, 20 May 1992, Richardson files 295).

This use of budget baseline resources to purchase outputs revealed two other matters requiring consideration: the manner in which the reduced resources available after extracting efficiency dividends from departments’ baselines could be applied at the purchasing stage; and Vote ministers’ ability to act as discriminating purchasers of outputs.

Efficiency dividends and the purchasing phase

The extraction of efficiency dividends from budget baselines required accommodation of those expenditure reductions in the purchasing phase of the budget process. Two expenditure-reducing options were identified: price reductions and output quantity reductions. Price reductions, acknowledged as a

blunt instrument, were rationalised at the time because inflation was low and therefore scope existed for "reductions in unit output prices paid by the Crown without unacceptable effects on the quality or quantity of outputs delivered, through departments achieving improvements in productivity" (ECC(91)M64/3, 11 December 1991, Richardson files 1024).

Output quantity reductions were achieved using a process which drew on the government's strategic objectives, but also required Cabinet identification of lower priority votes or expenditure areas. Vote ministers decided on output quantity reductions by aligning proposed expenditure with the government's priorities. They then identified their remaining "lowest priority 5, 10 or 15% outputs . . . ranked in order of priority and the extent to which those savings could be readily obtained". Vote ministers decided which outputs to purchase within the reduced resources available, while the low-ranked outputs were “tucker-boxed” for possible further savings as part of a later collective review phase (CSC(91)M24/4b & c, 19 June 1991, Richardson files 988; BR No 9, 9 October 1992, p. 7, Richardson files 305). The impact of this purchasing phase on the Department of Statistics reveals the effect of the policy strategy adopted, and the influence of those closely involved in development and operation of the financial management system compared with the reduced influence of those without such strong links to the ECC (Box 8.1).

Box 8.1 Purchasing and expenditure reductions

In 1992, the Government Statistician commented "only in the Balance of Payments and National Accounts areas has any explicit funding been provided to maintain the capability of the department in its statistical operations." According to the Treasury, this was because the department's priorities had been refocused on the provision of "high quality economic statistics", although gaps in those statistics still caused difficulties for macro-economic monitoring. For the 1992/93 budget round the department sought an additional $266,000 to reinstate the retail trade and overseas orders survey and the justice statistics, $1.5 million to improve the macro-economic statistics, and funding to implement a time use survey. Treasury advice to the Minister for discussion with the Minister of Statistics acknowledged the importance of social statistics and the Treasury's focus on finance portfolio interests. The reinstatements were declined, the resources for macro-economic statistics approved, and the funding of the time use survey considered the responsibility of those departments interested in it. Because the social policy reforms and wider social and economic changes implied a need for new official statistical information, the Government Statistician was directed to establish a standing review committee to assess priorities for social and population statistics. During the 1992/93 year, "following representations from private and public sector users, a number of organisations contributed to the one-off costs of reinstatement [of the retail trade and overseas orders surveys], and the Government Statistician agreed to reinstate them on a monthly basis from cost savings within the department." Following the decision that New Zealand host the 1995 Commonwealth Statisticians Conference, the department was required to meet the costs involved from within its baseline.

The 1993/94 budget required savings of 4%, plus contingency savings of 2%. The ECC categorised the savings offered into three tiers. It supported the first two tiers which included deferral of the work required to implement some recommendations from the macro-economic statistics review, closure of the Dunedin office, cancellation of statistics on deceased estates, cancellation of scheduled revisions to the Mining and Quarrying price index, cancellation of some publications, and productivity savings from information technology developments, but noted that some of those savings were "not robust". The contingency savings in the third tier mostly related to the remaining recommendations from the macro-economic statistics review and the ECC opposed these savings because they risked "undermining the quality of the department's statistical outputs with potentially significant flow-on effects to the users of those outputs, including social policy and macroeconomic policy advisers." Further reductions of 1.5% in the 1994/95 and 1995/96 financial years were to be absorbed by price reductions and, in the 1994/95 year, deferral of the biennial agriculture census, and reduced requirements to implement recommendations from the review of macro-economic statistics.

In 1996, after outlining the increasing difficulties facing the department, the Government Statistician commented that "although there is an increase in the demand for more complex measures, an unchanging funding base has meant that, once efficiency gains have been achieved, either fewer statistics in total can be produced, or their quality reduced . . . Management capability and the development of the skill base for the new environment have been constrained by inadequate funds for training needs . . . without additional funding, explicit cuts to major statistical services will be signalled before the end of the 1996/97 financial year . . . a case for analysing and addressing the perceived under-pricing of statistical outputs has several hurdles before it is able to be put forward"(T92/914, 27 March 1992, Richardson files 809; ECC(92)111, 21 April 1992, Richardson files 836; ECC(92)M14//1, 22 April 1992, Richardson files 1101; CAB(92)M15/10h, 27 April 1992, Richardson files 838; ECC(92)M16/8, 5 May 1992, Richardson files 1101; ECC(92)M21/4k, 13 May 1992, Richardson files 1101; CAB(92)M20/24n, 25 May 1992, Richardson files 840; CAB(92)M30/16, 3 August 1992, Richardson files 842; ECC(92)324, 2 October 1992, Richardson files 1052; ECC(92)M46/9, 6 October 1992, Richardson files 1101; CAB(92)M41/5h, 12 October 1992, Richardson files 843; T92/3683, 3 December 1992, Richardson files 804; T92/3762, 10 December 1992, Richardson files 805; ECC(93)93, 23 March 1993, Richardson files 971; ECC(93)M9/5, 24 March 1993, Richardson files 912; CAB(93)130 (Part 2) 26 March 1993, Richardson files 1016; CAB(92)M10/23k, 29 March 1993, Richardson files 910; Report of the Government Statistician for the year ended 30 June 1992, 1993, 1994, 1995, 1996).

Purchase advisers to assist ministers

With vote ministers expected to act as purchasers of outputs, the idea was that vote ministers would consider proposals for the supply of outputs from potential suppliers, either departments or other suppliers. They would also consider the costs involved and the contributions those outputs would make to achieving the government's desired outcomes. Vote ministers could then decide which outputs to purchase and, following executive approval, the proposed purchases would be summarised into Estimates for parliamentary appropriation. Purchase agreements could then be issued to successful suppliers, and each supplier's compliance with the purchase agreement monitored (Logan, 1991, recommendation 28, p. 97-98; CAB(92)M2/2, 27 January 1992, Richardson files 837; STA(92)20, 10 February 1992, Richardson files 958; CAB(92)M6/12, 24 February 1992, Richardson files 837; ECC(92)M50/2, 10 November 1992, Richardson files 1101).

The Treasury had already proposed support for Ministers in this purchasing process (T90/12N, 7 November 1990, Richardson files 758). Similarly, the Logan review recognised that Ministers did not necessarily have the skills, the experience, or the resources to act as the discriminating purchasers of outputs required to operate the reformed financial management system and this forced them to rely on departmental chief executives for advice about contracts and performance problems (Logan, 1991, p. 64). The working party on output definitions recommended the use of independent purchase advisers and, after consideration of the constitutional implications, the Treasury was directed to develop further this recommendation (T91/5246, 3 December 1991, Richardson files 834; ECC(92)353, 30 October 1992, Richardson files 955; ECC(92)M50/2, 10 November 1992, Richardson files 1101).

The process adopted for employment of an independent adviser required a purchase agreement for the advice, with that agreement signed by both the vote minister and the chief executive of the department concerned. The cost of the adviser must be charged against the vote about which advice is sought, and the adviser is accountable to the vote minister. Although these advisers were referred to as purchase advisers, the idea of an independent adviser was extended to include advice about ownership (STA(93)M5/2, 3 March 1993, Richardson files

1014; CAB(93)M7/4a, 8 March 1993, Richardson files 910; CO(93)9, 6 August 1993). Some Ministers used purchase advisers initially and the opportunity remains to use them, but the practice has largely ceased (CO(93)9, 6 August 1993; Discussion, State Services Commission and Treasury, March 2001).

Commercialisation

The commercialisation strategy adopted by the 1990 National government allowed development of Treasury's (1990, p. 86) advice to the incoming government that ministers' purchasing decisions would be improved if departments' outputs were made to resemble goods and services available in the private sector, and if both the public and the private sectors faced comparable costs.

Outputs like those available in the private sector

The Treasury had already proposed that system developments required detailed output specifications (T90/N12, 7 November 1990, Richardson files 758). Experience from the first budgeting round in 1991/92 resulted in the Treasury recommending again, and with support from the Logan committee report, that both output specifications, and the size of some outputs and output classes should be reviewed. Consistent with the Logan report recommendations, which noted disputes between departments and the Treasury over output specifications and classes, the Treasury established a working party on output definitions to devise principles for defining output classes, for "specifying outputs at lower levels of aggregation", and a negotiation process for output specification and changes in output class structures. The working party also recommended the adoption of purchase agreements (T91/3451, 7 August 1991, Richardson files 719; ECC(91)212, 15 August 1991, Richardson files 999; Logan, 1991, p. 97-99; STA(92)20, 10 February 1992, Richardson files 958; CAB(92)M6/12, 24 February 1992, Richardson files 837; T92/931, 30 March 1992, Richardson files 809; STA(92)63, 6 April 1992, Richardson files 959; T92/3253, 20 October 1992, Richardson files 800; ECC(92)353, 30 October 1992, Richardson files 955; ECC(92)M50/2, 10 November 1992, Richardson files 1101).

Output class structures

The working party equated output classes to product lines and proposed that the purchaser's perspective should dominate decisions about those output classes. It devised universally-applicable organising and aggregating principles to structure output classes. The organising principle assumed continued separation of policy advice, administration of payments, and service delivery, and proposed that an output class should "comprise only those outputs which are able to be meaningfully specified together (including by using common performance measures), from the purchaser's perspective". The aggregating principle assumed that any large output class should be reduced, with large defined as more than $50 million for an output class which is greater than 30% of the appropriations for a department's output classes or POBOCs (ECC(92)M50/2, 10 November 1992, Richardson files 1101). Application of these principles to determine and change output class structures required a consultative process between departments and the Treasury with disputes referred to the Vote Minister and the Minister of Finance. Structural, output class and output specification changes made in the Department of Justice reflected pursuit of the commercialisation strategy and the National government’s election manifesto commitments to private sector involvement in the prison system (Box 8.2).

Box 8.2 Commercialisation strategy and output class changes

The introduction of private sector contracting into the prisons system commenced with two sets of developments intended to achieve: entry into "contractual arrangements with private sector companies, or, more likely, consortia of companies to finance, design, build, own and operate a 350 bed medium security prison in South Auckland and a 250 bed remand facility in central Auckland"; and contract arrangements for prisoner escort and court-related custodial services. For both, in addition to legislative changes, structural and output class changes were required.

Structural changes

Two new management positions were created in the Department of Justice: General Manager Criminal Justice Development, "with responsibility for the development of policy applications in the field of criminal justice and the development of contracted corrections services; and General Manager Corrections Operations with responsibility as the provider of the public sector corrections services". From 1 October 1995, the Department of Justice was split into three, the Ministry of Justice, the Department of Corrections and the Department for the Courts. The Department of Corrections was "responsible for providing corrections services, managing the corrections systems and contract management. A separate agency, responsible only for delivering corrections services may be set up in a few years time." From the time of its establishment the Department of Corrections included in its organisation structure a contracts management group.

Output class changes

Examination of the Department of Justice and the Department of Corrections annual reports reveals regular change in all output classes. From 1991 until 1993 under two broad output classes: custodial remand services to courts, and administration of court sentences of imprisonment including corrective training, the range of prison services such as re-integrative programmes and provision of information about inmates were included. While the differentiation between remand and sentenced prison services was maintained, from 1994, the custodial aspect of imprisonment increasingly was separated from other aspects of imprisonment by creating new output classes for those other aspects, such as an information services class, while a sub-class of both sets of custodial services was the development of contract management services. In 1995, the custodial aspect was further segmented into different levels of security: maximum, medium and minimum. From 1996, a new output class was created which separated from the custodial services, escort and custodial supervision services to courts and, from 1998, another output class, contract management services was created. (CSC(92)153, 13 October 1992, Richardson files 1105; CSC(92)M52/5, 28 October 1992. Richardson files 1105; ECC(93)153, 6 April 1993, Richardson files 972; ECC(93)M13/6, 7 April 1993, Richardson files 912; CAB(93)M12/17e, 13 April 1993, Richardson files 910; Department of Justice, Annual reports for the years ended 30 June 1991 to 30 June 1996; Department of Corrections, Annual reports for the years ended 30 June 1996 to 30 June 2000).

Purchase agreements

The working party on output definitions recommended the issue of purchase agreements for all outputs purchased by the Crown, with each agreement specifying outputs "at a sufficiently detailed level for the parties concerned to identify and assign responsibility for the risks and obligations associated with delivery". Minimum specifications would describe the outputs and their cost, the terms of the agreement, performance measures, standards and procedures for assessment, reporting requirements, rewards, sanctions and processes for dispute resolution, and procedures for amending the agreements (ECC(92)353, 30 October 1992, Richardson files 955; ECC(92)M50/2, 10 November 1992, Richardson files 1101). Ministers were advised that the purchase agreements would allow them to:

> choose the mix of individual outputs we wish to purchase and ensure that these are consistent with the Government's strategy;
>
> ensure that the individual outputs are value for money by comparing the outputs offered by a department with those from other sources; and
>
> ensure that the outputs we are paying for are actually supplied. (T93/434, 4 March 1993, Richardson files 817).

The ability to compare departments' outputs with those from other sources was enhanced by amending the Public Finance Act to require a purchase agreement between the Crown and any output provider, and to require reporting payments made to external suppliers by output class (T93/1752, 8 July 1993, Richardson files 355; ECC(93)M27/6, 27 July 1993, Richardson files 912; Public Finance Act; Treasury, 2 June 1999, "Purchase agreements for non-departmental output class appropriations" FM/3/5, Treasury files).[34]

Departments, with Treasury assistance, developed the purchase agreements, while the Treasury also devised a technical review process and evaluated the implementation (Treasury, February 1993, "Purchase agreements background information, p. 2, Treasury files; Treasury, 9 February 1993, Guidelines for preparing and assessing purchase agreements, p. 9, Treasury files). According to the Treasury this initial technical review process was largely constructively-received (T93/2510, 29 September 1993, Richardson files 1094; Treasury, 12 November 1993, FM/2/13, Treasury files).

The ongoing technical reviews were intended to assist departments but, apparently as part of its more sophisticated approach to advising the Minister of Finance, the Treasury also expected that the information obtained from these reviews would allow it to give second opinion advice on low-priority outputs by assessing the extent to which ministers' purchasing is "consistent with the government's strategic objectives and priorities"; to assist with helpful information when departments cannot accommodate cost reductions; and to assess both efficiency and alternative sources of supply (T93/233, 10 February 1993, Richardson files 1093; T93/2951, 17 December 1993, FM/2/13, see also Chapter 6 and the financial management initiatives incentives theme). The dual purpose of

this technical review process is evident from the different reports issued on the technical review process (Box 8.3).

Box 8.3 Purchase agreements and technical reviews

The Department of Justice reported in its annual report for the year ended 30 June 1993 that, "Recent and ongoing state sector and departmental reforms mean that existing prisons are in a good position to compete with the private sector. The performance of each will be measurable and hence comparable. . . . [and this] should enhance performance in both privately managed prisons and publicly managed prisons. The department is currently developing contracts for the management of two prisons in the Auckland area. At the same time the department is developing contracts for the management of some prisoner escort services from prisons and police stations to courts, and for court related security services."

The technical review of the 1993/94 purchase agreement between the Department of Justice and the Minister of Justice resulted in two assessment reports, one for the department's chief executive, the Secretary for Justice, and the other for the Minister of Finance. The assessment issued to the Secretary for Justice proposed, in relation to the custodial administration of court sentences output class that "consideration should be given to further disaggregation of this output, for example, separate outputs for minimum, medium and maximum levels of security."

The assessment for the Minister of Finance noted the proposed introduction of private prisons, the department's internal restructuring to split its purchase and provision roles, and the planned work to revise output classes. It assessed the agreement using three broad tests: description of services; choice of services; and measurability. The assessment of choice required consideration of whether "the document highlight[s] opportunities for alternative providers. One area where this is imminent is private prisons". It sought separation of the costs of inspection, contracting and monitoring prisons; "unit costs for different levels of prisoner security . . . if a fair comparison is to be made for a particular facility", and noted a conceptual problem which was not applicable in the case of prisons, "that careful treatment is required of fixed costs to make explicit the avoidable costs of private provision". While praising the data in the purchase agreement because it allowed unit cost calculations, revision to output specifications was thought likely to improve the potential to introduce alternative suppliers of other activities: "the purchase agreement should highlight where alternative forms of provision are or might be considered" (Treasury, 21 May 1993, FM/2/13, Treasury files; Treasury, 28 September 1993, FM/2/13, Treasury files).

Eventually the role of the technical review process became "uncertain" and ceased after the 1996/97 budgeting round. The stated reason for this was that the technical quality of purchase agreements had improved, although quantity measures, quality measures and output class structures were considered risk areas (Treasury, 1997, Technical review panel (TRP) update; Discussion Treasury staff, August 2001).

Comparable output costs

The commercialisation objective required that departments and private sector output providers faced similar costs. The Public Finance Act required that departments' output costs be measured by full production cost (sections 2, 4),

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[34] In 1993/94 payments for outputs to non-departmental suppliers amounted to approximately 25%, or $8.9 billion of government expenditure (T93/1752, 8 July 1993, Richardson files 355).

which, according to the Treasury was important because in the absence of contestable prices, "where possible, the price charged should be based on full cost-pricing, including depreciation and a return on capital" (T91/22, 8 January 1991, Richardson files 780). The significant costs faced by the private sector and from which departments previously had been exempted were depreciation, finance costs in relation to both debt and equity, and taxation. The finance costs and taxation were incorporated in a capital charge designed to approximate those expenses, while asset valuations were important to determine the amount of both the capital charge and depreciation.

Asset valuations

Generally accepted accounting practice (GAAP) allows reporting entities the choice of either historical cost or modified historical cost for reporting on assets, a point noted by those responsible for developing phase 2 of the incentives for departmental performance as significant for competitive neutrality principles (Treasury, 10 April 1990, Incentives project phase 2: capital charge/interest regime, Treasury files).

Treasury instructions issued under s.80 of the Public Finance Act require all government departments to adopt modified historical cost for their valuation base, using net current value for land and buildings, and for intangible assets, depreciated replacement cost for specialised assets as determined by the Treasury, and historical cost for the remaining assets. This requirement to adopt the modified historical cost base automatically means that regular revaluations are required because of the provisions of applicable financial reporting standards (ICANZ, SSAP28; FRS3). The financial reporting standards require revaluations at least five-yearly, but the Treasury instructions require them at least three-yearly. Treasury instructions also require departments to revalue any purchased identifiable intangible assets and, while noting the Public Finance Act's interpretation of contingent liabilities is narrower than that in GAAP, prohibits departments from recognising contingent liabilities (Treasury instructions, www.Treasury.govt.New Zealand/instructions/html).

Capital charge

Early discussion of the capital charge assumed a goal of competitive neutrality, proposing that a capital charge be set at a rate appropriate to each department which would be the rate of a "private sector counterpart" (see chapter 6). From the Crown's perspective, the capital charge would represent "the return available from an alternative investment of similar risk" and would be based on adjustments to the 5-year rate for government bonds. Although the idea of an alternative investment makes no sense in the public sector, this discussion carried through into early announcements of the capital charge and departments were advised of the process required to negotiate their capital charge rate (TC1990/13, 25 October 1990, p. 7, Treasury files).

The Labour government in power until late 1990 had agreed that those departments without a private sector counterpart would be subjected to one of two alternative default rates related to the level of risk involved. These rates were to be set by the Minister of Finance but early in 1991, the default rates the Treasury proposed were so high that some ministers queried the charge. Whereas the interest rate on which the capital charge was based was 12%, the capital charge rates proposed were 20.5% and 17.8%. This prompted the review of the state sector reforms (Chapter 6) but, in addition, the Cabinet established a working group to make recommendations on "a capital charging regime for government departments which is tailored to the particular objectives and requirements of Government" (TC1990/13, 25 October 1990, p. 9, Treasury files; T91/71, 15 January 1991, Richardson files 783; CEG(91)M9/4, 12 March 1991, Richardson files 936; CAB(91)M13/11, 8 April 1991, Richardson files 867; T91/1525, 18 April 1991, Richardson files 663).

The report of the working group viewed the overall objectives of the capital charge regime as "consistent with the Government's broader objective of getting improved departmental performance", and identified two specific objectives. The first of these was "to make clear the *full* costs of goods and services produced by departments" (emphasis in original). This was further explained as assisting "ministers to make decisions which are not consistently biased in favour of departmental production", and, where competition is limited, "to make more

informed choices on the basis of the full costs of the goods and services needed to achieve their policy objectives", with value-for-money more likely to be achieved by removing the bias in favour of capital-intensive outputs. The second specific objective was "to provide the information and incentives needed for efficient management of the Crown's investment in departments". Departments would receive output appropriations which cover all costs including the capital charge, but if departments were to reduce their net assets and return capital to the Crown, they would have "the flexibility to apply that capital charge amount to other inputs" (STA(91)68, 21 May 1991, p. 3-4, Richardson files 1033).

This report stated that in principle the capital charge rates should be "agreed for individual departments based on the costs of capital and expected future growth for private sector counterparts", but proposed for the first year that a "single standard rate of capital charge be applied to all departments". Following some adjustment to the calculation process, the standard rate proposed was 13% based on an interest rate of 10% (STA (91)68, 21 May 1991, Richardson files 1033).[35] This was agreed and announced to departments, although this rate was also considered high. The Treasury was instructed to convene an officials group to monitor implementation of the charge and chief executives were advised that they would need to negotiate a capital charge rate for the following year. The media announcement of the capital charge regime stated that the charge "represents the return the Government might expect to obtain from an investment of similar risk" (STA(91)M15/6, 22 May 1991, Richardson files 988; CAB(91)M20/8, 27 May 1991, Richardson files 868; TC1991/4, 7 June 1991, Richardson files 868; T91/2940, 6 July 1991, Richardson files 704; STA(91)108, 8 July 1991, Richardson files 1034; T92/2843, 15 September 1992, Richardson files 796).

The officials group made several recommendations for further development of the capital charge regime, including that it should be based on the revalued amount of assets, and methods for incorporation of the charge in departments'

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[35] The first calculation process included an adjustment for expected future growth of private sector counterparts and a tax adjustment at the full tax rate of 33%. This was changed to an adjustment for inflation and to recognise that the effective tax rate approximated 20%. The high charges proposed which prompted the

output costs. It also made two proposals which the chairman of that group and the Minister of Finance opposed: a reduction in the standard capital charge rate for the 1992/93 year, and a pilot scheme to establish department-specific rates.[36] The Minister of Finance was requested to establish a process for setting department-specific rates, and a pilot group of departments tested this process (T92/520, 21 February 1992; Richardson files 809; T92/611, 28 February 1992, Richardson files 809; STA (92)35, 10 March 1992, Richardson files 958; CAB(92)M10/10, 23 March 1992, Richardson files 837; T92/2618, 25 August 1992, Richardson files 794; STA(92)190, 8 September 1992, Richardson files 963; CAB(92)M38/7f; T92/2843, 21 September 1992, Richardson files 796; CAB(92)M43/12, 27 October 1992, Richardson files 874).

The Treasury advised the Minister of Finance that department-specific capital charge rates would ensure that departments' activities are neither subsidised thus "crowding out possible private sector suppliers" nor charged out at "too high a price", and that they would encourage the use of relevant private sector performance indicators and techniques (T92/3403, 6 November 1992, Richardson files 802; STA(92)224, 10 November 1992, Richardson files 1012; STA(92)M38/2, 11 November 1992, Richardson files 1011). The department-specific rates devised were "generally lower than the standard rate", thus supporting earlier assertions that the standard rate of 13% established in the first year was high in relation to private sector operations. The need to review the parameters for setting the standard rate was noted, as were the implications of applying the standard rate to derive third party charges:

> The client is faced with a charge that has built into it a rate of return that is perceived to be much higher than that prevailing in the industry. This problem may be general to the supply of non-contestable outputs to third parties (e.g., Justice registries). (ECC(92)451, 14 December 1992, Richardson files 955, p. 3).

A further report on issues related to the establishment of department-specific capital charge rates was requested in time for the 1994/95 budgeting round, but no documentation has been found and no other departments received department-

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review were based on an underlying interest rate of 12%, but this was reduced to 10%, with that change attributed to falling interest rates and the passage of time.

specific rates for their capital charge (ECC(92)M55/30, 15 December 1992, Richardson files 956; CAB(92)M52/36, 21 December 1992, Richardson files 875). The pilot departments continued with department-specific rates, but those rates were abolished from 1 July 2001. Maintenance of department-specific rates "required considerable input from departmental finance staff as well as Treasury vote teams and Ministers" and therefore had "an associated compliance cost" (email from Treasury to S. Newberry, 2 November 2001).

The parameters of the standard rate continued unchanged but more recently the Cabinet approved a modified formula for calculation to take effect from 1 July 2002 (TC2000/16, 21 December 2000, Treasury files). This modified formula is based partly on recommendations made in 1997, but combined with changes in the method of determining the interest rates to reduce annual fluctuations (Lally, October 1997, www.treasury.govt.nz/costcapital; CAB(00)M42/11, 18 December 2000, Treasury files)[37]. The parameters used in this revised capital charge suggest that the standard capital charge rate remains biased high in relation to private sector operations. Although the impact of this biasing was acknowledged for third party outputs, what was not acknowledged was its effect on outputs for supply to the Crown and the effect of decisions which ignore the effect on the Crown as a whole. Both were noted in a review of the capital charge regime (Box 8.4).

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[36] There was disagreement within the group over the capital charge regime and its implications. The effect of changes in the capital charge rate was explained in the previous chapter.

[37] This recommendation followed the development of capital charge parameters for Crown companies and implied an increase in the capital charge rates determined. The comparison of the Crown company model's parameters and those applying to the capital charge regime is inconsistent with the actual application of the capital charge regime. Lally (1997) states that the capital charge regime applies a rate of 6.5% above the government stock rate. This 6.5% is an average of the high and low rates used (9% and 4%), but the method of applying the parameters does not result in a single rate of 6.5% and Lally's claim that the proposed changes are fundamental only in relation to taxes is incorrect.

Box 8.4 Full production cost: asset valuations and the capital charge

In 1993, Price Waterhouse reported on a survey of the benefits and current issues relating to the capital charge regime. The report noted that departments were considering renting assets as an alternative to owning them. "Renting assets would of course free up surplus capital and reduce both depreciation and the capital charge. On the other hand, the owner of the assets presumably needs to obtain a rent which is economic and covers the owner's costs of holding the assets . . . A particular reason which may make leasing more attractive than owning is the opportunity the lessor has to deduct depreciation for tax purposes. While this may result in a saving to the department there would possibly be a net loss of revenue to the Crown through reduced taxes of the lessor" (p. 14).

Price Waterhouse also commented that, "The Justice Department will be required to compete with private sector providers of prison services. Justice Department prisons are likely to be older and less suitable for modern rehabilitation methods. Their value on a replacement basis (and therefore the capital charge) is also likely to be higher than the value (and target returns) of new purpose built prisons provided by the private sector. The higher cost of capital for Justice Department is compounded by higher operating costs. It will be necessary for Justice Department to understand the economics of alternative service providers and to develop an appropriate response. The subsidy involved in maintaining very old prisons may need to be isolated" (p. 20).

From 1991 until 1993, the Department of Justice reported prison buildings on the basis of depreciated replacement cost. In its 1993 annual report, it adopted a specific in-use market value basis and revalued the prison assets. In combination with a general fall in property values, the effect was a downward revaluation of $111.689 million which also affected the future capital charge and depreciation expense. (Price Waterhouse, Capital charging regime for Government Departments - survey of benefits and current issues, August 1993; Department of Justice, Annual report for the year ended 30 June 1993, (ECC(93)318, 6 September 1993, Richardson files 911; ECC(93)M33/6, 7 September 1993, Richardson files 912; CAB(93)670, 10 September 1993, Richardson files 1246; CAB(93)M36/14ad, 27 September 1993).

Costing standards and guidelines

The need for rigorous costing systems was argued on several bases and the promulgation of costing standards and costing guidelines was agreed. Following agreement to the proposed programme for the departmental management initiatives (Chapter 6), the Treasury devised cost accounting standards, which are incorporated in the Treasury instructions issued under s.80 of the Public Finance Act. These costing standards took effect from 1 July 1994. They require that all operating costs, whether direct or indirect, be assigned to outputs but that other expenses not be assigned to outputs.[38] They also specify requirements for the documentation and disclosure of cost accounting policies, including policies on the assignment of direct and indirect costs, and consistency in applying those policies (Treasury, 24 October 1990, An overview of Mode C, Treasury files;

[38] Depreciation and the capital charge are classed as operating costs. Other expenses are expenses that cannot be attributed to outputs and which require a separate appropriation. According to Treasury instructions other expenses are those expenses not related to the current production of outputs such as major restructuring expenses, asset write-offs and redundancy costs (TC1995/8).

Logan, 1991, recommendation 30; STA(92)46, 17 March 1992, Richardson files 958; STA(92)M7/1, 18 March 1992, Treasury files; STA(92)147, 13 July 1992, Richardson files 961, p. 2; CAB(92)M28/8d, 20 July 1992, Richardson files 841; T92/2805, 11 September 1992, Richardson files 796; STA(92)258, 8 December 1992, Richardson files 1013; STA(92)M42/3, 9 December 1992, Richardson files 1011; ECC(92)428, 11 December 1992, Richardson files 955; ECC(92)M55/19, 15 December 1992, Richardson files 956; CAB(92)M52/16q, 21 December 1992, Richardson files 875; Treasury, Cost Accounting Policy Parameters, Treasury instructions, www.Treasury.govt.NZ/instructions.html).

The Treasury issued a booklet of costing guidelines in 1994. This booklet, which is guidance rather than an instruction under s. 80 of the Public Finance Act, recognises that costing systems in both the public and private sectors provide internal management information but that, in addition, the costs derived from the public sector system are used to determine the price of outputs, provide the legal limit for appropriation, and are externally-reported (Treasury, 1994, Improving output costing: guidelines and examples).

Pricing

The need to separate prices from costs of outputs was identified in the *Report on Departmental Incentives,* included in phase 3 of the first departmental incentives project, and then pursued as part of the departmental management initiatives project. Contestability, where possible, was considered the best way of achieving this but, in the absence of contestability, the use of pricing rules was advocated, examples of which were benchmarks based on the costs of a hypothetical efficient provider, or using the provider's prospective costs (Treasury and SSC, 1989, p. 17, Treasury files; T90/N12, 7 November 1990, Richardson files 758).

Although "pricing (or cost comparisons)" were intended to complement the improved output specifications and be phased in over several budget rounds, the Treasury preferred prices set using the previous year's costs reduced by an efficiency dividend, arguing that the resulting resource pressure would force innovation and prompt improved quality. This cost-based rule was retained for all

outputs, but alternative output pricing methods would be "phased in on a case by case basis where this represents a cost effective opportunity for getting better value from purchasing for Government". The pilot project to devise a pricing rule suitable for pricing policy advice outputs resulted in a proposal for the use of benchmark prices independent of any individual provider's costs but the benchmark prices were not used for payment purposes (T91/2578, 17 June 1991, Richardson files 695; ECC(92)47, 9 March 1992, Richardson files 836; CAB(92)M9/20, 16 March 1992, Richardson files 837; T92/3696, 4 December 1992, Richardson files 804; STA(92)258, 8 December 1992, Richardson files 1013; STA(92)M42/3, 9 December 1992, Richardson files 1011; ECC(92)428, 11 December 1992, Richardson files 955; ECC(92)M55/19, 15 December 1992, Richardson files 956; CAB(92)M52/16q, 21 December 1992, Richardson files 875; T93/346, 24 February 1993, Richardson files 355; T93/367, 25 February 1993, Richardson files 355; T93/1555, 21 June 1993, Richardson files 355; T93/1947, 28 July 1993, Richardson files 356; ECC(93)272, 2 August 1993, Richardson files 911; T93/2029, 6 August 1993, Richardson files 911; ECC(93)M29/1, 10 August 1993, Richardson files 912; T93/2111, 13 August 1993, Richardson files 356; CAB(93)M30/8, 16 August 1993, Richardson files 1018; ECC(92)306, 30 August 1993, Richardson files 911; ECC(93)M32/5, 31 August 1993, Richardson files 912; T93/2490, 24 September 1993, Richardson files 356; Treasury, 30 October 1995, Financial management initiatives: the next steps, p. 4, footnote 7, Treasury files).

A booklet of guidelines for setting charges in the public sector was issued in late 1997 and reissued in 1999, following the government's decision to encourage contestability. The booklet addresses user charging for outputs provided by the public sector, but proposes prior consideration of alternatives to public sector provision: whether the provision of particular outputs could be made contestable; whether the outputs should be out-sourced from the private sector; whether provision should be left to the private sector; and whether technology changes might affect cost recovery options. The booklet then identifies four types of goods: public goods, club goods, private goods and merit goods, but notes that merit goods combine elements of public and private goods. It sets out a framework to consider the charging options available, omitting merit goods from

the framework (p. 11-15). As with the costing guidelines, compliance with these pricing guidelines is not compulsory, although departments are likely to be required to show that they have followed them when (Treasury, 1999, "Guidelines for setting charges in the public sector", p. 5):

> legislation enabling the recovery of costs is reviewed;
>
> capital injections are sought for capital expenditure related to outputs whose costs are recovered;[39] and
>
> approval is sought for a significant change in charges.

These guidelines aim for full cost recovery and, although intended for services for which monopoly conditions exist, are not limited to those services (p. 3):

> COMPETITIVE NEUTRALITY
>
> Although the guidelines focus on setting charges for public sector outputs, they are also intended to foster alternatives to public-sector provision of services by requiring some consideration of alternative sources of provision. By requiring the recovery of full costs in most cases, the guidelines also provide a means by which the costs of public provision can be assessed against private sector alternatives.

The continued application of these guidelines to government departments was confirmed in 2000 (www.Treasury.govt.New Zealand/publicsector).

The commercialisation strategy

In the early stages of the financial management reforms, indications were that through commercialisation, competitive neutrality would be achieved. The introduction of depreciation and the capital charge were crucial to this commercialisation process. The competitive neutrality aspect of commercialisation, however, became blurred from 1991 and this blurring affected the costs introduced as a part of the commercialisation process. For example, early proposals that the capital charge should be consistent with the return from other investments of the same risk changed, less than a year after implementation of the capital charge regime, to a suggestion that the rate should be consistent with the rate earned by other government investments, with the expected return to be earned from the monopolist electricity-generating SOE presented as a comparison.

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[39] An explanation of this point was that the use of full costs recovers current costs which include depreciation over the life of an asset but that the government provides the initial financing of that asset. The possibility was raised that when there is a "high degree of overlap between current users and the future users" those initial capital costs could be recovered early through higher charges (p. 19).

Similarly, early discussion of the asset base for imposition of the capital charge and depreciation acknowledged that requiring assets to be reported at market values could remove "comparability with the private sector", while subsequent developments required particular revaluation policies, some of which later were taken up controversially in financial reporting standards. In addition, Treasury instructions require more frequent revaluations than do the financial reporting standards as well as revaluation of purchased intangibles (Treasury, 10 April 1990. Incentives Project Phase 2: capital charge/interest regime, Treasury files; STA(92)35, 10 March 1992, Richardson files 958; TC92/3467, 13 November 1992; ICANZ, FRS3).[40]

Early proposals for introduction of the depreciation and the capital charge sought competitive neutrality and a "fair comparison between private sector and public sector service providers" but, after initial introduction, further developments were justified on the basis that departments should not be "given an unfair advantage of a lower cost of capital, forcing private sector participants out of the market". Having initially proposed the removal of any bias between the public and private sectors as a part of the commercialisation process, these developments, the non-development of department-specific capital charge rates, the continued application of the standard rate knowing that it was high, and the imposition of particular revaluation requirements for assets, might, arguably, ensure application of charges that look like those faced in the private sector, but those charges are high, thus implying the reversal, rather than the removal, of the earlier bias (T91/1229, 30 March 1991, Richardson files 653, p. 1; STA(92)35, 10 March 1992, Richardson files 958; T92/3467, 13 November 1992, Richardson files 802; T94/54, 21 January 1994, Treasury files FM/2/2; T96/3632, 6 December 1996, Treasury files; T98C/3430, 13 October 1998, FM/2/2 Treasury files).[41]

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[40] The requirement for revaluation of purchased intangibles is consistent with an international accounting standard which restricts revaluations by not allowing the revaluation of self-created intangibles. Prior to the issue of this standard departments were required to value their intangibles if possible.

[41] Draft documentation preceding these official rationalisations argued that the standard capital charge rate was “intended to: ensure that departments do not undertake activities in competition with the private sector. This happens when departments are given an unfair advantage of a lower cost for capital in their investment decisions” (Treasury, October 1992, Officials’ meeting, capital charge standard rate for 1993/94 and budget process to deal with a change in the capital charge rate, p. 4, Treasury files).

These commercialising developments were part of a regime in which comparative prices were expected to determine Ministers' resource allocation decisions without the need for direct intervention to force private sector involvement as had occurred in the United Kingdom. In other words, commercialisation would not necessarily create a competitively neutral regime, it would instead support privatising initiatives by disadvantaging public sector operations. Later comment and developments, however, suggest that commercialisation and competitive neutrality are the same or, as revealed in the pricing guidelines, that competitive neutrality has been achieved. For example, when the government adopted as a strategic priority a commitment "to encourage the contestable supply of resources and services in areas of public sector responsibilities", "indifference by Government as to whether the supplier of outputs is from the public or private sector" was an important part of this contestability strategy. The Treasury advised that a competitively neutral environment would allow "prices to signal how resources should be allocated and specifically to identify whether suppliers of inputs or outputs should be public or private sector agencies" (T92/2652, 29 September 1992, Richardson files 794; T93/434, 4 March 1993, Richardson files 817; Treasury, 1997, "Setting charges in the public sector", p. 3; Treasury, T98C/3994, 1 December 1998, Treasury files; Treasury, T99C/305, 23 February 1999, Treasury files).[42] Public announcements of that contestability strategy stated that it would:

> encourage innovation and efficiency in both the public and private sectors. [The government] is developing new principles to open up opportunities for private sector supply in areas of public sector responsibility where this is in the interest of New Zealanders. (Birch, 1998, Budget Policy Statement 1999).
>
> To ensure the best use of taxpayers' money, the Government will continue to scrutinise the quality and effectiveness of its spending. This may mean that the Government funds private sector organisations to provide services where they can give better value for money. (Birch, 1999, Budget speech and fiscal strategy report 1999).

[42] The Treasury's 1999 advice to the government about competitive neutrality did not claim that a competitively neutral environment existed, but the Treasury's pricing guidelines certainly suggest that that is the case.

Possibly, if a department's costs are biased high, privatisation may be politically acceptable if pursued as an expenditure reduction strategy, and if it *appears* to reduce costs (Box 8.5). [43]

[43] In the *Report on Departmental Incentives* one of the consultants involved had proposed that imposition of the capital charge on revalued assets would prompt optimal divestment decisions but, in phase two of the Incentives for departmental performance project, it was acknowledged that requiring revaluations would prevent comparability with the private sector and possibly bring the financial management reforms into disrepute (see Chapter 5). That consultant, in a publication, proposed that the capital charge regime was intended to encourage departments to sell surplus assets and return funds to the Crown, and to discourage departments from seeking capital contributions. Although the model is similar to that found in the private sector, "the adjustment is conservative in that it is biased against rather than in favour of government investment" (Lally, 1993, The cost of capital for government entities: an evaluation of the New Zealand Government's capital charge model, Treasury files).

Box 8.5 Privatisation: political strategy or expenditure-reducing fiscal strategy?

Work commenced on the privatisation of aspects of the prison system as early as July 1989 when the Strategos report was issued. The National Party's 1990 election manifesto stated its commitment to increase the role of the private sector in the prison system. From 1990 to 1993, the period covered by Minister of Finance Ruth Richardson's archives, considerable efforts were made to pursue this commitment: Justice officials' involvement in opening services to foreign investment; the pursuit of legislative changes; and departmental restructuring and revisions to output classes and output specifications.

Although the building and operation of prisons and provision of escort services were classified as role of the state issues, the project was pursued as an expenditure reduction project. The inevitable cost increases arising from the conflicting manifesto commitments to both considerably increase police numbers *and* reduce government expenditure evidently provided a rationale for urgency, pursuit under the expenditure reduction strategy, and the ECC's involvement. Authorised public announcements stated that the "contracting process will allow costs savings and improved comparison of service delivery options".

The Penal Institutions Act required amendment before contracting arrangements could be commenced and this was achieved in 1994, followed by penal institutions' operational standards which came into effect in 1999. Essential to the contracting process was the need to show that, "the successful tenderers won their contracts purely on merit." This required "systematic evaluation by a group of independent experts, the seeking of Cabinet committee approvals at each critical stage, and with the final decision being made by Cabinet." In 1998, "the Government announced that it intends to build and contract out the management of a new remand prison in Auckland". In 2000, after competitive tendering processes, Australian Corrections Management was operating the new Auckland Central Remand Prison under contract, while Chubb New Zealand Ltd was the provider of escort and courtroom custodial services in the Auckland and Northland areas. (T91/500, 19 February 1991, Richardson files 631; letter, R. Richardson to D. Graham, Richardson files 104; T91/610, 26 Feb 1991, Richardson files 634; CAB(91)M16/2a, 29 April 1991, Richardson files 868;letter, P. East, Acting Minister of Justice to R. Richardson, 14 June 1991, Richardson files 104; CAB(91)M23/28h, 17 June 1991, Richardson files 869; T91/4246, 23 September 1991, Richardson files; ECC(91)302, 12 November 1991, Richardson files 1027; ECC(91)319, 18 November 1991, Richardson files 1020; ECC(91)312, 18 November 1991, Richardson files 1027; T91/5197, 29 November 1991, Richardson files 345; T92/470, 18 February 1992, Richardson files 756; T92/731, 12 March 1992, Richardson files 809; T92/955, 1 April 1992, Richardson files 345; ECC(92)96A, 7 April 1992, Richardson files 836; ECC(92)96B, 7 April 1992, Richardson files 836; ECC(92)96C, 7 April 1992, Richardson files; 836; ECC(92)M12/2, 8 April 1992, Richardson files 1101; ECC(92)201, 25 May 1992, Richardson files 1052; ECC(92)M28/7, 26 May 1992, Richardson files 1101; T92/2527, 18 August 1992, Richardson files 345; CSC(92)M37/6a&b, 26 August 1992, Richardson files 1105; CSC(92)153, 13 October 1992, Richardson files 1105; CSC(92)M52/5, 28 October 1992. Richardson files 1105; T92/3228, 20 October 1992, Richardson files 345; CAB(93)M15/25, 3 May 1993, Richardson files 1018; CSC(93)M29/10; 14 July 1993, Richardson files 1019; CAB(93)536, 16 July 1993, Richardson files 1245; CAB(93)M26/14, 19 July 1993, Richardson files 1018; CSC(93)M29/11; 14 July 1993, Richardson files 1019; CSC(93)M29/11, 14 July 1993, Richardson files 1019; Department of Justice, Annual report for years ended 30 June 1993 -30 June 1996; Department of Corrections, Annual report for years ended 30 June 1996 - 30 June 2000).

The contestability strategic priority was dropped following the change of government late in 1999 and references to competitive neutrality died, with the terminology reverting to value-for-money.[44] Evidently, the Treasury's competitive

[44] Treasury documentation is clear that "competitive neutrality" and "value-for-money" may be viewed as synonyms, although the value-for-money focus suggested in late 1999 proposed that the term encompassed four dimensions (see Chapter 6 and T99/61, 20 December 1999, Treasury files). According

neutrality developments were re-aligned to focus on value-for-money, along with the other developments occurring under the value-for-money theme (see Chapter 6). The Labour coalition government has stated that it wishes to "maintain and strengthen the public sector" (Advisory Group, 2001, p. 10). It does recognise, however, that it is attempting to deliver services within constrained resources and identifies improvements in value-for-money as one possible source of funding for new initiatives because expenditure reductions achieved will enable the redirection of spending (Cullen, 2001, Budget Policy Statement).

Increased detail and more sophisticated monitoring

The idea of the output purchasing model assumed competition, and that the existence of competition would help to improve efficiency. The removal of "biases toward government provision" of outputs, combined with assumptions that departments could control all of their costs, requirements that departments use an explicit output costing system, and prohibition on them from cross-subsidising outputs would allow "effectiveness and efficiency of resource use" assessments by comparing outputs with those available in the private sector (Ball, 1993a, p. 5; Ball, 1993c; 1995; Scott and Ball, 1993, p. 6; Scott and Gorringe, 1989, p. 87). Similarly, the compilation of financial reports by output class would allow debate about the particular output classes purchased, the prices paid for those outputs, comparisons with the private sector, and assessment of departments' effectiveness in producing those outputs (Scott and Ball, 1993).

The biases toward government provision of outputs had been reversed by 1993 and the departments required to incorporate the increased costs in their output costs. Following the proposal for more sophisticated monitoring (Chapter 6), both purchase agreements and technical reviews of those agreements were introduced, with a dual reporting process adopted for the technical reviews (see Box 8.3). The

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to the Treasury, value-for-money is not defined in any legislation and so there is no single "right" definition (email, Treasury to S. Newberry, 12 November 2001). From the commencement of the reforms, most comment on value-for-money has suggested that price comparisons between public sector providers and alternative providers will help to achieve value-for-money, and this is evident from quoted documentation presented earlier in this chapter. A recent explanation states that "reliable value for money assessments can only be made if costing decisions are based on information that reflects the full cost of providing a

same proposal for more sophisticated monitoring argued the need to ensure that departments deliver the required services at reduced costs, suggesting that achieving this through the vote analysis function would not imply reversion to centralised input controls (T93/233, 10 February 1993, Richardson files 1093). In its briefing to the incoming government after the 1993 election, the Treasury proposed in-depth reviews of departments' activities, with those reviews conducted outside the budget cycle by Treasury, the State Services Commission and the Department of the Prime Minister and Cabinet. These reviews would consider alternative policy instruments, such as regulatory intervention instead of expenditure, focus "on achieving better quality service and cost-effectiveness", and would allow ministers to deal with more strategic matters such as determination of policy goals and outcomes instead of these day to day matters (Treasury, 1993, p. 19, 28, 97; 1996, p. 15).

The 1994-95 incentives developments received support from Coopers and Lybrand's report on their review of departments' costing systems which proposed that the Treasury encourage departments to develop good costing techniques. Those techniques, which identify costs "at a more detailed level than output", would allow production of that more detailed costing information to underpin purchase agreements. This would require a focus on output components, called intermediate outputs, and allow increased application of pressure on departments through competitive bidding, cost benchmarking, and, for high volume outputs, the negotiation of variable funding within the budget appropriation (Treasury, 30 November 1994, Surplus retention, Treasury files; September 1995, Coopers and Lybrand pp 6-8, p. 38, Treasury files).[45] The negotiation of variable funding within the output appropriations was called the separation of price and cost. Because a departments' output appropriations set a maximum amount for its costs, the separated price for outputs could only be less than those costs given that exceeding the appropriated amount would be illegal. With departments' output

service. The capital charge is an important mechanism to help achieve this". (TC2000/14, 20 October 2000, p. 7, Treasury files).

[45] Coopers and Lybrand's review was one of an ongoing series of good practice reviews intended to assess departments' financial management systems and to provide departments with examples of good financial management systems (Coopers and Lybrand, 1995).

costs viewed as variable when compared with other providers of outputs and intermediate outputs, the likely effect of these developments was recognised. Departments were likely to experience financial difficulties, especially because they were constrained from expanding their activities (Treasury, 24 October 1995, Efficiency and innovation in the public sector, FM7/4, Treasury files). A variable funding pilot project with the Customs department stalled when fractious relationships developed and, although other variable funding projects were recommended, it is not clear that any proceeded (Treasury, 1999, Output pricing/baseline reviews, Treasury files; Discussion Treasury June/August 2001).

The Treasury (1996) advised the incoming government of that year that lack of competition facing departments, and information imbalances between departments and Ministers, impeded price and quality comparisons with other providers. It proposed for inclusion within the budget cycle specific processes with a value-for-money focus. These would require departments to demonstrate improvements in the quality of spending, examine "opportunities for contracting out, benchmarking prices or costs, and [evaluate the] effectiveness and continued need for additional resources provided in earlier Budgets" (Treasury, 1996, p. 126, 132). The 1999 briefing, however, noted concerns about capability and hardly mentioned such matters.

The Treasury's role and the commercialised model

Gorringe (1995a and 1995b), a Treasury staff member and a key reformer in the early stages, had thought that the objective of the financial management reforms was the achievement of allocative and productive efficiency. He regarded the Treasury's role as one of resource allocation and demonstrated, using mathematical models, that attention to "the big allocation questions" is far more effective for achieving allocative and productive efficiency than attention to fine detail (1995a, p. 5-7, 16).

Gorringe believed that a rhetoric had been built around output purchasing and argued that when the purchasing model was devised and applied to all departments, the output specification and measurement problems, and the adverse consequences of adopting such a model, had been underestimated. Many outputs

may be "definable, homogeneous and measurable to a degree sufficient to allow some comparison with similar services" elsewhere, but such comparisons merely provide rough checks which are unsuitable for "profit centre governance" (1995a, p. 21). These specification and measurement problems also meant that the idea of surplus retention then under reconsideration was inappropriate because it offered "outrageous incentives for shading the quantity and quality of outputs, with the likelihood of damaging the Crown's purchase interest in both the short and the long term" (Gorringe, 1995b, p. 12).

According to Gorringe, the reality of budgeting was that it consisted of allocations "for ill-specified groups or classes of idiosyncratic, heterogeneous outputs that do not lend themselves to 'pricing' individually, and much less so as a group". In the private sector this would result in employment of staff rather piecework contracting arrangements, vertical integration rather than arms-length contracting, cost centres rather than profit centres, quality control via specification of some key inputs or product guarantees, and cost measurement (1995a, p. 11). He viewed as inappropriate the attempt to devise detailed output specifications and costs for use in an arms-length purchasing process as suggested by the contracting rhetoric. Further, even if arms-length contracting were appropriate, mode B appropriations for costs, together with the dubious conceptual basis of the capital charge, is inappropriate for use with such a process.

Gorringe questioned the "resources devoted to a contracting regime", arguing that attempts to "improve the translation of politicians' preferences into outputs are likely to have a low yield in terms of allocative efficiency" (1995a, p. 5-7, 16). He believed that "the gains from a fine specification of contracts may not be so great in the [budget] sector, and a broader specification may be more cost-effective" (1995a, p. 5-7, 14, 18, 21). Stressing "one chief message", Gorringe argued that the continued emphasis on competitive market ideas was inappropriate:

> We are on the wrong track if we put more and more emphasis on trying to make our system resemble as closely as possible contracting arrangements which are found in environments where measurement is easy. (1995a, p. 12).

The financial management system developments then occurring within Treasury required departments to provide increasingly detailed information and

Gorringe believed that these developments risked repeating the "excesses of the old input control regime". Arguing that a group within the Treasury had gone "off the rails", Gorringe observed that the previous onerous input controls had been replaced with a growing "information and accountability Leviathan":

> The danger is that the new accountability regimes may grow and grow until the deadweight and dynamic losses they impose become the impetus for a new set of public sector reforms. The new regime's costs are not met by the regulators, and the usual set of dynamics that gives rise to this is operating. (Gorringe, 1995a, p. 21).

Gorringe did propose an alternative to those developments but it required revisiting both the State Sector Act 1988 to reconsider the employment security of chief executives, and the Public Finance Act 1989 to allow some reversion to input controls (1995a, p. 9, 12; 1995b). He argued for recognition of the "more subtle efficiency properties" required for incomplete contracting, such as the hierarchy of organisational routines that comprise a department's capabilities. These are ignored by the private sector-oriented principal-agent model, and Gorringe proposed replacing that model with a commitment model for "long-term, incomplete, 'relational' contracts" which would require shared understandings, the development of such cultural factors as morals, ethics and staff commitment, and trusting chief executives.

Chapter summary

This chapter explained the commercialising developments applied to all aspects of departmental operations. The developments commenced as the creation of an output purchase model which would allow cross sector comparisons, but the commercialisation of departments' outputs was obviously contentious, with the specification of outputs and output classes resulting in some friction between departments and the Treasury. The Logan report had noted that there seemed to be no common or clear idea of the intent or eventual endpoint of the financial management reforms (see Chapter 5), and the dual reporting process adopted with the technical review of purchase agreements seems rather furtive, suggesting that the intent was not widely known. The report to the Secretary for Justice implied a concentration on technical matters, while the report to the Minister demonstrated a much more obvious privatising intent. Departmental management obviously were

aware of privatising developments but, perhaps, unaware of the extent of the privatising agenda.

The other key aspect of the commercialising development required determination of full costs which, supposedly, would allow valid comparisons between departments' output costs and competitors' output prices. Departments' costs were knowingly biased high, with much of that high biasing caused by asset revaluation requirements which feed through to a capital charge based on a rate that is also biased high, and to depreciation expense recognition requirements. High costs of compliance with the increasingly detailed accounting requirements required for the "information and accountability Leviathan" (Gorringe, 1995a, p. 21) would also have increased departments' costs, especially given the ideas from 1994 onwards that the accountability developments should require departments to do the monitoring work. While the published pricing guidelines suggest that these commercialising developments created a competitively neutral environment, clearly they did not. The commercialisation strategy created a contracting regime biased against public sector providers. Comparisons of departments' full costs with private sector providers may suggest that contracts should be awarded to the private sector providers when, in fact, the result will be more expensive for the Crown.

The idea that this output contracting regime did not generate the competitive environment expected coincided with recognition that under a new MMP electoral system, highly unpopular developments, such as privatisation, would be difficult to sustain. The lack of competition and information imbalances at the output level provided the rationale for driving the commercialised approach to a more detailed level. The proposals for in-depth reviews conducted by central agencies as a means of relieving ministers of day-to-day detail suggests that the comparative processes would be conducted by those central agencies at a less visible level, while allowing ministers to ignore such matters and focus on more strategic matters. The nature of the monitoring and review processes developed is the subject of the next chapter. Gorringe's arguments over these developments, however, made two important points. First, having thought that the financial management reforms aimed for productive and allocative efficiency, Gorringe's comments suggest that some other goal had taken precedence. Second, if

productive and allocative efficiency were to be the goal, Gorringe suggested that both the model and the legislation required change.

This chapter has focused on the conditions created for the purchasing model and, in effect, that model provides a means of determining the resources to be supplied to a department and how those resources will be used. Another rule constrains departments' ability to retain resources and this, together with the development of monitoring and review processes, is considered in the next chapter.

9 Resource retention, monitoring and review

The two-step budget process uses rules to determine the amount of resources departments will receive. A separate rule has developed to determine the extent to which departments may retain resources. Section 14 of the Public Finance Act requires that any operating surplus be returned to the Crown and, like the budget baselines and commercialisation processes, this rule has developed over the years. This chapter commences by explaining development of the rule and its effect, before considering the broader monitoring and review processes anticipated and developed. Finally it examines the detailed baseline review processes developed as a central agency task. Examples from the Department of Statistics and the Inland Revenue Department illustrate various aspects of these processes.

Resource retention and repayment of operating surplus

Departments receive resources as a result of the budgeting process outlined in Chapters 7 and 8, but their annual financial reports are used to determine the extent to which they may retain resources. A department's reported operating result will either increase or decrease its level of net assets but the Public Finance Act refers only to surpluses, interpreting an operating surplus as "the amount by which departmental revenue exceeds the expenses of a department" (s. 2).[46] The act requires that:

> except as agreed between the Minister and the Responsible Minister, no operating surplus resulting from the activities of that department shall be retained by the department. (Public Finance Act, 1989, s. 14).

Evidently, this requirement is based on the view that all profits of a department belong to the owner, and that it is the owner's prerogative to decide whether to re-invest such profits in a department (Treasury, March 1991, FMRP3, p. 4).

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[46] The interpretation of departmental revenue is "revenue generated by a department . . . resulting from the supply by the department . . . of goods, services, rights, or money to other parties, including the Crown" and expenses is "expenses measured in accordance with generally accepted accounting practice; and includes costs" (s.2). Between 1989 and 1992 operating surplus was interpreted to include abnormal and extraordinary items. This changed in 1992 to remove reference to those abnormal and extraordinary items. The change was related to anticipated accounting developments intended to abolish extraordinary items.

Although the Act is silent, earlier comment on operating losses views them as "a measure of poor performance" and rejects any idea that departments might receive a capital contribution to offset such losses (Treasury, November 1989, FMPG7, p. 1).

Early Treasury documents referred to the reported operating result simply, as the 'bottom line' of the operating statement. They were, therefore, consistent with the interpretation of operating surplus in the Public Finance Act 1989 (Treasury, November 1989, FMPG7, p. 1). Subsequent Treasury instructions, however, although issued subject to the provisions of the Public Finance Act (s. 80), modify that interpretation. The Treasury instructions contain conflicting statements. On one hand, all Treasury instructions should be read in conjunction with the Act, and "all terms [in the Treasury instructions] have the same meaning as in section 2 of the . . . Act". On the other hand, the instructions state "the Treasury will from time to time issue a Treasury Circular to define the operating surplus and how to calculate it", thus ignoring the interpretation in the Act (Treasury instruction 3.5).

In 1991 the Treasury advised the Minister of Finance that the Act's interpretation of operating surplus, although appropriate under most circumstances, requires adjustment for the purpose of calculating the amount of surplus for repayment to the Crown (T91/3722, 23 August 1991, Richardson files 727). At the time, the Treasury proposed adjustments to the operating surplus based on an interpretation of operating surplus that is "tighter than that in the Act and is therefore not inconsistent with the legal requirements" (T91/3722, 23 August 1991, Richardson files 727). One adjustment related to the speed of implementation of accrual accounting and the need subsequently to adjust the amounts at which assets and liabilities were reported. These were considered merely corrections of the opening position which should be excluded from the operating surplus for repayment. Another related to the interest earned on departments' bank accounts. Cabinet had decided that the "interest earned from departmental bank accounts . . . is returned to the Crown as part of a department's operating surplus", but, with effect from the 1990/1991 financial year, this

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Although extraordinary items were not abolished, they were restricted to such an extent that they are expected to be very rare events (see FRS7).

decision was extended to require that "the full amount of interest earned should be returned to the Crown irrespective of any losses that a department incurs". This was stated to be an interim position awaiting further policy development as part of the incentives project (CAB(91)M8/13; 4 March 1991, Richardson files 867; T91/3722, 23 August 1991, Richardson files 727; Treasury, TC1994/15, 13 September 1994, Treasury files). (see Chapter 6 for the introduction of interest in conjunction with the capital charge regime).

Since 1991 when this first reinterpretation of operating surplus occurred, the rule for determining the operating surplus for repayment to the Crown has evolved into a complicated three-step process. The philosophy underlying this process is that any operating surplus belongs to the owner, but any operating deficit reflects poor departmental performance and must be borne by the department. For the purpose of applying this philosophy, the reported operating result is viewed as comprised of several distinct parts, each of which must be considered separately.[47] Each part of the operating result that represents a surplus automatically returns to the owner, while each part that represents a deficit is borne by the department.

The evolution of the three-step rule is complex and occurred over a period of five years. Today, the process to determine the amount of surplus for repayment involves a first step which applies adjustments to the operating result reported in the financial reports; a second step which identifies and totals four figures included in the financial report; and a third step which compares the results of the first two steps and requires payment to the Crown of the higher positive figure.

The first step requires reversing out of the reported operating result the effect of: adjustments arising from the implementation of accrual accounting; all other expenses; and any deficits on Mode B net outputs (deficits from the sale of outputs on a competitive basis to third parties). Then, any realised revaluation reserves, which, under GAAP requirements are excluded from the reported

[47] The operating surplus for which departmental retention might, eventually, be considered is restricted to the supply of outputs to the Crown. To date, retention has not been allowed and, as suggested in chapter 6, retention seems unlikely until competitive pricing and payment in arrears has been achieved.

operating result, must be added. With the possible exception of the adjustments arising from the implementation of accrual accounting which are no longer an issue, the effect of all of these adjustments is to increase the reported operating surplus or to reduce any reported deficit, possibly with the result that the adjusted figure is a surplus.

As these repayment of surplus requirements evolved reasons were stated for the adjustments. The reason for reversing other expenses out of the reported result was that when a department received an other expense appropriation without specific funding, the expectation was that the department would absorb the expense and therefore "you would expect that, all other things being equal, the Taxpayers' Funds would decrease" (Treasury, TC1994/15, 13 September 1994, p. 1). This, however, contrasts with the early explanation to the Minister of other expenses which stated that "in cases where the operating surplus achieved by a department in the supply of outputs is large enough, ownership costs will reduce but not eliminate the operating surplus and thus will not reduce taxpayers' funds" (T91/4462, 8 October 1991, Richardson files 750). The adjustment for Mode B net deficits was required to ensure that departments should not be allowed to offset third party output costs against "revenue Crown from Mode B gross outputs; interest earned; [or] other ownership gains from departmental operations" (STA(92)190, 8 September 1992, Richardson files 963; CAB(92)M38/7f, 21 September 1992, Richardson files 843; T92/3246, 4 November 1992, Richardson files 800). The adjustment for the realised revaluation surpluses was because under GAAP such surpluses are excluded from the reported operating result. After adding back to the reported operating result each of these items, the adjusted result must be compared with the result of the second step which is outlined below (Treasury, T91/3722, 23 August 1991; Richardson files 727; Treasury, TC1994/15, 13 September 1994, p. 1; STA(92)190, 8 September 1992, Richardson files 963; CAB(92)M38/7f, 21 September 1992, Richardson files 843; T92/3246, 4 November 1992, Richardson files 800).[48]

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[48] It was recognised that the sale of an asset and the use of the proceeds to purchase another merely exchanges one asset for another. “For example, suppose a building is purchased for $20m, building prices increase, and the building is then sold for $30m and replaced by an identical building for the same price but in a different location. There is no obvious reason why the $10m gain should be called income rather than

The second step to this repayment of operating surplus rule ignores the reported operating result, which may be a deficit, and requires selection of certain figures from the operating statement to determine the minimum amount for repayment. These are the total of interest revenue, any net gain on sale of fixed assets, and any realised net revaluation reserve transfers where these are positive. The aggregated deficits from Mode B net outputs must also be added, thus forcing a reduction in taxpayers' funds in the event that a department incurs a loss on those outputs. (STA(92)190, 8 September 1992, Richardson files 963; CAB(92)M38/7f, 21 September 1992, Richardson files 843; T92/3246, 4 November 1992, Richardson files 800; ECC(92) 375, 9 November 1992, Richardson files 955; ECC(92)M50/11, 10 November 1992, Richardson files 955; ECR(94)M34/1, 27 September 1994, Treasury files; Treasury, TC1994/15, 13 September 1994, p. 4; Treasury, TC1996/2, 22 September 1997).

The final step for application of the repayment of surplus rule is comparison of the figures resulting from the two prior steps and repayment of the higher of the two figures. The effect of the rule is that departments will always repay to the Crown *at least* the amount of any reported operating surplus as that term is interpreted in the Act, but they may be required to repay considerably more than that, thus eroding taxpayers' funds while reported deficits cause further erosion (Table 9.1).

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capital solely to prevent its retention by the department. If the department could not retain the $10m it would have to reduce its physical capital" (Treasury, 1992, Lally: the base for calculating the capital charge, p. 9, Treasury files, emphasis in original).

Table 9.1 Repayment of operating surplus

	Department of Statistics			Inland Revenue Department		
Y/e	Reported operating result $'000	Surplus repaid $'000	Total effect on taxpayers' funds $'000	Reported operating result $'000	Surplus repaid $'000	Total effect on taxpayers' funds $'000
30/6/90	-383	0	-383	N/a	N/a	N/a
30/6/91	-10	0	-10	-143	0	-143
30/6/92	204	-204	0	11,400	-11,400	0
30/6/93	-3,657	-175	-3,832	6,471	-6,471	0
30/6/94	-2,779	-61	-2,840	-1,020	-4,989	-6,009
30/6/95	-2,166	-420	-2,586	4402	-9,825	-5,423
30/6/96	-2,362	-792	-3,154	-35,041	-7,897	-42,938
30/6/97	-5,713	-306	-6,019	3234	-3,234	0
30/6/98	81	-81	0	4,320	-4,320	0
30/6/99	-1,982		-1,982	6,470	-7,060	-590
30/6/00	-187		-187	7,650	-7,650	0
Total	**-18,954**	**-2,039**	**-20,993**	**7,743**	**-62,846**	**-55,103**

Monitoring and review processes

From the outset of the financial management reforms, much was made of the need for monitoring the government’s purchase and ownership interests in departments to offset the increased freedom allowed to chief executives. Apparently less important was the monitoring of the delivery and suitability of outputs, which was considered the consumers’ responsibility (Treasury, 1984; Treasury, 1990; T90/N12, 7 November 1990, Richardson files 758).

The central agencies intended to focus their attention on financial performance assessment techniques which would impose "strong incentives and pressures for efficiency through better management of balance sheets" (Scott, 1996, p. 65; see also, Dale, 1992; Ball, 1995; Scott *et al.* 1997, p. 376). Chief executives were considered crucial to the reformed financial management system because departments’ performance was their responsibility. A chief executive’s continued employment and part of their remuneration would, therefore, depend on their department’s achievement of specified results (Scott and Gorringe, 1989; Scott *et al*, 1990, p. 17; Ball, 1993a; Scott *et al.*, 1997).

The State Services Commissioner is responsible on behalf of the government for chief executive performance assessments (State Sector Act 1988). According to advice to the incoming Minister of Finance in 1990, the relationship between a responsible minister and departmental chief executive should be formalised in a

written performance agreement which states the performance expected of the chief executive and the basis for assessment of that performance (T90/N14, 7 November 1990, Richardson files 758). Three features should be incorporated in those agreements: the government's output purchases from the department (representing the government's purchase interest); the department's financial performance (representing the government's ownership interest); and the management practices to be observed. Since 1991 written performance agreements, which include those features, have been required. Following the Logan review, a fourth feature consistent with the government's stated fiscal strategy at the time, expenditure constraints, was incorporated as representative of the government's collective interests (Treasury, 1990; Briefing to the Incoming Government; CSC(91)2, 12 February 1991, Richardson files 989; T91/1737, 1 May 1991, Richardson files 670; CSC, 9 May 1991, Richardson files 989; CSC(91)29, 14 May 1991, Richardson files 989; Logan, 1991, Recommendation 6, p. 64; Recommendation 8; CAB(92)M3/3d, 3 February 1992, Richardson files 837; STA(92)20, 10 February 1992, Richardson files 958; CAB(92)M6/12, 24 February 1992, Richardson files 837; STA(92)95, 18 May 1992, Richardson files 960, p. 2; STA(92)M15/1, 20 May 1992, Richardson files 840; CAB(92)M20/43, 25 May 1992, Richardson files 840; CAB(92)M28/18, 20 July 1992, Richardson files 841). Similar requirements have also been written into corporate plans, appropriations, budgets, and the financial reporting system (Scott and Gorringe, 1989, p. 81-89; Scott and Ball, 1993, p. 8; Ball, 1995, p. 5; Scott, 1996, p. 63; Scott *et al*, 1997, p. 360).

The Treasury explained the government's interests in departments in more detail. The government's purchase interest required knowledge of the manner in which outputs contribute to outcomes and ensuring that the agreed outputs are delivered and comply with specifications, although much of that monitoring function would be the consumer's responsibility. The government's ownership interest covered four dimensions: "financial performance, capitalisation, area of business, and managerial practices", each of which was explained in more detail (T90/N13, 8 November 1990, p. 1, Richardson files 758).

Financial performance could be compared with that of private sector operations or SOEs, and so it could be assessed by return on taxpayers' funds, with good

financial performance considered to result from good management and financial management practices. The level of a department's capital (taxpayers' funds) represented the investment by its owners, and would "have a major impact on how it operates". The nature and volume of the outputs produced by a department would help to determine the level of capital to be invested in that department. The area of business in which a department is involved was important because it is up to the owner to "determine the type(s) of outputs it wishes an organisation to produce and therefore the type of business it wishes to be in", while "owners also have the right to dictate management practices they want applied" (p. 2). Some departments had commenced operation under the accrual accounting regime in weak financial positions and with negative working capital, suggesting that for some departments, the asset base was inadequate (Table 9.2).

Table 9.2 Financial position on commencement of accrual accounting

	Department of Statistics 1 July 1989 $'000	**Inland Revenue Department 1 July 1990 $'000**
Current assets	910	3,185
Current liabilities	4,180	33,144
Working capital	**-3,270**	**-29,959**
Fixed assets	6,978	66,532
Taxpayers funds	3,708	36,573

Six features of good ownership monitoring were identified and explained (T90/N13, 8 November 1990, p. 1, Richardson files 758). The first two features required control over a department's capital, and a public statement of the department's business area. The financial management system established already imposed some controls over capital by prohibiting departments from borrowing and by requiring the return of operating surpluses to the Crown. Increases in a department's capital required a capital contribution and departments seeking such a contribution would be required to show that they could generate an adequate return. Decreases in a department's capital would result from Ministerial review and decisions about capital withdrawal, and from the capital charge regime which would encourage departments to return capital to the owners (p. 3). Area of business decisions had, until that time, been *ad hoc*, resulting from the State Services Commission's machinery of government reviews and output purchasing decisions, but "a more deliberate approach" was suggested (p. 4).

Three features of good ownership monitoring related to reporting: the public reporting of financial performance targets at the beginning of the reporting period; the public reporting of actual performance compared with those targets after the end of the period, together with reporting of business areas; and ongoing reporting and monitoring of both financial performance and business area (p. 3). Most of the public reporting features had been captured by the Public Finance Act reporting requirements but more detailed requirements should be incorporated in chief executives' performance agreements. For ongoing monitoring and review, departments were required to produce monthly monitoring reports for their Responsible minister, with these reports forwarded to the Minister for Treasury analysis.

The sixth feature of good ownership monitoring was the imposition of controls over managerial practices, but these should be minimised:

> Any stipulation of management practices by the owner is effectively an input control which limits the discretion of the chief executive. While this might be desirable in some cases, it should be treated with caution to ensure that detailed input controls don't result. Not only may input controls actually hinder efficiency, they also reduce the accountability of chief executives. (p. 3).

A formal ownership monitoring cycle was proposed. It consisted of four elements, the first of which was a strategic review prepared by each department before the commencement of the financial year, and covering the nature of the department's business, its asset base and the efficiency of asset use. The second element required capital investment reports to assess capital contribution requests and any investments that exceeded a chief executive's authority[49]; while the third was progress reviews which would focus on the department's performance in relation to the ownership targets established for it. The fourth element was in-depth efficiency reviews, which would be required in the absence of external comparators or independent checks of output pricing. Examples of such reviews were conducted by the State Services Commission and external parties (T90/N13, 8 November 1990, p. 1, Richardson files 758; T91/763, 6 March 1991,

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[49] This ambiguous meaning of the term capital, as investment by the government in a department, and as a department's investment in fixed assets is a consistent feature of the financial management system.

Richardson files 638, p. 3). Arguably, responsibility for ownership monitoring was not clear because the legislation was not explicit:

> The Treasury's interest has been subsumed within its overall responsibility for providing advice to the Minister of Finance on economic and financial matters. In addition, the State Services Commission has statutory backing through the State Sector Act, namely the function of "… review(ing) the performance of each department, including the discharge by the chief executive of his or her functions." Clearly both organisations have a role to play. At this stage, we see no immediate reason to further clarify (eg through legislation) the roles of Treasury and the State Services Commission in this area. While the potential for some duplication exists, we would want to discuss our work with the Commission to ensure that departments were not being "over-reviewed". We would envisage that the Treasury focus will be more directly linked to the budgetary process than that of the Commission, which is likely to conduct less frequent reviews. (T91/763, 6 March 1991, Richardson files 638, p. 2).

The ownership monitoring cycle was proposed for inclusion within the annual budget cycle and a pilot exercise of ownership monitoring was proposed which would focus on the strategic overview report. This strategic overview would include an assessment of each department's asset base. These early intentions for the Treasury's role in monitoring and review required analytically-skilled Treasury staff with specific industry and business knowledge, financial analysis skills, documentation, communication and marketing skills, legal knowledge and internal auditing skills. Those staff would engage in "senior level professional working relationships", work alongside departmental management, and advise the Minister about strategic, economic and financial issues related to departments (Treasury, T90/N13, 8 November 1990, Ownership monitoring). Lack of skilled staff meant that this monitoring regime did not eventuate (Treasury, 12 December 1995, Vote analysis: a strategy for lifting our game, Treasury files).

The State Services Commission was instructed to develop an approach to performance assessment in consultation with the other central agencies, the Treasury and the Department of the Prime Minister and Cabinet. There was some friction between the central agencies over the Treasury's role in performance assessment and the Treasury was, initially, largely excluded. Eventually, in mid-1992, a process for completing and assessing performance agreements, which included the department's corporate plan in the agreement and included the Treasury, was agreed (STA(91)46, 30 April 1991, Richardson files; STA(91)M13/8, 8 May 1991, Richardson files 934; T91,2343, 6 June 1991, Richardson files 688; STA(91)M22/5, 17 July 1991, Richardson files 934;

CAB(91)M34/9, 19 August 1991, Richardson files 871; T92/1149, 14 April 1992, Richardson files 786; CO(92)11, 13 May 1992, Richardson files 1005).

The 1993 proposal for the Treasury to adopt a more sophisticated approach to advice on expenditure and departmental performance implied that the Treasury was extending its monitoring and review role, possibly without the State Services Commission's knowledge or involvement. The Treasury defended this monitoring development as within its mandate because the Treasury supplies second opinion advice to the Minister (see Chapter 6, Financial management initiatives). The Treasury acknowledged that it was "not clear about 'ownership', why it matters and the relationship between the purchase and ownership interests that the Crown has in departments". With a common vocabulary suggested at that time, the Treasury's ownership vocabulary increasingly referred to risk management (T93/233, 10 February 1993, Richardson files 1093, p. 4). Although reference to the government's different interests in departments has continued, there is little evidence to suggest those different interests affect the annual reporting function (Box 9.1).

Box 9.1 The inter-connection of the purchase and ownership interests

Published financial reports contain information about departments' alignment with the government's objectives but there is no specific ownership focus. The Department of Corrections exemplifies this lack of a specific focus in its most recently published annual report by classifying as Purchaser/Owner Interest the statement of responsibility; statement of objectives and service performance; the financial summary; and the report of the Audit Office. It classifies for Management Interest information about capital projects, information technology, human resource management, public service ethics and integrity, and statutory and advisory board reports. (Department of Corrections, Annual report 1 July 1999 - 30 June 2000).

The 1994 and 1995 internal Treasury proposals for more focused monitoring, including ownership monitoring, brought acknowledgment that the Treasury lacked sufficient skilled analytical staff. Monitoring and analysis fell to relatively junior and unskilled vote analysis staff who were difficult to retain. The effective use of the information already available was in doubt in the absence of skilled staff, and it was, therefore, unlikely that Treasury could perform this monitoring function (Treasury, 12 December 1995, Vote analysis: a strategy for lifting our game, Treasury files). Discussion with Treasury staff suggests that the same lack of skills exists today (Interviews Treasury, June 2001).

The clear specification and monitoring of the ownership interest had been recommended, with effect from the 1995/96 financial year (12 October 1994, Report of the Working Party to the Advisory Group: review of accountability requirements, p. 1, Treasury files; Treasury, 30 November 1994, Surplus retention, p. 5, Treasury files). A working group on ownership, which included representatives from the State Services Commission and departments, devised proposals, discussion points and suggested ownership interest specifications which were circulated to chief executives. Following consultation, four ownership dimensions, intended to "provide chief executives with a framework within which to develop their departmental ownership strategies" were devised: departments' strategic alignment with the government's objectives; the integrity of the public service; ensuring that the public sector has the capability to meet demands to be imposed on it in the future; and ensuring that departments' production of outputs is cost effective over the long run.

The cost-effectiveness dimension had received little discussion in the consultative sessions (State Services Commission, 1998, The ownership interest: a composite record of the discussion sessions among chief executives and senior managers – July 1995). That dimension, however, is linked with the capability dimension because it implies that "the price paid allow[s] appropriate investment in long-run capability, so as to avoid unnecessary costs in the future" (State Services Commission, 1998, Taking Care of Tomorrow Today).

The Treasury had proposed extracting maximum leverage by shifting the burden of proof onto departments, and the expenditure constraints requirement in chief executives' performance agreements was replaced with the responsibility for ensuring management of the ownership interest, with each of the four ownership dimensions annexed to the chief executives' performance agreements. These ownership dimensions included self-review prompts for the chief executive to incorporate when reporting to the responsible minister. Chief executives are expected to apply pressure to departmental costs through benchmarking, co-operative cost reductions, and consideration of contracting out a department's non-core functions (Treasury, 30 November 1994, Surplus retention, Treasury files; Treasury, 21 November 1995, Vote analysis priorities over the next two years, p. 3-4, Treasury files; State Services Commission, 1998, Taking Care of

Tomorrow Today; State Services Commission, Proforma for the 2000/2001 chief executive performance agreement).

From 1995, departments' budgets were required to identify the links between departmental activities and the government's strategy as developed into SRAs, KRAs and milestones. The KRAs and milestones were then drawn into chief executives' performance agreements. With the subsequent change in terminology, identification of the way in which a department will contribute to key government goals is now required (Proforma for the 2000/2001 chief executive performance agreement, www.ssc.govt.nz/siteset/htm).

In 1996, the Treasury proposed incentives for chief executives to improve departmental information systems, with those incentives intended to avoid over-reliance on the central agencies. In addition it proposed an increased range of sanctions for poor performance, and improved incentives for good performance including a higher proportion of chief executives' pay at risk (The Treasury, 1996, p. 111). From 1997, the proportion of chief executives' remuneration made subject to performance assessment increased from 10% of the total remuneration package to 15% (Gregory, 2001, p. 224).

The Treasury's financial performance assessments of departments are included as part of the State Services Commission's chief executive performance assessment process (Treasury's 2000/01 Core Performance Expectations, www.treasury.govt.nz/publicsector/corexp/2001); Proforma for the 2000/2001 chief executive performance agreement, www.ssc.govt.nz/siteset/htm). Assessment of chief executive performance, however, covers all of the requirements imposed on those chief executives and so is not confined to the financial aspects of departmental performance. Instead, a chief executive's performance is viewed as a combination of personal and departmental factors. Particularly significant in the personal contribution is the chief executive's relationship with the Minister and key stakeholders. Consequently, information used to assess chief executives' performance is drawn from a variety of sources, just one of which is financial performance assessments (State Services Commission, Interview June 2001).

Clearly the effect of financial rules developed has been diluted in the assessment process. Other more detailed review processes have developed, however, in which financial information derived from the financial management system is likely to be applied more strictly. These are the baseline review processes.

Baseline reviews

Chapters 7 and 8 noted that departments must bid for increased resources and that the budgeting process erodes departments' resources with the intention of forcing such bids. At that time an output price review (OPR) will be conducted. Another more recent development is a value-for-money review (VFM) which examines spending within a department's baseline. The names of both forms of baseline review imply little more than revisiting the amounts paid to a department to produce its outputs, but they involve considerably more than that. They require assessment of the extent to which a department's outputs contribute to the government's desired outcomes, reconsideration of whether the department is the appropriate agency to supply those outputs, and then assessment of the output prices (State Services Commission, 26 April 1999, Output pricing reviews - a guide (draft), State Services Commission; Treasury, 8 March 2001, Value Wheel, Treasury files).

Output price review (OPR)

Output price reviews (OPR) were introduced in late 1996. An OPR will result if Cabinet accepts the recommendation of the Treasury and the State Services Commission that the sustainable delivery of a department's "core organisational outputs" is at risk either because the level of output appropriations provided to the department is inadequate, there is an increasing level of demand for the outputs concerned, or the department's financial condition, including its ability to maintain its core organisational infrastructure, is at risk. Even if the outcome of an OPR is acknowledgment of inadequate output prices, decisions about increased resources must be made during the new initiatives phase of the budget cycle when all resource proposals are prioritised. The decision "on the volumes to be purchased,

and the source of outputs, in order to determine the changes in baselines" is a separate one (State Services Commission, 26 April 1999, citing CSC(96)M17/2).

A chief executive seeking increased resources for departmental outputs must first prove that a price increase is justified while also knowing that additional resources might not follow. The Cabinet minute establishing the requirements for OPRs did not specify the level of proof required but draft guidelines for OPRs indicate both the level of proof required and the likely OPR process (Treasury, 1999, Output pricing/baseline reviews, Treasury files; State Services Commission, 26 April, 1999, Output pricing reviews - a guide (draft), p. 6-8). This draft was prepared following State Services Commission concern over the output price review process, and its CAP project seemed at least, in part, to represent an attempt to adopt an alternative approach (State Services Commission, 13 January 1999, "Future application of output pricing reviews: incentives, options and strategies", Treasury files (see chapter 6)). The draft represents the OPR as a joint process between the State Services Commission, the Treasury and the department concerned, although more recent documentation suggests that Treasury will conduct the review, involving the Commission only if the government's ownership interest is affected (CO(00)12, 23 November 2000).

Proof of the need for an output price review

The chief executive must prove the need for an OPR by producing evidence which makes readily apparent that "a substantial receivership or resource capacity risk" exists. This evidence must show either "serious erosion, or risk of erosion, in the quality of outputs"; or serious core staff retention problems and resource maintenance problems; or a prior argument for "a substantial need for bolstering ownership capacity through other investment" (Treasury, Output pricing/baseline reviews, Treasury files; State Services Commission, 26 April, 1999, Output pricing reviews - a guide (draft), p. 6-8).

An OPR request must also be supported with information about the circumstances leading to the request, the operation of the department's cost allocation and reprioritisation processes, an analysis of the relative worth and

appropriateness of the department's interventions, and a quantified proposal to remedy the risks identified (State Services Commission, 1999, p. 7).

Benchmarking information must be produced to demonstrate "that there are no further efficiencies to be obtained from current operations of the department". That demonstration requires proof that the department's management systems function well and that the department complies with best practice with respect to both the government's purchase interest and its ownership interest (State Services Commission, 26 April 1999, citing CSC(96)M17/2). This, in turn, requires "well-framed" output specifications; adequate cost allocation systems; competitive prices supported by evidence from external sources; previous efficiency gains reflected in lower prices; good strategic planning processes; "good performance management systems and human resources policies"; evidence that known efficiency gains have been identified and achieved, including unbundling the outputs, market testing the intermediate outputs, and "consideration of substitution of inputs"; and an appropriate balance sheet structure (State Services Commission, 26 April 1999, citing CSC(96)M17/2).

The scope of an OPR must be sufficiently broad to allow targeting of inefficiencies and low priority outputs. It must cover most of the department's output classes and have a potential impact of no less than $10 million in annual baseline changes or in capital contributions, and the chief executive must accept that "the review will include examination of the appropriateness of agency activities requiring investigation of potential: business process re-engineering solutions; outsourcing solutions; minor organisational redesign solutions." These requirements mean that a chief executive must prove circumstances that the central agencies should already be aware of (Box 9.2).

Box 9.2 Proof of the need for an output price review

Between 1992 and 1996, the Department of Statistics' annual reports explained how funding reductions and the department's inability to meet the required third party revenue targets impaired the department's ability to function. As early as 1993 the Treasury advised the ECC of the department's lack of resources and the resulting fiscal risks to the Crown.

In 1996, the Government Statistician commented on the hurdles to be jumped before additional resources would be provided (see Box 8.1). The Department of Statistics was the first government department to undergo an OPR and this was conducted between September 1996 and February 1997. The bibliography of resources used during that OPR includes eleven separate reports prepared by the department during 1996: *Adjustments to State Sector Reforms; Annual report of the Government Statistician for the year ended 30 June 1996; Diversity of Markets for Official Statistics; New Directions in Statistical Publishing; Marketing and Sales Division Business Plan: 1996/97; Official Statistics: Cost and Price Issues and Trends; Paying for Official Statistics: an Analysis of the Funding and Contracting Arrangements for Today's World and Tomorrow's Challenges; Towards a new Segmentation Schema; Statistics New Zealand Asset Base and Impact on Economic Value; Statistics New Zealand Corporate Plan 96/97; and SNZ Output Costs Review: Summary of Analysis and Conclusions.*

The OPR report acknowledged prior awareness of financial difficulties, commenting that "during the last few years it has become apparent that Statistics New Zealand (SNZ) faces a number of significant problems", and referred to "recent Annual Reports of the Government Statistician" for information about those problems which included: "funding difficulties, in particular the inability to meet the third party revenue targets . . . ; wider trends such as globalisation . . . [which challenge] SNZ's ability to maintain the quality and relevance of existing statistics; increasing user demand for more timely statistics and a greater range of economic and social statistics; and shortages of skilled and experienced staff" (ECC(93)329, 20 September 1993, Richardson files 911; ECC(93)M35/4, 21 September 1993, Richardson files 912; CAB(93)M36/10c, 27 September 1993, Richardson files 1018; Report of the Government Statistician, years ended 30 June 1992, 1993, 1994, 1995, 1996; The Statistics New Zealand Output Price Review, March 1997).

An OPR seems to involve an adversarial process. The applicant chief executive must bear the burden of proof by producing substantial information while, from the Treasury's perspective at least, the aim to maintain that burden of proof implies that little, if any, helpful information will be provided to the chief executive (Treasury, 1999, Output pricing/baseline reviews, Treasury files). Ideally an OPR would assess the appropriateness of all of a department's output classes, conduct a "full management audit of departmental management systems and resourcing using industry comparators", and benchmark a broad set of a department's outputs. An OPR might not achieve that ideal, but it does consist of the three processes suggested by the ideal: an output mix examination to determine the particular mix of outcomes required to allow the government to achieve its objectives; a resource analysis to confirm the existence of serious capacity risks and to assess the proposed remedies; and a price efficiency evaluation to assess the department's comparative efficiency (State Services Commission, 26 April 1999).

Output mix examination

An output mix examination considers the government's desired objectives, the appropriate mix of purchases required to achieve those objectives, and alternative purchase options available to the government. This examination has three components: outcome analysis, output-outcome analysis, and development of output mix options.

The outcome analysis identifies the outcomes sought by the government by considering its strategic priorities, as well as various statutory obligations and requirements imposed on the department. It therefore requires identification of the contributions to those outcomes, the "appropriate role of Government" in relation to those outcomes, and the "strategic fit" between those outcomes and the department's outputs (State Services Commission, 26 April 1999, Output pricing reviews - a guide (draft), p. 16). Determination of the appropriate role of government uses general "machinery of government principles" which propose that government should intervene only if market forces or community provision will not achieve the desired outcomes, a cost-benefit analysis shows that the benefits exceed the costs, (with the costs of not intervening or of intervening inappropriately also identified), there is no duplication of other agencies' operations, and contestability is not possible or transaction costs are excessive (State Services Commission, 1999, p. 17). These machinery of government principles also require consideration of the department's role, including whether other output providers exist. Evidently these machinery of government principles have changed since the 1989 machinery of government review of the Department of Statistics which required it to generate sufficient third party revenue to cover 25 per cent of its gross expenses (Box 9.3).

Box 9.3 OPR and output mix examination: machinery of government principles

The 1996 output mix examination of the Department of Statistics required development of criteria to decide which outputs the government should purchase and the department's scope of business beyond that. It was based on a "public policy framework which draws a distinction between public and private goods", with the requirement that Ministerial purchases relate to public goods, leaving those outputs with private good characteristics to be funded by groups of users. Potential funding sources were classified as Minister pays, club funding, and 3rd party funding. The public good statistics were those that provide "a central measure of New Zealand's economic and social performance" and were "strongly market and/or politically sensitive, or central for forecasting and policy design, with a large number of users and a high need for independent/technical specification and long-term continuity of supply, or critical to the production of such statistics." Application of the criteria involved considerable subjectivity and circularity, and the need for refinement of the assessment criteria was noted.

This output mix examination identified as clearly public goods statistics which included Gross Domestic Product, Balance of Payments, the Consumer Price Index and the Census of Population and Dwellings. Beyond the public good statistics, the department's scope of business should be confined to "outputs with synergy to core official statistics that: can be produced profitably, do not put the core business at risk, do not exploit Statistics New Zealand's statutory powers and monopoly position, or crowd out possible private sector providers." Noting that the department must retain custody of confidential information, the possibility of franchising was raised.

According to the Government Statistician, the OPR concluded that a national statistical office should attend to its core business instead of attempting to act as "a market research or information analysis house to reduce its government funding base. Rather, funding from sources other than directly from the taxpayer may expand the range of official statistics, to the extent that insufficient priority is given to national objectives on health, education or justice." Commenting on the trend away from "some traditional areas of statistics . . . and measurements less critical to the national accounts" he noted the "understandable reluctance" of various sector groups to "accept that previously publicly funded measures for their industry are becoming, in the government's eyes, a partial private-good-type service" (The Statistics New Zealand Output Price Review, March 1997; Report of the Government Statistician, years ended 30 June 1997, 1998).

The output-outcome analysis attempts to assess the contribution of the department's outputs to the government's desired outcomes, and this was acknowledged as a difficult task. The development of output mix options relies, to some extent, on the result of the output-outcome analysis which, presumably, would allow consideration of alternative outputs to achieve the outcomes. It is, however, intended to provide ministers with output mix alternatives intended to meet the government's medium to longer term objectives.

Resource analysis

The resource analysis process is determined by the Cabinet's agreed strategy for the particular OPR, but it is intended to assess the department's ability to produce its outputs over the medium term. The resource analysis examines the human, financial and physical resource gaps identified by the chief executive. Given the burden of proof requirements, it is not clear whether an OPR would consider the adequacy of resources not already identified by the chief executive.

The resource analysis involves two steps: resource assessment and systems assessment. The resource assessment requires prior identification of the department's expected future core competencies so that the nature of the resources required to sustain those competencies may be determined. The systems assessment compares the department's management systems against the technical standards of good practice and devises an appropriate programme to bring those systems into line if necessary. As revealed in the resource analysis for the Department of Statistics, some disagreement may arise (Box 9.4).

Box 9.4 OPR and resource analysis

According to the report of the OPR, the resource analysis was "required to ensure that any proposed price adjustment would be effective in sustaining SNZ's core business". Assessments were conducted of human resources, financial management, financial condition, information technology and strategic management.

Human resources: High staff turnover and skill shortages were attributed primarily to uncompetitive salaries. Staff lacked career development opportunities, adequate technical training, and adequate management development. "Generally, SNZ will have real difficulty in maintaining an adequate succession pool and the appropriate skill set for specialist and managerial staff unless a substantial ongoing additional investment is made."

Financial management: The department's financial management was assessed as having both strengths and weaknesses. Development priorities identified included an internal audit capability, budgeting improvements, an improved output management focus and improved output costing systems, and long-term planning for asset replacement. The good practice standards sought for the output costing systems required output component costing. Long-term planning for asset replacement was lacking and the department had no resources for long term asset replacement: "Because SNZ has been spending all of its depreciation as it goes it is likely that SNZ's long-term capital replacement needs will be greater than its current internal financing capability. This means that either the Crown will have to fund the shortfall (something it is unlikely to favour given that it has already funded it once), or SNZ will have to run cash surpluses until such time as an adequate reserve is established."

Financial condition: this assessment focused on operating profitability and the balance sheet structure. The department's operating deficits, which "have been supported by Treasury as a way of managing the adjustment to a higher third party activity" had resulted in an "ongoing 'structural deficit' problem" which meant "the Crown is funding output delivery through the back door of deficit funding. This understates the true cost of outputs . . . SNZ should move to a fully funded output basis and away from deficit funding." The balance sheet structure was "unsustainable" because "SNZ has insufficient cash reserves to meet its current operating commitments (let alone its capital commitments). This problem is the direct result of the owner's agreement to allow SNZ to produce more outputs than the funding allowed."

According to the Government Statistician, "The strategic planning, financial management, human resources and information technology management systems were all judged to exhibit many aspects of good practice . . . There were some areas where capability improvements were assessed as desirable, and these are being followed up with provision made during the budget process. A major issue arising several times during the review was the issue of cost allocation. It was concluded that costs should be allocated to a finer level of detail, so that the cost drivers of individual production processes for the core statistics and third party revenue statistics are more transparent." The OPR recommended "SNZ should consider using allocation of direct and indirect cost to each database and output on the basis of specific cost drivers for each production function" (Report of the Government Statistician for the year ending 30 June 1997; The Statistics New Zealand Output Price Review, March 1997).

Price efficiency evaluation

The price efficiency evaluation attempts to determine minimum output prices that are sustainable over the medium to long term. Evidently such prices provide some assurance that departments are paid a competitive and fair price for their outputs. The price efficiency evaluation relies on benchmarking, and requires clear output specifications, a clear model of the department's output production functions, and sound cost allocation systems. It involves two steps: an input efficiency assessment and price/cost benchmarking.

The input efficiency assessment compares the department's key input costs with other norms. Typical key input costs relate to staffing and pay rates, property management, and other major expenditure items such as information technology. Contracted specialists may conduct this step.

The price/cost benchmarking draws on three possible approaches to benchmarking. Price benchmarking for output provision requires selection of a representative output and checking the department's price either through competitive tendering or by obtaining a shadow price. This requires alternative suppliers or potential alternative suppliers for an output or output class. If price benchmarking is not possible, the cost benchmarking of representative outputs is considered the next best alternative. For this to occur the production process function must be formulated and "appropriate external benchmarking partners" engaged to benchmark both the business process and the costs. When representative outputs cannot be cost benchmarked, the next alternative is to analyse the department's output production into production functions so that fully-costed shadow tenders may be obtained for similar production functions performed by others.

Because the price efficiency evaluation is resource intensive, generally only two or three pilot benchmarking exercises are conducted. Ideally, these exercises should be representative of a department's outputs, but the reduced focus of this evaluation process allows the targeting of areas where savings may be possible (State Services Commission, 26 April 1999, Output pricing reviews - a guide (draft); Treasury, 1999, Output pricing/baseline reviews, Treasury files). The

price/efficiency evaluation process is also expected, over time, to allow decisions on the future, more systematic, application of benchmarking in the department concerned. Apparently, a cost benchmarking exercise requires finely detailed costing systems to enable benchmarking of individual production functions, thus explaining the dispute during the Department of Statistics' OPR about the costing systems and the recommendation that benchmarking processes be continued with proposed completion by 31 December 1998 (Box 9.5).

Box 9.5 OPR and price efficiency evaluation

The price efficiency evaluation of the Department of Statistics involved two pilot benchmarking studies of the department's production functions but the review concluded that the department should improve its cost allocation processes and "reduce the data information gaps from the external benchmarking partners" before continuing to apply benchmarking to all of its outputs. The "pilot surveys have not produced any conclusive evidence that the prices for these two databases are 'unfair' to either party, the purchaser or the service provider." The Government Statistician described the process adopted: "As Statistics New Zealand does not operate in a commercial market place, it is difficult to determine prices that are 'fair' to both the purchaser and the department. The approach adopted is to benchmark the department's costs of producing statistical outputs against those of equivalent activities that do operate in competitive markets. This is a process that will take time to implement across the large number of different statistics produced, but it will ultimately provide assurances that the department's prices are such that the government is getting value-for-money".

Recommendations of Output Price Review: Department of Statistics

The recommendations of the output price review sought changes to:

- output definitions: more detailed output specifications and costings in purchase agreements;
- the cost allocation system: to allocate costs for each production function
- price benchmarking: ongoing joint work with Treasury and the State Services Commission to benchmark the cost of each production function;
- scope of business: to apply the machinery of government criteria to all future decisions on changing outputs, and to make alternative arrangements with other suppliers for those third party outputs that could be supplied efficiently by them
- planning: extend planning to include all assets and develop corporate strategies
- financial position: provide additional financial resources for adequate staffing, restructure the balance sheet; agreement between the department and Treasury on third party sales figures;
- financial management: that the department develop internal audit capability, that Treasury and the department work on "accounting for statistical databases as assets" and payment on delivery of outputs

The department received a capital contribution of $4 million and improved output prices. The Government Statistician commented that, "We are well placed to meet the challenges and take up the opportunities likely to arise over the next five years", and that "many of the issues detracting from the potential of the department in earlier years had been addressed". In 1999, however, following the ongoing benchmarking project, he argued "In essence, we should not judge the efficiency of the Government's official statistical business by the least cost of a series of individual survey transactions. Rather, we should compare the total long-run costs and benefits of the whole official statistical system in creating knowledge bases that have the integrity necessary for government and the community" (The Statistics New Zealand Output Price Review, March 1997; Report of the Government Statistician, years ended 30 June 1997, 1998, 1999).

Value-for-money (VFM) review

The VFM review was trialled in 2000. With recognition that resources for new budget initiatives were limited, a search commenced for resource re-allocation from within existing budget allocations. The objectives of the first VFM review were to:

> improve the effectiveness of public spending and ensure consistency with the Government's policy objectives and priorities;
>
> increase funding for new initiatives in future budgets through re-prioritisation and management of fiscal risks. (POL (00) M15/1, 28 February 2000, Treasury files).

This review process, conducted outside the budget cycle, attempted to develop a "sound process for testing existing baselines" with those vote areas unable to demonstrate such a process considered low priority for the purposes of distributing additional resources. In accordance with the resource re-allocation intent of the process, the baseline testing does not extend to baseline increases which must be considered as part of the normal budget process. Resources found from the VFM reviews were to be re-allocated, with the finance ministers recommending the re-allocation either within the vote, within a group of votes or according to budget priorities determined by the finance ministers (POL (00) M15/1, 28 February 2000, Treasury files).

In 2001, the VFM review process remains the same but is now viewed as contributing to the first stage of the budget process and therefore as integrated into that budget process. The Minister of Finance and the relevant vote minister, on the basis of Treasury and departmental advice, decide on particular reviews. Reviews are targeted to those areas where there is likely to be the greatest scope for VFM gains. Typical steps involved commence with ministers identifying an area for review, and the department conducting a review in consultation with Treasury, the State Services Commission, and other appropriate departments. The department then reports to the ministers, the Treasury provides second-opinion advice, and the ministers decide the outcome which may, if policy changes are involved, require Cabinet consideration (email Treasury to S. Newberry, 12 November 2001).

The nature of the techniques used in a VFM review is suggested by Treasury's value wheel which is intended as a simple analytical device to assist vote analysts. It requires answering a set of questions in order (Box 9.6):

Box 9.6 Value wheel: techniques for spending assessments

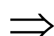
Value wheel (Treasury, 8 March 2001)

1. Direction: Outcome performance measurement and alignment to government goals
1.1 Is the outcome(s) clearly specified?
1.2 Is the outcome(s) aligned to the government's key goals?
1.3 If information can be collected, are there clear performance measures and reporting?

2. Effectiveness: Ex-ante intervention analysis
2.1 Is there a clear rationale for government to intervene?
2.2 Is it the best possible intervention?
2.3 Is the level of intervention appropriate?
2.4 Is there a process to evaluate achievement of outcomes?

3 Effectiveness: Ex-post policy evaluation
3.1 Has the intervention achieved the desired outcome(s)?
3.2 Has the intervention been effective?
3.3 Would evaluation justify continuation of current policy programmes?
3.4 Is the mix of outputs appropriate to meet the desired outcome(s)?

4. Delivery (current and future = capability): governance and accountability arrangements
4.1 Is it the right organisational design?
4.2 Is the corporate strategy aligned and appropriate?
4.3 Are accountability documents contractible?
4.4 Does management have incentives to disclose under-performance?



5. Delivery (current and future = capability): output pricing and funding arrangements
5.1 Is the right output price being paid?
5.2 Is 3rd party pricing appropriate?
5.3 Is government funding sufficient to maintain future production capability?
5.4 Are the financial management information systems robust?

6. Efficiency: output measurement and delivery
6.1 Have the contracted outputs been delivered?
6.2 Have the contracted milestones been achieved?
6.3 Are the outputs of the required quality?

7 Efficiency: production and processes
7.1 Are production costs reasonable?
7.2 Processes are not duplicated or replicated?
7.3 Is production efficient?

8 Economy: input monitoring and control
8.1 Are input costs appropriate given the required outputs?
8.2 Are all services that should be bought rather than made contracted-out?
8.3 Is the mix of inputs appropriate to provide the contracted outputs?

The presentation of this set of questions as a wheel requires drawing a link between the first set of questions, those considering the direction and alignment with the government's goals, and the last set of questions, those requiring economy, input monitoring and control. In the wheel, the link between these two sets of questions is represented as value-for-money. According to the Treasury, this link might be viewed as the relationship between inputs and outcomes, with VFM improving if more outcomes may be achieved from the same inputs. The relationship between inputs and outcomes therefore implies all of the four key dimensions of VFM identified in 1999: efficiency, effectiveness, capability, and

innovation (T99/61, 20 December 1999, Treasury files; email Treasury to S.Newberry 12 November 2001).

The process stated for applying the value wheel is to ask each of the questions in order. If following a negative answer to any question, "further analysis would add **value for money**, and the work cannot be delegated to another agency, **then** public expenditure analysis by Treasury is indicated" (Treasury, Value wheel, 8 March 2001, emphasis in original). The process suggested is acknowledged as resource intensive and in reality is likely to be more selective. Further, the statement on the value wheel that "public expenditure analysis by Treasury is indicated" is misleading and a better description would be "Treasury analysis may be indicated". The VFM process may, therefore, be less formal than suggested in the value wheel while its logic is acknowledged as similar to that of an output price review (OPR) (emails Treasury to S. Newberry, 2 November 2001, 12 November 2001).

Chapter summary

This chapter has considered departments' ability to retain resources and explained the repayment of surplus rule. Even if applied according to the Act's interpretation of operating surplus this rule would still add yet another resource-eroding force to those already affecting departments. This is because it is based on the artificial distinction between the Crown and departments, and a philosophy that surpluses belong to the owner and deficits belong to the department. The development of the rule, although consistent with the philosophy, has resulted in the operating result being analysed into components with each component treated separately. The effect is that each component that is a surplus must be repaid while each component that is a deficit belongs to the department. Depending on the transactions incurred during a financial year, a department may be required to pay considerably more than any reported operating surplus, thus increasing the eroding effect on taxpayers' funds.

The State Sector Act, the Public Finance Act and comment from the time all suggest that the Treasury's role is to develop the financial management system which provides the criteria for review of chief executives and departments and,

therefore, that the Treasury's role in review processes is, at best, minor. This may derive from the early idea that a department's performance is the chief executive's performance. Whether the legislative split between roles is appropriate is not clear, but the relative roles of the central agencies in the review processes, especially the State Services Commission and the Treasury have been contested. Although the Treasury has perceived a review role for itself, with those reviews relying on financial information produced from the financial management system, given its lack of staff with the high level analytical skills required for review, there seems to have been some attempt to convert review processes to rules-based processes for application by relatively unskilled staff. The value wheel and its development as a simple analytical device exemplifies this simplification process for application within Treasury, while the ownership monitoring dimensions and the prompts for chief executive self review exemplify the same simplification process for application by chief executives. The value wheel also reveals that the earlier intention to allow chief executives to determine the appropriate mix of inputs required to produce outputs has been abandoned. The re-instatement of input controls commenced with a focus on intermediate outputs and a denial that this was tantamount to input controls. Neither the OPR nor the VFM review processes, however, attempt to conceal their examination of inputs.

The validity of the individual rules developed for use in monitoring processes is, at best, dubious. But the rules are devised for application in combination and some rules contradict others, thus negating the extent to which they could reasonably be applied even as a rough guide. With these rules presented as appropriate for simple application, they seem likely to be applied as if they are valid, and without recognition that the effect they are supposed to create is negated by other rules. Presumably, fairly senior staff conducted the OPR on the Department of Statistics but, even having acknowledged various resource eroding-effects operating on the Department, the report of the review still suggested that one of the department's weaknesses was that it had spent "all of its depreciation as it goes". With resource-eroding processes intentionally built into the financial management system, the OPR report's proposal that the department run "cash surpluses until such time as an adequate reserve is established" must surely seem unreasonable, especially in light of the revelation in the department's annual

report the following year which showed just one of those resource-eroding processes at work (Box 9.7).

Box 9.7 Requirement to use depreciation content of output prices

The 1998 annual report for the Department of Statistics stated that, "In 1996, a proposal to extend the [information technology] programme for a further two years (to December 1998) was endorsed in an independent analysis commissioned by the Treasury. This extension has enabled technological advancements that have occurred since work commenced to be adopted. The programme was funded by a direct injection of $18.0 million of capital funds and the subsequent depreciation generated from the early years of the programme. The final cost of the programme is expected to be $24.2 million."

Clearly, the financial management system does erode departments' resources, the next chapter considers the debate over the financial management system and the nature of the system created.

10 The financial management system and erosion of resources

The previous chapters have shown that the financial management system erodes departments' financial resources through three major processes, each of which has been developed over time to increase the eroding effect. First, as explained in Chapter 7, budget baselines are held at fixed nominal amounts with the intention that inflation gradually will erode the real resources available to departments, thus forcing them eventually to bid for additional resources. While fixed and nominal baselines cause less erosion than the earlier efficiency dividend extractions, other features added to the budget baselines system now help to accelerate the resource-erosion process. Secondly, and as explained in Chapter 8, the full costing requirements are stacked against public sector providers and imply that full costs are variable. A sophisticated user of financial information might understand the shortcomings of full costs but the evidence suggests that much of this financial information is intended for use by those without such sophisticated understanding. The treatment of fully costed outputs (and output components) as if they are variable adds to resource-eroding processes, a point noted when the extraction of efficiency dividends from budget baselines ceased. The application of increased pressure to contract out output components seemed to be viewed as an effective alternative to efficiency dividends (Chapter 6). Thirdly, as explained in Chapter 9, the requirement for departments to repay any reported operating surplus would have a resource-eroding effect anyway, but the re-interpretation of operating surplus increased the resource-eroding effect. All of these financial resource-eroding processes operate in combination to create, as described by one departmental source, a perception of creeping death. At the same time, the early idea that managers would have increased discretion with monitoring confined to output monitoring changed first to output component monitoring and requirements for increased detail and now, as evidenced by the value wheel, input controls are being reinstated on top of the other accountability requirements associated with the output controls. Gorringe's "information and accountability Leviathan" has indeed continued to grow (1995a, p. 21).

This chapter does not question the need for New Zealand's financial management reforms, and neither does it challenge the introduction of accrual accounting or deny that benefits have been achieved. Other commentary which discusses such issues may be divided, roughly, into highly informed key reformers promoting their success (Scott et al, 1990; McCulloch and Ball, 1992; Scott, 1996; Scott et al, 1997) and more independent commentators, possibly with limited time in which to conduct their review (Schick, 1996), or without access to the hidden and constantly changing technical details of the system (Boston et al, 1991; 1996; Pallot, 2001). As the financial management system has developed the more independent commentators, while acknowledging benefits, have expressed disquiet with aspects of it. The concerns raised by the State Services Commission (1998) and the Controller and Auditor-General (1999) suggest that this disquiet should not be overlooked. This thesis reports on research which focused on aspects of that disquiet by conducting a more detailed examination to determine what New Zealand's financial management reforms really are achieving and how they do that (Hopwood, 1984). Specifically, it has attempted to identify whether and, if so, how and why, the financial management system erodes departments' resources in an attempt to assess the apparently differing views of the Controller and Auditor-General (1999) and the Treasury (1999).

Moe (1990a; 1990b) believed that NEO theorists' obsessive focus on legislation designed to benefit powerful interest groups may result in technically dysfunctional or even subversive legislation. This chapter begins by identifying several dysfunctional and/or subversive features of the legislation and the financial management system that has developed from that legislation which cause financial resource erosion. It then assesses the views expressed by those on each side of the debate leading to this research: whether the financial resource erosion and losses of capability provide evidence that parliamentary scrutiny and control have been neglected (State Services Commission, 1998; Controller and Auditor-General, 1999); or whether the system is based on a sound legislative foundation and further progress on that foundation will improve performance and value-for-money (T99/61, 20 December 1999, p. 7, Treasury files). Conclusions are then drawn, followed by acknowledgment of research limitations and suggestions for future research.

Features of the legislation and financial management system that contribute to resource erosion

Most comment on the financial management system as it affects the core public sector focuses on the Public Finance Act 1989 and on its companion State Sector Act 1988. The links between these two acts are acknowledged, but the full suite of reforming legislation and its inter-connectedness should not be ignored. All of this legislation was discussed in Chapter 4 and is not re-considered here other than in relation to specific points of interest. Typically, the financial resource-eroding features of the financial management system have been rationalised using technical accounting terminology but those rationalisations are contradictory and of dubious validity. Features of the legislation underpinning the financial management system and which help to rationalise the system's financial resource-eroding tendencies include an ambiguous interpretation of the Crown and its components, and the selective use made of this interpretation; the powers delegated by the legislation and the use made of those delegated powers; ambivalence over accrual accounting; and the nature and focus of appropriations.

The interpretation of the Crown

The Public Finance Act interprets the Crown as "Her Majesty the Queen in right of New Zealand; and includes all Ministers of the Crown and all departments", but the Act also distinguishes between the Crown, Ministers, and departments (s.2). This ambiguous interpretation implies that departments and ministers are at the same time both part of, and separate from, the Crown. To the extent that they are separate, the Act presents the relationship between the Crown and its departments as if the Crown is merely a purchaser from, and an investor in, departments. Even at first bill stage of the Public Finance Act 1989, the Legislative Advisory Committee advised that this interpretation misrepresents the relationship. This ambiguous interpretation flows into the financial management system as inconsistencies. Sometimes the system views the Crown, its departments and ministers as if they are separate entities, but at other times it views them as one. The selective application of this interpretation is important in the other features of the legislation which have helped to rationalise resource erosion and in the development of the financial management system.

Delegated powers to regulate

The ability to regulate is an important source of executive power but Palmer (1987, p. 165) noted the long-standing tendency of New Zealand parliaments to erode their own role by delegating the power to regulate "matters of the most fundamental policy". Delegation of powers may be advantageous for administration of details or technical matters that parliament cannot scrutinise effectively, but matters of detail may conceal significant policy matters, while policy matters easily may be re-cast as technical issues (see for example, Boxes 5.2 and 8.5). Delegation of the power to regulate allows regulations to be devised and implemented without either public scrutiny or debate and, possibly, without adequate attention to their effect.

The Public Finance Act delegates regulatory powers to the Governor-General, the Minister, the Treasury, and, via the Financial Reporting Act, to the Accounting Standards Review Board. Provided those parties use their delegated powers lawfully, departmental chief executives must comply with the regulations devised. The regulatory powers delegated to the Minister and the Treasury, particularly the power to direct the use of money and the power to regulate "the accounting and financial management and control procedures relating to contracts of the Crown" (s. 79-81), allow them considerable scope for the exercise of discretion. Given the subjectivity of accrual accounting, the ability to create notional costs, the ability to determine the treatment of those notional costs, and the ability to require particular financial management control procedures allows the Treasury to determine such matters as what costs, including notional costs, must be included in the full costs of outputs, the asset valuation base on which those notional costs must be levied, and how the capital charge is calculated. It has even re-interpreted the Act's interpretation of operating surplus.

Public money

The Public Finance Act requires that all public money be lodged in either a Crown bank account or a departmental bank account (s. 20). The Controller and Auditor-General's controller function applies to any public money paid out of the Crown bank account. Such payments require prior Audit Office certification and

the Governor-General's signature. For the purposes of this controller function, the Crown and its departments are viewed as separate entities. Although all of the money in bank accounts is public money, the interpretation applied to the Crown bank account excludes the departments' bank accounts from application of the controller function (Treasury, November 1989, FMPG7, The controller function, Treasury files; Treasury, 1994, A guide to appropriations).

Appropriations generally involve spending public money, and appropriations are subjected to parliamentary scrutiny. The appropriations legislation, however, is silent on which bank account or accounts should be used. Parliament approves the appropriations, but the Act allows the Minister and the Treasury to issue instructions regarding the money held in bank accounts other than the Crown account and to transfer money between accounts (s. 18-19, 21). The Minister and the Treasury may decide exactly which public money is spent. In effect, the use of all public money is subject to appropriations legislation but by interpreting the Crown as separate from the departments, the public money passed to departments is subject to the controller function, while the departments’ subsequent use of that public money, although subject to compliance with appropriations is not subject to the controller function.

For the purposes of the Treasury's centralised cash management system, a different interpretation of the Crown is applied. All public money in all bank accounts is regarded as the Crown's money, suggesting either that the Crown and its departments are viewed as one entity, or that the Crown and its departments are viewed as separate entities but that the public money held by departments is the Crown's money (see Chapter 6). Arguably, the establishment of separate departmental bank accounts has reduced the powers of the controller and increased the Treasury's and the Minister's power and discretion over the use of public money.

Ambivalence over the adoption of accrual accounting

Early proposals to adopt accrual accounting in the public sector argued that accrual accounting would overcome the faults of the previous cash accounting system. The adoption of accrual accounting under the Public Finance Act was

accompanied by both accrual and cash appropriations. Consistent with the move to release controls over inputs and shift controls to outputs, the usefulness of the controller function was questioned but some form of ex ante parliamentary control was required. The controller retained direct control over cash appropriations, but direct controls were not possible for accrual appropriations.[50] Indirect proxy controls were devised, using cash as the proxy, thus potentially reducing the effectiveness of the controller function (Treasury, FMPG8, October 1989, Treasury files).[51]

Proposals for fiscal policy began with cash accounting ideas, but underwent a problematic conversion to accrual accounting ideas (Treasury, 1984, p. 183-184; Treasury, 1987, p. 235; see Chapter 4). While accrual accounting is presented as appropriate for monitoring departments, it is partially rejected for the purpose of monitoring the government's activities. A recently developed measure, the operating balance excluding revaluations and accounting policy changes (OBERAC), suggests that the operating result derived from accrual accounting does not provide an appropriate measure for assessment of government financial operations. It adjusts out of the operating result the revaluation effects of net present valued assets and liabilities, market-valued financial assets and liabilities, gains or losses on sale (because "selling an asset for greater (or less) than its book value is a terminal revaluation"), and "changes in accounting policy around the recognition of assets and liabilities" (Cullen, 2001, p. 76).[52] The explanation of OBERAC states that it was introduced because some factors, which are beyond the government's control, "flow from highly technical and inherently subjective assumptions. The valuation change does not involve hard cash, is based on essentially theoretical assumptions, and usually reverses out over time". OBERAC is described as "the fiscal equivalent of the underlying rate of inflation" and "may be regarded as the measure of the underlying surplus". Supposedly, this

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[50] According to the Treasury, this is because it is not "possible to prevent a department obtaining credit or to stop an asset depreciating" (Treasury, November 1989, FMPG8, p. 1, Treasury files). See also Chapter 4 and the Legislative Advisory Committee's comments.

[51] The appropriations legislation allows for cash to be released up to the full amount of the accrual appropriations (see Chapter 4).

[52] OBERAC is not adjusted for any revaluations that result from a policy decision (p. 76).

underlying surplus allows assessment of the government's underlying stewardship "without abandoning basic accounting principles" (Cullen, 2001, p. 4).

This ambivalence over accrual accounting and the selective use of either accrual accounting or cash accounting ideas has also affected both resource provision and judgement of performance.

Resource provision

Evidently, accrual accounting is essential for the good management of departments but, even though accrual appropriations have been adopted, the budget baseline guidelines aim to restrict departments' access to cash and they use whichever form of accounting is necessary to do so. The underlying intention is that departments should not receive any real increase in resources unless they bid for it (Barnes and Leith, 2000), but that is not acknowledged in the budget baselines guidelines. Instead, the budget baselines guidelines selectively apply the ambiguous entity ideas of the Crown as either including departments or separate from them, and either accrual or cash-based accounting ideas. For those budget baseline changes categorised as technical changes, the Crown and its departments are regarded as a single entity. Some of the technical changes allowed in the budget baselines guidelines ignore accrual accounting and assume that no cash effect on a department in the current financial year implies no cash effect at all. Others ignore cash issues to assume that departmental costs arising from third party revenue shortfalls, forecasting changes, recognition of pre-existing liabilities, incurrence of other expenses, and other technical accounting adjustments may be absorbed by those departments in order to prevent any effect on the whole Crown entity.

The Cabinet always has the discretion to increase budget baselines but, within the general operation of the financial management system, budget baseline changes to increase the amount provided to departments for output production, require an output price review. Such a review casts the Crown as a purchaser of outputs engaged in contractual arrangements with separate providers and ignores any effect on the Crown as a whole. It focuses on departments' full costs of outputs and output components as compared with the prices from any other

provider (Box 9.5). A value-for-money review implies a similar approach (Box 9.6). Despite the use of euphemistic terminology, such as value-for-money, by ignoring the effect on the Crown as a whole, this review process has the potential to increase costs to the Crown as a whole.

The recently announced change to the capital charge regime highlights the inconsistencies applied to resource provision decisions. Should the capital charge rate increase, it seems likely that the Crown and its departments will be viewed as separate entities, and departments required to absorb any increase in the charge or undergo the equivalent of an output price review. Should the charge decrease, however, the Treasury may seek a baseline change through the normal budget process and, given earlier experience with decreased capital charge rates, the Crown and its departments may well be viewed as one entity, and departmental baselines reduced accordingly (see Chapter 7 commentary on fiscally neutral adjustments).

Judgement of performance

If accrual accounting provides an inappropriate basis for assessing whole of government operations, and if underlying stewardship can be assessed only by excluding some factors, such as revaluations, which "flow from highly technical and inherently subjective assumptions", it must be recognised that the Crown financial statements incorporate those of departments and exactly the same revaluations rejected in the Crown financial statements are used to assess departmental performance. Asset revaluations have been required since 1992 when the officials group monitoring the capital charge recommended that it be based on revalued assets, and these revaluation requirements include intangible assets (see Chapter 8). This contradiction over the validity of revaluations and their effect on performance assessment is even more puzzling because these subjective revaluations flow into other accrual accounting figures which include depreciation and, for departments, but not the Crown, the capital charge.[53] Both of these affect departments' reported performance and output costs but, according to

[53] The capital charge would be eliminated in the consolidation process.

the Treasury (1999, p. 47), they "have helped tell us how much the public sector really costs". Apart from the contradiction of requiring revaluations at departmental level and rejecting them at whole of government level, on one hand the idea promoted is that recognising these costs allows cost checks against competitors, while on the other hand, the idea promoted is that if departments receive these prices they will be able to replace their assets. Neither idea is valid, a point discussed in more detail in the next section.

Nature and focus of appropriations

All of the features mentioned so far, the ambiguous interpretation of the Crown, the delegated powers, and the ambivalence over accrual accounting, flow through into the Estimates and appropriations requirements. Democratic control over the use of public money is a recognised feature of public sector financial management (Pallot, 1992), but neither the Public Finance Act nor Appropriations Acts provide any interpretation of the meaning of appropriations, the most fundamental means by which parliament may exert control over the executive government. The Public Finance Act allows appropriations for the expenditure of public money, suggesting cash-based appropriations, and allows appropriations for incurring expenses and liabilities, suggesting accrual appropriations. The effect on the controller function of the accrual appropriations has already been noted, but it is not clear whether these two undefined forms of appropriation are mutually exclusive or whether they allow double-dipping (s. 4).

> (1) No expenditure of public money shall be made other than in accordance with an appropriation by an Act of Parliament.
>
> (2) No expense or liability shall be incurred by the Crown in relation to any transaction for which expenses or liabilities are required to be appropriated under subsection (3) of this section other than in accordance with an appropriation by an Act of Parliament.
>
> (3) A separate appropriation shall be made for (a) each class of outputs. . . (b) each category of benefits or other unrequited expenses . . . (c) each category of borrowing expenses . . . (d) each category of other expenses . . . (e) each capital contribution. . . . (f) each purchase or development of capital assets contained in the Estimates . . . and (g) each repayment of debt . . .

One point that is clear from these appropriations requirements is that the use of accrual appropriations has not closed the long-existing loophole in parliamentary scrutiny and control created by the omission of all forms of securities from the estimates presented to parliament and, therefore, from prior parliamentary

scrutiny. Prior to the financial management reforms, the Treasury identified this major loophole as a problem: "Liabilities, commitments and guarantees are included in the Estimates only in the year that a cash payment is expected" (Treasury, 1987, p. 81; see also, Longdin-Prisk, 1986). The implication was that the adoption of accrual accounting would allow closure the loophole but it has been kept open, enlarged, and promoted. The loophole has been kept open by selectively applying the interpretation of the Crown. The Crown itself cannot raise loans, issue guarantees or other forms of security without an act of parliament, but the Minister, who for this purpose is not the Crown but acts on behalf of the Crown, may issue all forms of security without an act of parliament. Early in the financial management reforms, this power was explained as the Treasury's responsibility, although the Act states that the Minister may not delegate this power (Treasury, November 1989, FMPG11 Operating and Financing leases, Treasury files; see Chapter 4).

The loophole has been enlarged by the Act’s inclusion within the interpretation of securities of arrangements to purchase goods and services, but the exclusion of those arrangements from the interpretation of raising a loan. These arrangements give rise to commitments, which the Act omits from subsection (3). Departments may enter such arrangements and, although for annual financial reporting purposes, a separate statement of commitments is tabled in parliament, the information that must be tabled with the estimates excludes any statement of commitments (s. 49; see Chapter 4). Arguably, departments should be able to enter contracts for the purchase of goods and services but, with the increasing popularity of financing arrangements constructed as contracts for the purchase of goods or services, very large amounts and long terms may be involved. For example, even the major financing packages for the provision of infrastructure (known as private finance initiatives or public private partnerships) may be packaged as contracts for the purchase of goods or services (Broadbent and Laughlin, 2000; Savas, 2000; see Chapter 3). In New Zealand there are no specific requirements under GAAP for the commitments represented by contracts for goods and services to be recognised in financial reports as liabilities, but their non-recognition does not change the fact that payments have been committed into

the future without prior parliamentary scrutiny and that the Crown has a liability to pay.

Use of the loophole is promoted through recent developments related, ironically, to the monitoring and demonstration of compliance with the adopted principles of fiscal responsibility. Commitments constitute debt in everything but name, yet they are excluded from the counting framework provisions, both the expenditure provisions and debt provisions. At best, only a single year's reported expense would be noted. Having earlier expressed disapproval that commitments are omitted from the estimates, the Treasury now encourages the Crown and its departments to enter into such arrangements and promotes these private financing arrangements as reducing "the borrowing requirements of the Crown" (T99C/213, 11 February 1999, Treasury files).

Appropriations for the operation of departments

Three key appropriations are relevant for the operation of departments: output appropriations, capital contribution appropriations, and other expense appropriations. As noted earlier, the controller function applies to these appropriations only if money is paid from the Crown bank account to departments.

The very idea of output appropriations suggests that all public sector activities are outputs which may be contracted out and yet Gorringe (1995a; 1995b) pointed out that in the private sector many activities would not be contracted out and that vertical integration would be more sensible. Further, the mode B output appropriations are appropriations for costs and are inappropriate for a contracting regime.

Output appropriations must be reported at their full cost, including depreciation and a capital charge. The Treasury (1984, p. 183-184; 1987, p. 235) had suggested that if resources are provided to department for these full costs, departments should be able to replace their assets and Crown borrowing may be confined to the initial cost of additional assets (see also, Chapter 3, Chapter 6, and Box 9.4), but this idea is theoretically dubious. Even if it were intended initially that departments should be able to replace their assets, other rules have been devised

to prevent departments from doing so and the thinking underpinning the replacement cost idea has been flouted (see Chapter 3, Box 9.1; 9.5):

> The provision of depreciation and pricing to cover this charge will generate free cash which may be used to finance other capital expenditure . . . GAAP does not require that accumulated cash be attached to specific assets or accumulated in sinking funds. (Treasury, 1998, Capital Contributions, FM/2/4 Vol4, p. 10, Treasury files).

This research suggests that both the capital charge and depreciation expense, especially in conjunction with revaluation requirements, function as little more than cost-inflating mechanisms intended to disadvantage departments in any price comparison between departments and private sector providers (see Chapter 8). Other cost-inflating mechanisms include the compliance costs required of departments by, for example, expectations that they should apply good costing practices at very detailed levels.

Appropriations legislation shows the expense to the Crown of departments' output costs but ignores the clawback from departments of the inflated capital charges, and ignores the book entry nature of depreciation. Comparisons between departments' output costs and the prices of other potential providers ignore the effect on the Crown as a whole. With departments' assets and capital charges inflated and output costs treated as variable, decisions announced on this basis may appear justified but potentially they increase costs to the Crown as a whole (see Box 8.4).

In contrast to the attention paid to appropriations for outputs, appropriations for other expenses and capital contributions have received comparatively little attention. Departments do not receive Crown funding for other expense appropriations but must use their own resources (Table 7.1). A capital contribution is always the last resort of finance and, before a department will receive a capital contribution appropriation, it must first attempt to finance its own needs by using its free cash, selling any surplus assets, and considering arrangements that create commitments but will not be reported as debt, such as sale and leaseback or other executory commitments. Capital contribution appropriations for parliamentary scrutiny are not necessarily sufficiently specific to show that the purpose for which those contributions have been obtained can be achieved only by further consuming departmental resources.

One early argument against accrual appropriations, was that they would increase the management's and the executive government's discretion while reducing parliamentary scrutiny and control. This was because the release of cash to match the accrual appropriations for the full costs of outputs would allow the accumulation of cash beyond the reach of the Controller, and that cash could, feasibly, be applied to other purposes (Pallot, 1991). This research suggests that those early concerns under-estimated the level of discretion transferred. In effect the Treasury and the Minister have usurped a considerable part of the controller's powers as those powers relate to the exercise of financial controls over the operation of government departments. This has occurred because with accrual appropriations there is now a separation between appropriations, the amount of cash involved, and which bank account is used to meet any cash costs. This separation forces the controller to use only a proxy control, and that control is restricted to movement from the Crown's bank account to departments. It has also transferred discretion with the cash appropriations because capital contribution appropriations achieve a different separation. Although the controller function applies to the cash transferred from the Crown bank account to the departments' accounts, that control relates to the money paid to departments to increase their net assets. The use to which that money is put by departments is covered by the section 11 permanent appropriations which allow discretion. It seems ironic that whereas the legislation requires the controller function to apply to accrual appropriations, the Treasury's controls over departments are cash-oriented.

Consideration and reconciliation of different views

The previous section outlined several features of the legislation and the financial management system that has evolved from it that contribute to departmental resource erosion. The list is not exhaustive. This section assesses the Controller and Auditor-General's views that legislative change is required to overcome the flaws he identified before assessing the Treasury's views that the legislation is soundly based and should be retained.

Financial resource erosion without effective parliamentary scrutiny and control

The effectiveness of Parliamentary scrutiny must be affected by both the volume and complexity of the financial information tabled in parliament and the gradual reductions in time allowed for such scrutiny following changes made to parliament's standing orders in 1992, 1996 and 1999 (CAB(91)357, 17 May 1991, Richardson files 877; Standing Orders of the House of Representatives 1986; 1992; 1996; 1999). Debating time allowed was changed from days to a specified number of hours in 1992. The time available to debate the Estimates was reduced from 13 days to twenty hours but, by 1999, had been reduced to eight hours. Similarly the time for financial review was set in 1992 to ten hours but by 1999 had been reduced to four hours. Earlier comment in Chapter 4, however, noted that the Controller and Auditor-General's controller function was reduced to a proxy control over accrual appropriations and, with the establishment of departmental bank accounts, was confined to control of funds from the Crown bank account. The implications of these developments are that both parliamentary scrutiny and the controller functions have been weakened.

The three major processes of the financial management system consist of the budgeting and expenditure control stage which precedes the preparation of estimates and appropriations; the purchasing stage which results in the preparation and tabling in parliament of estimates of appropriations; and the monitoring and review stage which also involves tabling in parliament audited annual financial reports. The budgeting and expenditure control stage is not subject to parliamentary scrutiny and is, therefore, largely invisible, while the two later stages are subject to parliamentary scrutiny and control.

Expenditure control stage

Chapter 7 showed that, after initial reviews and budget cuts, the budget baselines have been maintained at fixed and nominal amounts and that the intent of the budget baselines regime is that departments should receive no real increase in resources. To the extent that budget baseline increases are allowed, the selective interpretation of the Crown as including, or distinct from, its

departments, and the selective use of either cash or accrual accounting ideas, mean that departments may increase their budgeted expenditure, but by consuming pre-existing departmental resources. Other expense appropriations require similar absorption of departmental resources while capital contribution appropriations require prior consumption to have occurred. This expenditure control stage which precedes parliamentary scrutiny involves considerable financial resource erosion and provides incentives for particular privatising arrangements, classed as commitments, which neither count against any fiscal targets, nor are subjected to prior parliamentary scrutiny (Treasury, 1984, Public Finance Act 1989, s. 2, 4, 9, 34A, 35, 38, 39, 49; Treasury, T99C/213, 11 February 1999, Treasury files).

Parliamentary scrutiny of appropriations

Parliamentary scrutiny of appropriations affecting government departments focuses on the purchase of outputs in the current year and appropriations for other expenses and capital contributions. As explained earlier, for output purchases, the financial management system views the Crown as distinct from its departments and any other parties the Crown is purchasing outputs from.[54] Parliament may be deceived by decisions which appear efficient. Although appropriations allow the expenditure of public money on up to the appropriated amount, the power delegated to the Minister and the Treasury allows them to decide from which bank account any such expenditure must be made. Parliament may *think* that appropriations always involve the transfer of money from the Crown to departments. Capital contribution appropriations increase a department's net assets, but the permanent appropriation in section 11 of the Public Finance Act allows discretion in the use of such money. This discretion was evident with the Department of Statistics and the use of capital contributions to supplement inadequate funding for its operations (see Box 7.2).

[54] Output appropriations are appropriations which allow departments to incur costs, they are not purchases.

Parliamentary scrutiny of annual reports

Examination of departments' published financial reports reveals both erosion of departments' financial resources and financial distress, thus raising questions about the effectiveness of parliamentary scrutiny of those reports. In 1989 the Public Finance Bill proposed that any increase or decrease in a department's equity would require an appropriation thus ensuring attention to changes in departments' reported equity. This was removed prior to enactment (see Chapter 4). In the time allowed for parliamentary scrutiny of annual reports, even the obvious erosion of departmental financial resources may be overlooked. This erosion is caused by operating deficits, by a repayment of operating surplus rule that ignores any deficits and, in many instances, requires repayment of far more than the reported operating surplus (Table 10.1), and by other requirements which prevent departments from building up sufficient financial resources to replace assets. The obvious flow-on effect is that suggested by the SSC (1998) and the Controller and Auditor-General (1999), that the erosion prevents departments from maintaining capability.

Table 10.1 Operating results, repayment of surplus and effect on taxpayers' funds

Explanation	**Department of Statistics $'000**	**IRD $'000**
Total effect on taxpayer's funds (statement of movements in equity)		
Taxpayer's funds on commencement of accrual accounting	3,708	36,573
Reported operating results	-18,954	7,743
Less: repayment of surplus to the Crown	-2,039	-62,846
Net effect of operations on taxpayers' funds	-20,993	-55,103

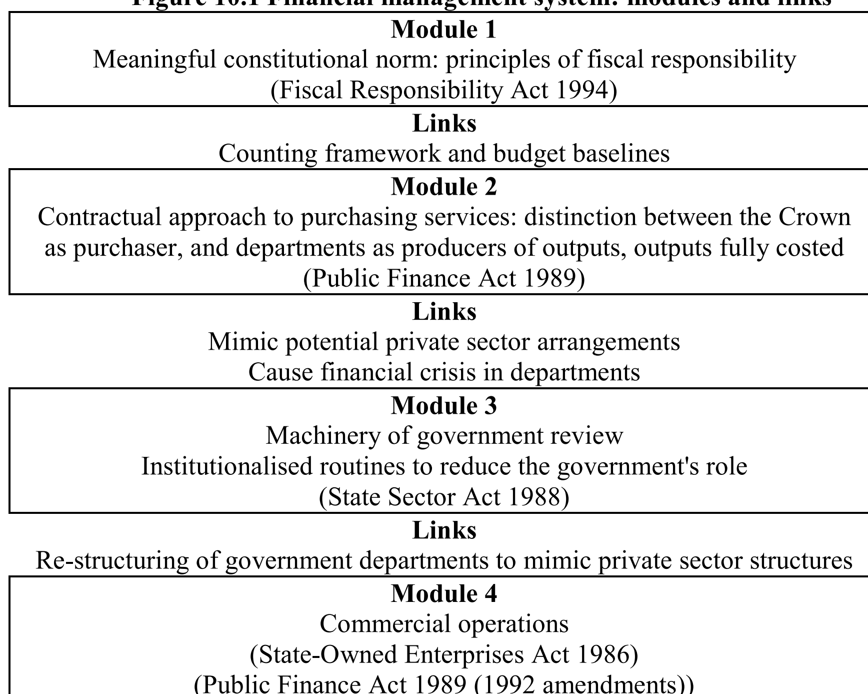
Financial resource erosion in a soundly-based system

According to the Treasury, the financial management system is built on a sound legislative framework, but the dysfunctional and financial resource-eroding features of the financial management system outlined above raise questions about how that framework could be considered sound. The following comments represent my interpretation of the nature of the financial management system in an attempt to explain how the system might be considered soundly based. This research involved no attempt to determine who, if anyone, understands and is

responsible for the nature of the system that has developed and neither did it consider the roles or activities of any particular people. The research focus is on the system, not on identifying exactly who is responsible for creating it.

New Zealand's public sector financial management reforms are remarkable for their legislative foundation which created four modules, each of which is consistent with the ideas and privatisation objectives in the theoretical and practical literature reviewed in Chapters 1 and 3. The theoretical consistency of the legislation suggests a sound legislative framework, but the soundness seems to relate to the reformers' aims to "profoundly alter the role of the state" by shrinking the government's role and privatising functions (Scott *et al*, 1997; see Chapter 3). Over time the financial management system has linked these modules so that now all are a part of the financial management system (Figure 10.1).

Figure 10.1 Financial management system: modules and links



Module 1: meaningful constitutional norm

The first module, the Fiscal Responsibility Act 1994, provides a meaningful constitutional norm intended to constrain the government's access to resources and thus force load-shedding (Buchanan and Wagner, 1978; Buchanan, 1989; Jones 1992a; Savas, 1982, see Chapter 2). This legislated requirement to observe principles of fiscal responsibility and to adopt fiscal targets operates at whole of government level and is drawn from cash accounting.

Despite the dubious claims about what those principles of fiscal responsibility will achieve in an accrual accounting environment, the establishment of provisions determines the amounts available for additional expense and debt, and allows the fiscal targets to impose top-down resource restrictions on vote ministers and departments. The effectiveness of such targets is evident in the recent development of the value-for-money review process which was established to re-prioritise resources in order to fund new initiatives (see Chapter 9).

The counting framework links the provisions to the next module. The exclusion of commitments, that is, arrangements for the purchase of goods or services, from counting against either the expenditure or debt provisions makes advantageous for financial reporting purposes the disposal of assets and reported debt, and their replacement with private finance forms of arrangements (commitments). In the context of the literature reviewed in Chapter 3, the philosophy behind the disposal of public sector assets and engagement in commitments is that by maximising the property held in the private sector, the government's coercive powers may be restrained (Rowley, 1993). Savas's definition of privatisation includes reducing the government's role in owning property. He promotes arrangements such as these because they advance privatisation, while both he and the Treasury promote them because they project the *appearance* of reducing debt (T99C/213, 11 February 1999, Treasury files; Savas, 2000, p. 237-240). According to the Treasury, disposing of assets reduces the risks of government ownership, but whether the risks of the alternatives receive adequate consideration is not clear (Treasury, 21 November 1995, Vote analysis priorities over the next two years, Treasury files, see Chapter 6).[55] The incentives developed in the financial management system make advantageous entry into these off-balance sheet arrangements.

The load-shedding pressure on departments is increased by holding the budget baselines at a nominal dollar amount, thus allowing inflation to erode the purchasing power of the budget involved (Savas, 1982; Barnes and Leith, 2000).

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[55] The Treasury's 1999-2004 strategic plan includes a programme of asset divestments (www. treasury.govt.New Zealand.strategicplan/functions).

The baselines regime also forces departments to consume their financial and other resources through the selective interpretation of the Crown and its departments. These resource-eroding requirements help to impose on departments the financial stress that both Savas (1987) and Osborne and Plaistrick (1997) consider essential to make feasible additional privatising initiatives that might otherwise be resisted (see Chapter 3).

Module 2: Contractual approach to purchasing outputs

The second module, the Public Finance Act 1989, is constructed around New Zealand's novel application of the idea that all of a government's activities may be viewed as the purchase of outputs, a contractual approach which is at "the heart of the entire concept of privatization" (Savas, 2000, p. 65; see also Scott *et al*, 1997). That novel application is constructed around the ambiguous interpretation of the Crown and the misrepresentation of the relationship between the Crown and its departments as an investor/purchaser relationship. This module requires making government-produced goods and services to look like those available in the private sector; and it requires full costing, including a capital charge and depreciation, to allow price efficiency comparisons between departmental and alternative providers (Niskanen, 1975; Savas, 1982, 1987; Miller and Moe, 1983). Chapter 8 explained the development of this module and showed how, despite talk of competitive neutrality, it contains biases against government operations, biases that were noted at the time (see also Chapter 3, and Robinson, 1998b; Carlin, 2000). Privatisation of prison operations was intended and planned for, but the financial management system allowed that privatisation to be rationalised as if it were less expensive (Box 8.5). As this financial management system becomes embedded, decisions may be made without awareness of these biases. Williamson (1996) calls such biases natural opportunism, or tilting at the margins.

Over time, it seems that the margins have required further tilting and this seems to have occurred when the unpopularity of the privatising agenda and the pending change in the electoral system meant that the relatively open approach to privatisation could not be sustained. Arguably, the privatising intent continued, but surreptitiously, at a lower level away from public notice, and through the application of financial rules and procedures. Additional means to pursue this

intent were provided by the dual reporting process used in technical reviews of purchase agreements and revisions to output specifications, the development of good costing practices to allow the costing and benchmarking of output components, the modification of chief executives' performance agreements to demonstrate cost-efficiency and increase in chief executives' performance incentives. These increased efforts were recognised as likely to cause financial stress for departments and some were controversial within Treasury when they were developed (Treasury, 24 October 1995, Efficiency and innovation in the public sector; Gorringe, 1995a; 1995b).

This contractual purchasing structure has been linked to the next module by additional means of causing financial distress in departments. The contracting process itself is likely to cause distress by treating as variable costs the costs of departments' fully-costed outputs and output components. That financial distress is exacerbated by the initial neglect of the ownership interest with no apparent effort to check departments' financial stability under the accrual accounting regime, and the repayment of surplus rule. This financial stress provides the opportunity to impose further privatising pressures through the operation of the next module (Savas, 1987; Osborne and Plaistrik, 1997).

Module 3: Machinery of government review

The State Sector Act 1988 requires the State Services Commissioner to conduct reviews, and this review function seems to be the link between the State Sector Act and the Public Finance Act. That the legislation assigned review functions to the State Services Commission, omitting the Treasury, may have been an oversight but Chapter 9 shows the review function that the Treasury has carved out for itself. Gradually these review functions have been incorporated in the financial management system as a technical means of clearing the decks of both assets and functions and, significantly, incorporated into the budgeting process, thus placing these reviews within the Treasury's domain. Arguably, clear the decks routines should be conducted as small periodic processes which "gradually and continuously" reduce the government's role, preferably with strong advocates (Savas, 1982, 1987; Osborne and Gaebler, 1992; World Bank, 1995; Osborne and Plaistrik, 1997, see Chapter 3).

Three clear the decks routines have been institutionalised, one to clear the decks of assets, the requirements for a capital contribution; and the other two to clear the decks of output provision functions, the output price review (OPR) and the value-for-money (VFM) review. The OPR began as a joint process between the Treasury and the State Services Commission but the State Services Commission was unhappy with the outcome of such reviews — recommendations limited to clearing the decks by reducing business scope, reducing low priority outputs, and divesting physical assets. The current budget baselines guidelines and the Treasury's value wheel suggest that the State Services Commission is now largely excluded from these functions and that the Treasury's role has expanded to include them (State Services Commission, 13 January 1999, "Future application of output pricing reviews: incentives, options and strategies" Treasury files; see Chapter 8; CO(00)12, para 22). The OPR and capital contribution requirements are less regular forms of clear the decks routines than the VFM review but their requirement for dire financial circumstances to exist means that the other parties brought into the process occupy comparatively strong positions. This, in turn, allows for the imposition of load-shedding arrangements which may have been unacceptable under less difficult financial circumstances (Savas, 1987; Osborne and Plaistrik, 1997).

The machinery of government principles adopted for these routines use some of the ideas Savas (2000) presents as pragmatic ways ideas to rationalise privatisation. Departments have been required make their outputs look like those available in the private sector and, as shown in Chapter 8, the output definitions seem to be devised from within the Treasury. Similarly, departments have been encouraged to adopt the good costing techniques which analyse their outputs into output components and commentary about the Department of Statistics' output price review suggest that that encouragement is very strong. The crowding-out rationalisation for privatisation suggests that if public sector outputs or output components can be made to look like those available in the private sector then public sector production should cease, especially if the private sector providers offer more efficient prices (see for example, Chapter 3, 8 and the Guidelines for setting charges in the public sector; Box 9.3).

The types of privatising arrangements that may result from clear the decks routines may involve decisions to stop producing particular outputs, to contract out the production of particular outputs or output components, or to dispose of assets, either completely, or legally, but not substantively, by engaging in sale and leaseback arrangements, or sale and other purchasing arrangements which allow continued use of the assets but without legal ownership. These forms of privatisation may be achieved within the system modules as outlined to this point. Other forms of privatisation, however, require restructuring the department or parts of a department into commercial operations and therefore involve the next module. These restructuring forms are also indicated in step 4 of the Treasury's value wheel (Box 9.6).

Module 4: Commercial operations

The fourth module of the financial management system provides a means of privatisation by which specific governmental operations, once commercialised and re-structured, may be privatised. The State-Owned Enterprises Act 1986 provided the first of these structures while the 1992 amendment to the Public Finance Act 1989 provided an alternative, a company structure called the Crown-owned entity. Both involve company structures and share equity, leading to obvious pressure to privatise these operations by selling them on the basis that the government should not run commercial operations (Williamson, 19940; World Bank 1995).

Conclusions

The debate which gave rise to this research was whether legislative change is required because the financial management system erodes departments' financial resources and escapes parliamentary scrutiny in the process, or whether the system is based on solid legislative foundations and further progress within the current framework will help it to improve performance and value-for-money.

The aims stated in the Public Finance Act, such as providing a framework for parliamentary scrutiny, effective and efficient use of financial resources, and the safeguarding of public assets, are aims that might be expected of any public sector financial management system. Given these stated aims, the system's ability to

escape parliamentary scrutiny while eroding departments' financial resources suggests that the Public Finance Act is weak and, as the Controller and Auditor-General proposed, that legislative change is required. This in turn would result in significant financial management system changes.

The financial management system is not confined to one piece of legislation but encompasses several, and the Public Finance Act's stated objectives are, at best, secondary to the financial management system's aim. That aim, which seems to be privatisation, transcends all of the legislation and has tended to be expressed in symbolic terms likely to appeal to the particular political climate. Stated aims of performance improvement and value-for-money might be viewed in this light. Privatisation as a political objective is well-recognised as lacking public support, both in New Zealand and elsewhere, while privatisation for pragmatic reasons, such as poor and deteriorating public services, superior private sector efficiency, financial crises which present sudden, supposedly unanticipated needs for additional investment, and crowding out apparently receives easier acceptance (Richardson, 1995 and see Chapter 3). New Zealand's public sector financial management system is indeed built on solid and consistent legislative foundations, as the Treasury suggested, but those foundations are foundations for privatisation, they are not foundations intended to meet the objectives usually attributed to public sector financial management. Further progress within the system's current framework will help to achieve the system's aim, and the nature of the current incentives developments under the value for money theme support that view.

The debate between the Controller and Auditor General and the Treasury seemed to suggest opposing views and a decision resulting from this research that the views of either one or the other may be supported. The difference between the Public Finance Act's stated objectives and the financial management system's aim, however, raises the possibility that the views of both may be supported. From the Controller and Auditor-General's perspective the system is not achieving the Public Finance Act's stated objectives. From the Treasury's perspective, the suite of reforming legislation is theoretically consistent and, therefore, might be considered sound. That suite of legislation has supported development of a financial management system which seeks an aim concealed in symbolic and euphemistic terms — that aim is privatisation.

New Zealand's financial management system operates surreptitiously to fabricate the circumstances likely to make privatisation acceptable and, arguably, both resource erosion and avoidance of parliamentary scrutiny are necessary to do this. The problem arising, however, is that the means by which privatisation is being pursued is contrary to the stated aims of the Public Finance Act.

NEO implies a secretive and subversive approach in pursuit of enacting legislators' objectives to provide ongoing benefits to their powerful interest group supporters (Moe, 1990a; 1990b; Horn, 1995). Events in the development of the financial management system suggest that subversion and stealth became essential to enable continued pursuit of the privatisation objective in the face of public opposition. Democratic notions suggest that important matters such as the role and size of government should be debated openly, but through the operation of the financial management system the role and size of government may be shrunk while avoiding any public debate. Democratic control over the use of public money is a recognised feature of public sector financial management (Pallot, 1992), but the gradual reduction of parliamentary scrutiny time during the 1990s has reduced the ability to apply such controls over the executive government, while reductions in the Controller function seem to have removed the Controller and Auditor-General's ability to see clearly how the financial resource-eroding features of the financial management system operate.

Institutional theorists have observed the ease with which institutional changes may be achieved even without agreement or full understanding of the intended or likely effects of those changes. Such lack of understanding has already been suggested in New Zealand (Steering Group, 1991, p. 11). Today, the financial management system is complex and operates though all three central agencies — the Treasury, the State Services Commission, and the Department of Prime Minister and Cabinet. The recent report to the government by the advisory committee which included the chief executive of each central agency reassured the government that the public management system provides a "reasonable base" from which the government may pursue its objective to "maintain and strengthen the public sector" (Advisory Group, 2001, p. 10). That reassurance is demonstrably wrong, but whether members of the Advisory Group know that is not clear. It is at this point that the subversive nature of NEO becomes most

apparent. The current government has, ostensibly, distanced itself from privatisation but, given the reassurance about the suitability of the system, the question arises as to the level at which the nature of the financial management system is known. There is a range of possibilities. At one end of the range, if the system's nature is known at all levels, the current government's distancing from privatisation might not be genuine. At the other end of the range, if the system's nature has not been recognised, then the reassurance issued may represent opinions honestly held and unintentionally mislead the government. In between those two extremes exists various possibilities which include knowledge at some level or levels of the system's nature, and misleading statements issued either intentionally or unintentionally. Irrespective of where knowledge of the system's nature is located, what is clear is that New Zealand's financial management system is not designed to support the ongoing management or maintenance of the public sector as implied by the Advisory Group (2001); it is designed to erode departments' resources and to provide support for privatising developments which project the appearance of occurring for technical and pragmatic reasons, rather than ideological or political reasons.

International commentary about NPFM techniques, many of which have been adopted in New Zealand, has challenged their validity and appropriateness. This research shows the manner in which some of those techniques have been applied and notes further points of concern that have received less international comment, especially the links to other initiatives, the level of discretion exercised by the Minister and the Treasury, the Treasury's expanding role, and the selective use of accounting to rationalise changes which advance the privatising intent. On the surface, accounting aspects of these NPFM developments appear puzzling and somewhat incoherent, but the selective interpretation of the Crown and its departments, and the selective application of accrual or cash accounting techniques regain some coherence if considered from a privatisation perspective.

According to Scott (2001) New Zealand's system of public sector financial management is no longer unique. To the extent that New Zealand's public sector financial management system is consistent with NPFM developments elsewhere, it should be recognised that it contains an underlying privatisation agenda and that "privatization *is* the New Public [Financial] Management" (Savas, 2000, p. 319).

The supposedly unintended consequences of NPFM for which the remedy is more of the same might be reconsidered in light of an unstated privatisation objective.

Limitations of this research

This research has focused on documentation that explains the first two layers of the financial management system, the conceptual instruments layer and the technical instruments layer. It has attempted, using numerous fragments of documented information, to reconstruct and explain the nature of the financial management system. The system is complex, and some important features may have been overlooked. Occasionally the existence or significance of some parts of the system was recognised only following chance comment. Not all features of the system are evident in published financial reports, and cross-checking to published financial reports could be performed only for those parts of the system that were evident.

To the extent possible, the research findings have been checked but the constraints of the Official Information Act make a more full check difficult. Treasury staff kindly reviewed and commented on my representation of facts in an early draft of each of chapters 5-9, and at final draft stage. State Services Commission staff did the same for those parts that related to the State Services Commission. As my understanding emerged, however, the earlier versions of those chapters changed significantly. Departmental staff have been unfailingly helpful and constructive. Any errors in the system as described in this thesis are my errors and should not be attributed to either department as a failure to comment. Arguably, the complete system's consistency is such that correction of any remaining errors would not change the conclusions drawn about its underlying nature and aim.

This research has revealed that at the conceptual instruments and technical instruments levels the system is designed in a manner which erodes departments' resources. It has confirmed some of this erosion through the examination and analysis of departments' financial reports. Ways may have been found through the informal situated interpretation layer of this system to modify some of its eroding effects, but those ways are not necessarily revealed by the research method

adopted. Evidently, some ongoing system developments have been devised to overcome earlier methods of escaping the system's intent. For example, the system would have greatest effect if performance assessment were confined to assessment of financial performance and chief executives' performance but the State Services Commission resisted such a narrow interpretation of performance. Arguably, the recent development in which the Treasury has taken over a part of the State Services Commission's machinery of government review function and designed that function into the financial management system as highly technical-looking clear the decks routines under Treasury influence and control represents the latest attempt to prevent defeat of the system's intent.

One remarkable finding from this research is the consistency of both the legislation and the system developed on the legislative base with the theoretical and practical literature reviewed in Chapters 1 and 3. This differs from Rhodes (1997) who proposes that institutions grow by accretion and not necessarily logically or consistently. In some ways, the consistency found should not be surprising given acknowledgment that the literature was influential, that even though developments occurred at different times, those developments were consistent, and recognition of New Zealand's small size and concentrated political environment (Hood, 1991; Scott *et al*, 1997; Goldfinch, 1998b). At the same time, it must be recognised that New Zealand’s leading role in developing NPFM has, to some extent, provided a model for others, including some authors reviewed. For example, New Zealand may have provided a model for Osborne and Plaistrik (1997) with some developments but they may also have helped to provide a model for New Zealand.

This research has focused on the financial management system and not the identification of particular knowledgeable people who developed this system. A different research method would be required to do this. It might be tempting to attribute a level of intention to particular agencies, such as the Treasury, or to particular people within the Treasury. Much of the archival information used in this research derives from the Treasury and this may project a biased impression of the Treasury's role in development of the financial management system. Certainly Treasury staff are very closely associated with the system and its development, but some aspects of the system as described imply limited

understanding within the Treasury of, for example, accrual accounting and the differences between accrual and cash-based accounting. Whether the system has been designed from within the Treasury, and whether current Treasury staff are aware of the system's effect and consistency are not questions that were raised in this research. Similarly, it might be tempting to attribute intention to all three central agencies, given that the system operates through all three and the recent endorsement of the financial management system as suitable for pursuit of an objective that it is designed to thwart (Advisory Group, 2001). Recognition is essential that the financial management system is complex and that it has received considerable positive and influential commentary (see Chapter 1), albeit that much of the commentary is promotional. This thesis should be read as explaining the financial management system developed and system's objective. It does not extend to comment on the behavioural or political intent of particular people.

Directions for future research

The literature reviewed in Chapter 1 considers essential the placement within key government agencies of econocrats to plan, develop and oversee the reforms (Williamson, J, 1994; Williamson, O, 1996). Such placement was a feature of New Zealand's reforms (Kelsey, 1995; 1999; Goldfinch, 1998b). In contrast, NEO views bureaucrats as the non-political agents of elected politicians. Moe questioned NEO's conceptualisation of bureaucrats, suggesting that all three sets of actors identified in NEO, interest groups, legislators and bureaucrats should be considered in their own right and in light of the way in which they operate to achieve their own ends. In some ways, this direction for future research follows from the preceding acknowledgment of the research limitations. Future research could look more closely at those involved in the financial management reforms to understand their role, both at the time of those reforms and subsequently. The research method adopted by Goldfinch (1998b) may help to identify those most closely involved. Alternatively, the activities, commitment and close connections of known prominent individuals, such as those who have published on the financial management reforms, and acknowledged their involvement, could be traced.

Legislation reforming the financial management of New Zealand’s public sector has not been confined to central government. Additional legislation has affected city and regional councils, while more recent system reform has been applied to Crown entities. The timing, controversy, and the nature of these developments suggest that they may conceal similar biased privatising intent. Financial management legislation and system developments to crown entities, and to city and regional councils could be examined more closely to assess whether they too relate more to surreptitious privatisation intent than to effective and appropriate ongoing financial management of government operations.

New Zealand’s financial management system is no longer unique (Scott, 2001). One noted feature of financial management system reforms in New Zealand and elsewhere is the role played by the transnational accounting firms. In this research, the development of good costing techniques, following an ostensibly-independent review of departments' costing systems by one transnational accounting firm, helped to justify requirements for costing output components and increasing financial pressure on departments. Evidently, a variety of technical good practice guidelines have been devised, both in New Zealand and internationally. This research has suggested that any descriptor attached to particular financial management practices and routines should not be taken at face value. Just as this research has attempted to interrogate the technical achievements of New Zealand's financial management system, these technical good practice developments could also be interrogated to develop understanding of exactly what is meant by good, whether those good practices are designed to contribute to the system’s privatising aim, and whether those good practices have spread internationally.

Among the good practice guidelines issued to government departments in New Zealand is one advising on internal controls and separation of powers. While, for departmental management purposes, separation of functions is advised, the Treasury’s expansion of functions to take over some of the controller function and the State Services Commission’s review functions, combined with its extensive delegated powers, raise questions about the wisdom of allowing such a concentration of power to develop within one department. At the same time, technical processes have been embedded in other central agencies: the budget

baselines guidelines in the Department of the Prime Minister and the Cabinet; and the ownership interest requirements, including the requirements to demonstrate cost effectiveness, in the State Services Commission's chief executive performance agreements. Questions arise whether those other central agencies appreciate the nature of those technical processes and their role in the overall system, or whether these routines represent the proposed increased co-ordination among the central agencies that was proposed in 1993 when it was recognised that pursuit of the "greater objective" would require increased sophistication. Future research might examine the issue of internal control at government management level, the need for separation of central agency powers as an internal control mechanism, and the migration of staff among central agencies.

New Zealand's public sector reforms are acclaimed for their theoretical coherence and consistency. This research highlights the consistency between the privatising intent of NPE and the related practical literature, and the specific accounting rules and techniques adopted in New Zealand's reformed financial management system. That consistency and coherence contrasts with the inconsistencies and incoherence evident in the accounting developments when considered from an accounting theory perspective. At the secondary level of rule development, the selective use of accounting techniques such as cash or accrual accounting suggests confusion over accounting concepts within the Treasury, but it must be noted that the selective use of those techniques helps to rationalise the privatising developments. At another level, however, where confusion over accounting ideas should not be a problem, the activities of the accounting profession, including consultants and accounting standard-setters raise questions about the legitimacy of a supposedly neutral professional group in the regulation process. In New Zealand, some of the financial reporting standards developed appear more consistent with the financial management system's privatising intent than with the dubious theoretical rationale claimed for them (Poskitt and Newberry, 1998). For accountants examining NPFM at a broader level, the links between accounting standard-setters, the means by which their accounting standards attain the force of law, and public sector reformers require investigation. Such investigation is especially warranted in New Zealand where those links are extremely close.

For all of the accounting profession's claims that accounting is a set of neutral techniques intended for use in the production of representationally financial reports, this research shows the folly of accepting such claims without question. In New Zealand's reformed financial management system, accounting is simply a tool for use to advance privatisation. The pursuit of privatisation through these technical accounting means avoids open political debate, and this may be useful from the perspective of NEO theorists seeking regulatory processes intended to benefit particular interest groups while concealing the identity of the beneficiaries and the nature of the benefits to them. The inherently political nature of NEO suggests that technical developments should not be allowed to act as barriers to researchers from other disciplines. Just as the group of NPE theories represents a combination of economics and politics, and trace through to NPM, this research suggests that the development of NPFM adds accounting to this mixture of disciplines. Further studies of NPFM would, therefore, benefit from cross-disciplinary research which analyses particular technical developments for consideration through the lens of other disciplines, thus allowing, for example, consideration from both a technical and political perspective.

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3/2/92	FM/2/2	Issues in the capital charge regime	Treasury
3/2/92	CAB(92)M3/3d	Privatisation: implementing the government's programme	837Rich
7/2/92	T92/345	Briefing note: monitoring compliance with govt purchasing policies	456Rich
10/2/92	T92/352	Officials response to the final report of the review of the SSR	755Rich
10/2/92	STA(92)20	Review of SSR: response to review's recommendations	958Rich
14/2/92	T92/444	Privatisation conference	756Rich
18/2/92	T92/470	Justice bilateral	756Rich
21/2/92	T92/520	Capital charge rate for 1992/93	809Rich & Treasury
24/2/92	CAB(92)M6/12	Review of SSR: response to review's recommendations - revised proposals	837Rich
25/2/92	T92/568	Proposed guidelines on interdepartmental charging for information	809Rich
28/2/92	T92/611	Capital charge rate for 1992/93	809Rich
28/2/92	FM/2/2	Officials' group to monitor implementation of the capital charge: report	Treasury
2/3/92	ECC(92)37	CEs' terms and conditions: Confidentiality concerns and SSC	836Rich
2/3/92	ECC(92)39	Dept capital expenditure scrutiny (following SSR recommendations)	836Rich
3/3/92	ECC(92) M5/12	Dept capital expenditure scrutiny	1101Rich
4/3/92	T92/443	Loss on sale of assets	756Rich
5/3/92	T92/678	Interdepartmental committee on charging for information - further work	809Rich
9/3/92	T92/712	Guidelines for purchasing policy advice	809Rich
9/3/92	ECC(92)47	Guidelines for purchasing policy advice	836Rich
9/3/92	ECC(92)49	Loss on sale of assets	836Rich
10/3/92	ECC(92)M6/6	Loss on sale of assets	1101Rich
10/3/92	STA(92)35	Officials group report on the capital charge	958Rich
10/3/92	T92/716	Treasury outputs relating to the SSR review	809Rich
12/3/92	T92/731	Meeting with Ministers of Justice and Police 12/3	809Rich
16/3/92	FM/2/2	Aide memoire for Cabinet 16/3/92: capital charge regime	Treasury
16/3/92	CAB(92)M9/25	Computing in the state sector: officials response	837Rich
16/3/92	CAB(92)M9/20	Guidelines for purchasing policy advice	837Rich
17/3/92	STA(92)46	Treasury outputs relating to the SSR	958Rich

18/3/92	FM/2/2 (STA(92)M7/1	Treasury outputs relating to the SSR review	Treasury
20/3/92	T92/850	Capital charge regime	809Rich
20/3/92	T92/845	Review of SSR: information to parliament and the role of the audit office	329Rich
23/3/92	CAB(92)M10/28	Additional item: guidelines for establishing the baselines for votes	837Rich
23/3/92	CAB(92M10/10	Capital charge: officials group report	837Rich
27/3/92	T92/914	Official statistics	809Rich
30/3/92	T92/931	Working party on output definition	809Rich
1/4/92	T92/955	Justice and police scoping study: savings	809/345Rich
3/4/92	CAB(92)224	Privatisation scoping studies	316Rich
6/4/92	Treasury	Working party on output definition	Treasury
6/4/92	STA(92)63	Working party on output definition	959Rich
7/4/92	ECC(92)96B	Police/Justice scoping study: Justice implementation strategy	836Rich
7/4/92	ECC(92)96C	Police/Justice scoping study: OCEC report	836Rich
7/4/92	ECC(92)96A	Police/Justice scoping study: police implementation strategy	836Rich
8/4/92	ECC(92)M12/2	Police/Justice scoping study: OCEC report	Rich
10/4/92	T92/1077	Prison canteen inmate earnings	345Rich
14/4/92	T92/1149	CE performance agreements 1991/92	786Rich
15/4/92	T92/1119	Key issues for Treasury in 1992/93	786/301Rich
16/4/92	BR No: 46	Fiscal strategy	295Rich
21/4/92	??	1992 budget process: bids for increased expenditure	295Rich
21/4/92	ECC(92)111	1992/93 dept budgets, baseline forecasts 1993/94 and 1994/95	836Rich
22/4/92	ECC(92)M14/1	1992/93 dept budgets and baseline exp forecasts 1993/94 and 1994/95	1101Rich
24/4/92	T92/1209	Enterprise council: the debate on incentives	303Rich
27/4/92	CAB(92)M15/10h	1992/93 dept budgets and baseline exp forecasts 1993/94 and 1994/95	838Rich
27/4/92	ECC(92)114	Cfwd of expenditure and costs into next financial year	836Rich
5/92	FM/2/1	Outputs, outcomes and policy advice	Treasury
1/5/92	T92/1279	Public finance amendment bill	786Rich
5/5/92	BR No: 53	Budget: strategic issues	295Rich
5/5/92	ECC(92)M16/8	The case for a time use survey	1101Rich
5/5/92	ECC(92)141	Vote:Justice: 1992/93 budget, 1993/94, 1994/95 baseline forecasts	836Rich
6/5/92	ECC(92)M18/1	Vote:Justice: 1992/93 budget, 1993/94, 1994/95 baseline forecasts	1101Rich
8/5/92	BR No: 56	Fiscal strategy	295Rich
8/5/92	Budget	Fiscal strategy	366Rich
8/5/92	FM/2/2	J. Lee fax: radical review of the nature of the capital charge	Treasury
11/5/92	CAB(92)M17/8g	Vote:Justice: 1992/93 budget, 1993/94, 1994/95 baseline forecasts	839Rich
13/5/92	ECC(92)M21/4K	1992 budget round: OCEC report: Statistics	1101Rich
13/5/92	CO(92)11	Process for completing 1992/93 CE perf agrmts and dept corp plans	1005Rich
18/5/92	ECC(92)170	Capital cost to justice of extra police	1052Rich
18/5/92	STA(92)95	Info and support for ministers for management of CE performance	960Rich
18/5/92	T92/1458	Votes Justice and police: 92/93 estimates	345Rich
19/5/92	ECC(92)M24/2	Capital cost to justice of extra police	1101Rich
20/5/92	BR No. 62	Establishing expenditure limits	295Rich
20/5/92	FM/2/6 (STA(92)M15/1)	Info and support for ministers for management of CE performance	Treasury
25/5/92	CAB(92)M20/43	Additional item: fiscal overview	840Rich
25/5/92	ECC(92)201	Private sector contracting in the prison system	1052Rich
25/5/92	CAB(92)M20/24n	Review of additional expenditure bids: Statistics	840Rich
26/5/92	ECC(92)M28/7	Private sector contracting in the prison system	1101Rich
27/5/92	FM/2/2	M. Lally fax: comments on J Lee memo	Treasury
28/5/92	CSC(92)M20/1	Revenue targets and fiscal strategy	1105Rich

2/6/92	CAB(92)M21/10aa	1991-92 final supplementary estimates	840Rich
2/6/92	CAB(92)M21/13	Revenue targets and fiscal policy	840Rich
8/6/92	ECC(92)220	Public finance bill: report back on crown-owned entities and remaining proposed provisions	1052Rich
8/6/92	CAB(92)M22/8a	Review of additional expenditure bids	840Rich
9/6/92	STA(92)111	Development of the public registries	961Rich
10/6/92	STA(92)M17/7	Development of the public registries	1105Rich
15/6/92	CAB(92)M23/12	Confirmation of budget baseline expenditure forecasts 1993/94, 1994/95	840Rich
22/6/92	CAB(92)M24/14	Development of the public registries	841Rich
29/6/92	Treasury	SNR mgmt meeting: output defn working party	Treasury
2/7/92	T92/2020	Cost allocation systems in departments	788Rich
3/7/92	T92/1971	Report of the working party on output definition	788Rich
7/7/92	STA(92)142	Report of the working party on output definition	961Rich
7/7/92	T92/2030	Speech, Ian Ball, AAANZ conference "Accrual accounting in the public sector: a case study"	788Rich
13/7/92	STA(92)147	Cost allocation systems in departments	961Rich
14/7/92	T92/2122	Controlling expenditure through performance management	789Rich
20/7/92	CAB(92)M28/18	Controlling expenditure through performance management	841Rich
20/7/92	CAB(92)M28/8d	Cost allocation systems in departments	841Rich
22/7/92	FM/2/2	Fax: Lally: McCulloch Capital charge with surplus retention & /or real debt	Treasury
22/7/92	AIP(92)M4/4	Report of the working party on output definition	1111Rich
27/7/92	CAB(92)M29/7j	Report of the working party on output definition	841Rich
3/8/92	CAB(92)M30/16	Review of statistics for social policy purposes	842Rich
18/8/92	T92/2527	Scoping study, picton and sentencing policy	793/345Rich
21/8/92	T92/2581	SSR: information for parliament	793Rich
25/8/92	STA(92)177	Follow-up to Logan report recommendations	962Rich
25/8/92	T92/2618	Officials report on the capital charge	794Rich
26/8/92	CSC(92)M37/6a,b	Scoping study: the scope for reducing the cost of administering the criminal justice system	1105Rich
27/8/92	T92/2641	Public Finance amendment bill: reporting to the house of representatives against the appropriations enacted by parliament	794Rich
28/8/92	T92/2663	Cost allocation systems in departments	794Rich
28/8/92	CO(92)15	Guidelines for contracting for services	1005Rich
8/9/92	STA(92)190	Implementation capital charge: report of the officials monitoring gp	963Rich
11/9/92	T92/2815	Capital charge regime for depts	796Rich
11/9/92	T92/2805	Cost allocation systems in departments	796Rich
13/9/92	FM/2/2	Capital charge: I. Ball to Yew Mun Ho	Treasury
15/9/92	T92/2843	Capital charge regime: dept specific rates	796Rich
21/9/92	ECC(92)304	Dept capital expenditure scrutiny (1993 budget - dept ownership issues)	1052Rich
21/9/92	CAB(92)M38/7f	Implementation capital charge: report of the officials monitoring gp	843Rich
28/9/92	CAB(92)M39/7	Unappropriated exp and costs incurred furing 1991/92	843Rich
29/9/92	CEG(92)M33/1	CER: 1992 review: outcome	1109Rich
29/9/92	ECC(92)M45/2	Dept capital expenditure scrutiny (1993 budget - dept ownership issues)	1101Rich
29/9/92	T92/2652	Reply to contracting out proposal from Mr Michael Cox	794Rich
10/92	FM/2/2	Officials' meeting: capital charge: standard rate for 1993/94 and budget process to deal with a change in the capital charge rate	Treasury
2/10/92	ECC(92)324	1995 Commonwealth statisticians conference	1052Rich
5/10/92	CAB(92)M40/9	1993 budget process - departmental ownership options	843Rich
5/10/92	CAB(92)M40/13	CER: 1992 review: outcome	843Rich
5/10/92	CAB(92)M40/10	Reinforcing the criteria agreed for 1992/93 supps	843Rich
6/10/92	ECC(92)M46/9	1995 Commonwealth statisticians conference	1101Rich
7/10/92	T92/3082	Costing and pricing in the public sector: speech notes for assoc Min of Fin	798Rich

9/10/92	BR No: 9	1993 budget process - strategic and purchase phases	305Rich
9/10/92	T92/3106	Cost allocation systems in departments	799Rich
12/10/92	CAB(92)M41/5h	1995 Commonwealth statisticians conference	843Rich
12/10/92	T92/2983	Recognition of contribution of Andrew Weeks	797Rich
13/10/92	CSC(92)153	Private sector contracting for prison services	1105Rich
19/10/92	T92/3203	Disclosure pay rates for CEs, directors of private sector firms, SOEs	800Rich
19/10/92	FM/8/2	Strategy for refinement of departmental management	Treasury
20/10/92	T92/3228	Bilateral discussion with Minister of Justice	800/345Rich
20/10/92	T92/3253	Reports of the working party on output definition	800Rich
20/10/92	T92/3227	Speech Tony Dale, IIR conference: implementing accrual accounting in the public sector "Accrual accounting in the public sector: the New Zealand experience"	800Rich
23/10/92	CO(92)16	Reinforcing the criteria agreed for 1992/93 supplementary estimates	1005Rich
27/10/92	CAB(92)M43/12	Establishing dept-specific capital charge rates	874Rich
27/10/92	FM/2/2	M. Lally: Adjusted and unadjusted betas	Treasury
28/10/92	CSC(92)M52/2	Fiscal strategy	1105Rich
28/10/92	CSC(92)M52/5	Private sector contracting for prison services	1105Rich
30/10/92	ECC(92)353	Report of working party on output definition	955Rich
4/11/92	T92/3246	Calculation of dept surplus to be paid to the Crown for y/e 30 June 1992	800Rich & Treasury
6/11/92	T92/3403	Capital charge: piloting the dept specific rates	802Rich
6/11/92	TC1992/4	The capital charge/interest regime update	Richardson
9/11/92	ECC(92)375	Calculation of dept surplus to be paid to the Crown for y/e 30 June 1992	955Rich
9/11/92	CAB(92)M46/9	Fiscal strategy	874Rich
10/11/92	ECC(92)M50/11	Calculation of dept surplus to be paid to the Crown for y/e 30 June 1992	1101Rich
10/11/92	STA(92)224	Capital charge: piloting the dept specific rates	1012Rich
10/11/92	STA(92)221	Development of public registries: prime parameters for head contract	1012Rich
10/11/92	ECC(92)M50/1	Proposed changes for incl dept baselines for 1992/93, 1993/94, 1995/95	956Rich
10/11/92	ECC(92)M50/2	Report of working party on output definition	1101Rich
10/11/92	STA(92)225	Review of SSR senior management development project	1012Rich
10/11/92	T92/3434	STA paper on public registries project	802Rich
11/11/92	STA(92)M38/2	Capital charge: piloting the dept specific rates	1011Rich
11/11/92	STA(92)M38/3	Development of public registries: prime parameters for head contract	1011Rich
11/11/92	STA(92)M38/1	Review of SSR senior management development project	1011Rich
13/11/92	T92/3467	Capital charge for 1993/94: officials recommendations to OCEC	802Rich
16/11/92	CAB(92)M47/7	1993 budget: determining the strategic priorities	874Rich
16/11/92	CAB(92)M47/8e	Baseline changes 1992/93 - 94/95: Justice	874Rich
16/11/92	CAB(92)M47/8h	Proposed changes for dept baselines: 1992/93-1994/95: Statistics	874Rich
16/11/92	CAB(92)M47/8	Proposed changes for inclusion in dept baselines for 1992/93, 1993/94 and 1994/95	874Rich
20/11/92	FM/2/2	Capital charge and business risk: discussion draft	Treasury
23/11/92	ECC(92)393	Police/Justice scoping study: unit (or day) fines: process of reporting	955Rich
30/11/92	CEG(92)216	GATS: New Zealand offer	1008Rich
30/11/92	??	Process for return of dept budgets reflecting agreed baseline reductions	305Rich
1/12/92	ECC(92)M53/16	Revised baseline expenditure forecast aggregates	956Rich
2/12/92	CS/4/1/1	Key issues for Treasury in 1993/94	301Rich
3/12/92	T92/3683	Comment of votes where issues require consideration	804Rich
4/12/92	T92/3696	Departmental management initiatives	804Rich
7/12/92	CAB(92)M50/26s	Revised baseline aggregates: Justice	875Rich
7/12/92	CAB(92)M50/26ai	Revised baselines: Statistics	875Rich

8/12/92	STA(92)258	Departmental management initiatives	1013Rich
8/12/92	STA(92)257	Strategic mgmt development in the NZ public service	1013Rich
9/12/92	FM/2/13	C Magiannis re purchase agreements	Treasury
9/12/92	STA(92)M42/3	Departmental management initiatives	1011Rich
9/12/92	STA(92)M42/2	Strategic mgmt development in the NZ public service	1011Rich
10/12/92	T92/3762	Vote Stats: capital injection for 1992/93	805Rich
11/12/92	ECC(92)428	Dept management initiatives	955Rich
14/12/92	CAB(92)M51/21	1993 budget: proposed initiatives	306Rich
14/12/92	ECC(92)451	Capital charge 1993/94	955Rich
14/12/92	ECC(92)432	Net funding policy: Department of Statistics	955Rich
15/12/92	ECC(92)M55/30	Capital charge 1993/94	956Rich
15/12/92	Gill:Hames	CSC Overview paper: Criminal justice	345Rich
15/12/92	ECC(92)M55/19	Dept management initiatives	956Rich
15/12/92	ECC(92)M55/13	Effect of forex movements of output prices	956Rich
21/12/92	CAB(92)M52/36	Capital charge for 1993/94	875Rich
21/12/92	CAB(92)M52/16q	Dept management initiatives	875Rich
21/12/92	??	MERT: paper on tariffs and GATT	310Rich
1993	FM/2/2	M. Lally: The cost of capital for govt entities: an evaluation of the NZ government's capital charge model	Treasury
1993	FM/2/2	M. Lally: Consistent cost of capital calculations for government entities	Treasury
28/1/93	FM/2/2	M. Lally: Taxation aspects of the public sector cost of capital	Treasury
2/93	FM/2/13	Purchase agreements: background information	Treasury
2/2/93	STA(93)1	Development of the public registries: legislative amendments	1015Rich
3/2/93	STA(93)M1/2	Development of public registries: legislative amendments	1014Rich
4/2/93	FM/2/2	Management of departmental surpluses	Treasury
9/2/93	FM/2/13	Guidelines for preparing and assessing purchase agreements	Treasury
10/2/93	T93/233	enhancing vote analysis as part of Treasury's core business	1093Rich
16/2/93	ECC(93)M2/2	Net funding policy: Dept of Statistics	912Rich
18/2/93	T93/305	Cost recovery in courts	345Rich
22/2/93	CAB(93)M5/6b	Net funding policy: Statistics	910Rich
23/2/93	STA(93)13	Dept mgmt initiative: spec, assess CE perf in dept management	1015Rich
24/2/93	FM/2/19	Departmental surpluses: composition and management	Treasury
24/2/93	STA(93)M4/1	DMI: specification and assessment of CE performance in dept mgmt	1014Rich
24/2/93	T93/346	The costs of policy advice	355Rich
25/2/93	T93/367	Policy advice	355Rich
1/3/93	ECC(93)40	Purchase advisers for Ministers	971Rich
3/93		Treasury's core performance expectations of departmental chief executives	Treasury
3/3/93	STA(93)M5/2	Purchase advisers for Ministers	1014Rich
4/3/93	T93/434	Purchase agreements	355 & 817Rich
8/3/93	CAB(93)M7/4a	Purchase advisers for Ministers	910Rich Treasury
9/3/93	STA(93)25	Review of public registries charges	1015Rich
10/3/93	STA(93)M6/6	Review of public registries charges	1014Rich
11/3/93	T93/521	Speech Ian Ball, National accountants in govt convention, Hobart "New Zealand public sector management"	355Rich
12/3/93	ECC(93)62	Review of public registries charges	971Rich
16/3/93	ECC(93)M6/6	Review of public registries charges	912Rich
17/3/93	T93/590	Publication Brian McCulloch "NZ leads in government management reform"	355Rich
22/3/93	CAB(93)M9/5e	Review of public registries charges	910Rich
23/3/93	ECC(93)93	1993 budget - Vote: Statistics	971Rich
24/3/93	ECC(93)M9/5	1993 budget - Vote: Statistics	912Rich

24/3/93	T93/663	Treasury's advice to Ministers on exp control and dept performance	815Rich
25/3/93	T93/671	"Non-political' fiscal and economic briefing (precursor to fiscal resp act)	815Rich
26/3/93	CAB(93)130 part2	1993/94 Estimates and 1992/93 Supps: Report of ECC	1016Rich
29/3/93	CAB(93)M10/23k	1993 budget: Statistics	1018, 910Rich
1/4/93	FM/2/2	M. Lally: Consistent cost of capital calculations for government entities	Treasury
2/4/93	CAB(93)166	Managing the recovery: enterprise and innovation	1017Rich
6/4/93	ECC(93)153	1993 budget - Vote: Justice	972Rich
6/4/93	CAB(93)185part 1	1993/94 estimates and 1992/93 supps: Justice	1017Rich
7/4/93	ECC(93)M13/6	1993 budget - Vote: Justice	912Rich
13/4/93	CAB(93)M12/17e	1993 budget: vote Justice	910Rich
15/4/93	T93/874	Speech, Graham Scott (IFAC public sector committee) "Financial management reform in the New Zealand government"	355 & 813Rich
27/4/93	CEG(93)M11/11	Review of information technology policy	1009Rich
3/5/93	CAB(93)M15/25	Penal institutions amendment Bill (No 2)	1018Rich
12/5/93	FM/2/13	Purchase agreements: issues raised by CEs	Treasury
14/5/93	FM/2/13	Invitation to purchase agreement conference	Treasury
17/5/93	ECC(93)224	1992/93 final supplementary estimates	972Rich
18/5/93	FM/2/13	Tech review panel meeting: review procedures purchase agreements	Treasury
21/5/93	CAB(93)336	Criteria for 1993/94 supplementary estimates	890Rich
21/5/93	FM/2/13	Dept Justice purchase agreement assessment	Treasury
24/5/93	CAB(93)M18/32y	1992/93: Final supps: Justice	1018Rich
28/5/93	T93/1216	Address on Law and Economics and Court Governance (M. Palmer)	903Rich
21/6/93	T93/1555	Suggested speech notes for Max Bradford "The purchase of policy advice"	355Rich
23/6/93	T93/1595	Suggested speech notes for Maurice McTigue "Accountability and the provision of policy advice"	355Rich
28/6/93	T93/1642	CE performance agreements 1993/94	907, 1015Rich
29/6/93	STA(93)74	CE performance agreements 1993/94	1015Rich
30/6/93	STA(93)M18/2	CE performance agreements 1993/94	1014Rich
8/7/93	T93/1752	Implementation of output class specs for POBOCs for outputs	355 & 909Rich
9/7/93	CAB(93)525	CE performance agreements 1993/94	1245Rich
12/7/93	CAB(93)M25/9	CE performance agreements 1993/94	1018Rich
12/7/93	T93/1792	Financial reporting bill: applying GAAP to the public sector	356 & 909Rich
13/7/93	STA(93)84	Computer devmts in public registries: selection of a business partner	1015Rich
14/7/93	CSC(93)M29/11	Contracting for prisoner escort services	1019Rich
14/7/93	STA(93)M19/2	Computer dev't in public registries: selection of a contracting party	1014Rich
14/7/93	CSC(93)M29/10	Private sector contracting for prison services	1019Rich
14/7/93	STA(93)M19/1	Strategic mgmt development in the NZ public service	1014Rich
16/7/93	CAB(93)536	Private sector contracting for prison services	1245Rich
19/7/93	CAB(93)M26/14	Private sector contracting for prison services	1018Rich
19/7/93	CAB(93)M26/5d	Procedures for the consideration of proposals with fiscal implications	1018Rich
22/7/93	T93/1882	Financial reporting bill: Implementation of improved fiscal reporting	356 & 819Rich
22/7/93	T93/1898	October economic and fiscal update: Budget baselines	819Rich
26/7/93	ECC(93)267	Implementation of POBOCs for output classes	911Rich
26/7/93	ECC(92)268	Review of departmental performance	911Rich
27/7/93	CEG(93)M20/1	Implementation of improved fiscal reporting	1009Rich
27/7/93	ECC(93)M27/6	Implementation of POBOCs for output classes	912Rich
27/7/93	ECC(93)M27/5	Review of departmental performance for 1992/93	912Rich

28/7/93	T93/1947	The speech Max Bradford did give "The purchase of policy advice: the New Zealand Model" seminar: "Observations from a parliamentary perspective"	356Rich
8/1993		Capital charging regime for govt dps: survey: benefits and current issues (PW)	Treasury
2/8/93	CAB(93)M28/5e	Review of dept performance for 1992/93	1018Rich
2/8/93	ECC(93)272	The introduction of pricing for policy advice (incls copy of CO(93)9)	911Rich
6/8/93	T93/2029	The introduction of pricing for policy advice	821Rich
10/8/93	T93/2057	Implementing POBOCs for output classes	356Rich
10/8/93	ECC(93)M29/1	The introduction of pricing for policy advice	912Rich
13/8/93	T93/2111	Cost of purchasing policy advice	356Rich
13/8/93	CAB(93)M30/8	The introduction of pricing for policy advice	1018Rich
16/8/93	CAB(93)M30/7	Legislating for improved fiscal reporting	1018Rich
17/8/93	T93/2131	Papers for World Economic Development Congress	822Rich
20/8/93	T93/2172	Unappropriated expenditure and exps during 1992/93	356Rich
27/8/93	CO(93)11	1993/94 supplementary estimates criteria	1005Rich
30/8/93	ECC(92)306	The introduction of pricing for policy advice: definition guideline	911Rich
31/8/93	ECC(93)M32/5	The introduction of pricing for policy advice: definition guideline	912Rich
31/8/93	ECC(93)M32/4	Unappropriated expenditure and expenses 1992/93	912Rich
6/9/93	TC1993/8	Pricing policy advice: comparative information	Treasury
6/9/93	ECC(93)318	Unappropriated expenditure & exps incurred during 1992/93: vote Justice	911Rich
7/9/93	ECC(93)M33/6	Unappropriated expenditure and expenses 1992/93	912Rich
8/9/93	T93/2310	Financial reporting bill: notification to FEC	356 & 824Rich
10/9/93	CAB(93)670	Unappropriated exp during 1992/93	1246Rich
20/9/93	ECC(93)329	1993 baseline update - vote Statistics	911Rich
21/9/93	ECC(93)M35/4	1993 baseline update vote Statistics	912Rich
24/9/93	T93/2490	Pricing policy advice	356 & 825Rich
27/9/93	CAB(93)M36/14ad	1993 baseline update: Justice	1018Rich
27/9/93	CAB(93)M36/10c	1993 baseline update: Statistics	1018Rich
27/9/93	CAB(93)M36/14aw	1993 baseline update: Statistics	1018Rich
27/9/93	T93/2495	Presentations in Washington (Ian Ball) "making ministries more accountable" and "cost allocation issues"	356Rich
28/9/93	FM/2/13	Pilot for tech review: D Oughton: Justice	Treasury
28/9/93	FM/2/13/	Pilot for tech review: L. Cook Stats	Treasury
29/9/93	T93/2510	Pilot for tech review procedures for pch agrments - feedback to ministers	356Rich
29/9/93	T93/2510	Pilot tech review procedures purchase agreements: feedback to Ministers	1094Rich
9/11/93	FM/2/19	Departmental surplus	Treasury
12/11/93	FM/2/13	Purchase agreements	Treasury
18/11/93	CAB(93)805	Departmental baselines	458Rich
17/12/93	T93/2951 FM/2/13	Purchase agreements	Treasury
1994		Review of Accountability Requirements	Treasury
1994	FMA(94)1	Compensating adjs to rev Crown for capital charge and depn exp changes	Treasury
21/1/94	FM/2/2 T94/54	Capital charge for 1994/95	Treasury
27/1/94	FM/2/12/5	Strategic assessments: lessons from the first wave	Treasury
3/94	Treasury	Treasury's core performance expectations of departmental chief executives	Treasury
20/4/94	Treas	Initial summary of best practices for performance measures (Technical review of purchase agreements)	Treasury
1/6/94	FM/3/17/	Fiscal responsibility bill as reported back from the FEC	Treasury
1/9/94	FM/2/19	Audit pronouncement re other exps	Treasury

5/9/94	Treasury	Financial management reforms	Treasury
18/8/94	FM/2/13	Letter: Stats to tech review panel	Treasury
9/94	FM/2/19	Rationale for Fiona Beck	Treasury
14/9/94	FM/2/13	Letter: Tech review panel to stats	Treasury
22/9/94	T94/2561 FM/2/19	Advising ECR of the new formula for calculation of payment os surplus	Treasury
23/9/94	ECR(94)210 FM/2/19	Calculation of the payment of departmental surpluses: new formula	Treasury
27/9/94	ECR(94)M34/1 FM/2/19	Calculation of the payment of departmental surpluses: new formula	Treasury
29/9/94	FM/7/4/	A-G's draft comments on incentives	Treasury
14/10/94	FM/2/19	Explanation to M. Horn: error in calculation of dept surplus	Treasury
12/10/94		Report of the Working Party to the Advisory Group: Review of Accountability Requirements	Treasury
19/10/94	FM/2/1/	FM Implementation	Treasury
14/11/94	CAB(94)M44/11	Guidelines for changes to baselines	Treasury
22/11/94	T94/3193	1993/94 NZDF Surplus: capital contribution	Treasury
30/11/94	FM/2/19	Surplus retention	Treasury
7/12/94	FM/2/19	Surplus management	Treasury
1995	FM/2/19/1	Response to comments on retention of income paper	Treasury
1995	FM/2/19/1	Retention of interest income	Treasury
1995		Improvements to the incentives regime - retention of interest income	Treasury
1995		Discussion paper: improvements to the incentives regime - retention of interest income	Treasury
23/2/95	FM/2/19	Surplus management	Treasury
27/2/95		Minutes of senior management meeting of 20 February 1995	Treasury
7/6/95	FM/2/19/1	Retention of interest income: discussion paper	Treasury
7/95	S.S.C	The ownership interest: a composite record of the discussion sessions among chief executives and senior managers	S.SC
6/7/95	FM/2/19	Financial management in a fiscal surplus environment	Treasury
25/7/95	FM/2/12/8	Progressing ownership	Treasury
27/7/95	T95/2198 FM/2/19/1	Managing over and under-recoveries of fully cost recovered outputs	Treasury
3/8/95	T95/2276 FM/2/12/8	Progress report: interdepartmental working group on ownership	Treasury
9/1995	FM/06/08	Coopers and Lybrand 1995 Review of costing systems and user charges	Treasury
15/9/95	CO(95)10	Guidelines for changes to baselines	Treasury
19/10/95	VACCM69	Vote analysis co-ordinating committee	Treasury
24/10/95	FM/7/4	Efficiency and innovation in the public sector	Treasury
30/10/95	FM/21	Financial management initiatives: the next steps	Treasury
20/11/95	FM/2/2	Process for setting dept-specific capital charge rates for 1996/97	Treasury
21/11/95	VACC	Vote analysis priorities over the next two years	Treasury
12/12/95	?	Vote analysis: a strategy for lifting our game	Treasury
13/12/95	T95/3866	The Public sector mgmt system as it relates to departments	Treasury
1995/96		Draft discussion paper: improvements to the incentives regime - retention of interest income	Treasury
5/2/96	FM/2/12/8	Re: Managing the government's ownership interest	Treasury
22/2/96	T96/438 FM/2/12/8	Managing the Government's ownership interest	Treasury
6/3/96	FM/2/2	Capital charge rate for 1996/97	Treasury
26/4/96	T96/1336	1996 bargaining round strategy	Treasury
10/5/96	T96/1551	1996 bargaining round strategy update	Treasury
14/6/96	T96/2022 FM/2/12/8	Ownership briefing for selected ministers	Treasury
10/96	FM/7/4	Summary of trip to Melbourne: J. Brumby	Treasury
6/12/96	T96/3632; FM/2/2	Capital charge rate for 1997/98	Treasury
9/12/96	BU2/3/5	1997 estimates including BBU and capital charge	Treasury

1997		Technical review panel (TRP) update	Treasury
1997		Technical review panel 1997, Purchase agreement checklist	Treasury
1997		The impact of the capital charge on government departments: J. Scott	Treasury
14/2/97	T1997/2	1997 BBU and 1996/97 supplementary estimates process	Treasury
3/97		The Statistics New Zealand Output Price Review	Treasury
23/6/97	FM/6/8	Report on the implications for departments of contracting out	Treasury
27/6/97	CO(97)7	Counting changes to the fiscal position against the (1996) coalition agreement's fiscal parameters	Treasury
22/9/1997	TC1996/2	Calculation of provision for payment of surplus	Treasury
10/97	From website	M. Lally: Estimating the cost of capital for Crown entities and SOEs	
98	FM/7/4	Strategic result areas for the public sector 1999-2002	Treasury
1998	FM/2/4/ vol 4	M. Lally: Financing leases and capital charging	Treasury
1998	FM/2/4/vol4	Capital contributions	Treasury
25/2/98	TC1997/11	1998 budget process and timetable, part 1	Treasury
2/7/98	FM/2/6	Letter Wintringham to Bollard	Treasury
7/7/98	TC1998/10	Changes to GSF employer contribution rates	Treasury
8/7/98	Treasury	Machinery of government	Treasury
17/7/98	T98C/2349	Strategic management of the public sector	Treasury
26/8/98	FM/2/4	M. Lally: Public sector cost of capital: a comparison of two models	Treasury
15/9/98	TC1998/15	Recognition of employee entitlement liabilities	Treasury
13/10/98	T98C/3430; FM/2/2	Capital charge rate for 1999/2000	Treasury
23/10/98	FM/7/4	Kim Hill interview with Simon Upton	Treasury
2/11/98	CAB(98)M41/21	Strategic priorities for the public sector 1999-2002	Treasury
11/11/98	TC1998/18	Criteria for baseline changes	Treasury
1/12/98	T98C/3994	Guidelines for setting charges in the public sector	Treasury
8/12/98	T98C/4002	Financial delegations to Mins and CE: CO(96)11	Treasury
8/12/98	EXG(98)190	Review of Financial delegations to Mins and CEs	Treasury
9/12/98	EXG(98)M19/6	Review of Financial delegations to Mins and CEs	Treasury
11/12/98	S.S.C.	Future application of output pricing reviews: incentives, options and strategies	Treasury
14/12/98	CAB(98)M47/9D(4)	Review of Financial delegations to Mins and CEs	Treasury
1999?	VAs' A-Z guide	Output price increases	Treasury
1999?		Output pricing/baseline reviews	Treasury
/99	FM/2/12/8	An authoritative adviser on the Government's ownership interest in the core state	Treasury
1999	FM/2/12/8	An authoritative adviser on the Government's ownership interest in departments	Treasury
2/99	T99C/204	Outcome measures: economic team ministers' agenda item 10 February 1999	Treasury
11/2/99	T99C/213	Meeting 12/2 on capital issues (note split cap vs op)	Treasury
23/2/99	T99C/305	Principles for competitive neutrality in the public sector	Treasury
26/4/99		Output pricing reviews - a guide	S.SC
1/6/99	FM/2/23	Feedback on output price review paper	Treasury
2/6/99	FM/3/5	purchase agreements for non-departmental output class appns	Treasury
4/6/99	FM/2/6	Guidance notes on 1999/2000 relationship and feedback letters	Treasury
21/6/99	FM/2/12/8	Ownership monitoring	Treasury
28/6/99	FM/2/12/8	Comments on " An authoritative adviser on the Government's ownership interest in the core state"	Treasury
13/7/99	STR(99)153; FM/2/12/8	An authoritative adviser on the Government's ownership interest in departments	Treasury
14/7/99	STR(99)M17/12; FM/2/12/8	An authoritative adviser on the Government's ownership interest in departments	Treasury
23/7/99	TC1999/9 BU/5/6/1	Fiscally neutral adjustments	Treasury
23/8/99	CAB(99)M20/15; FM/2/12/8	An authoritative adviser on the Government's ownership interest in departments	Treasury

3/9/99	FM/2/12/8	Draft: a framework for managing the Crown's ownership interests	Treasury
7/9/99	FM/2/12/8	SSCs changes: recent perspectives on the ownership interest	Treasury
7/9/99	FM/2/12/8	SSCs paper on managing the Crown's ownership interests	Treasury
28/9/99	T99C/2117; FM/2/12/8	SSCs draft STR paper on an ownership strategy	Treasury
4/10/99	STR(99)242; FM/2/12/8	Improving the mgmt of the ownership interests in public service departments	Treasury
6/10/99	STR(99)M23/3; FM/2/12/8	Improving the mgmt of the ownership interests in public service departments	Treasury
11/1999	FM/2/12/8	Draft ownership briefings: Ministry of Defence; IRD; New Zealand Customs	Treasury
18/11/99	TC1999/16	Introductory information for vote ministers	Treasury
22/11/99	FM/2/12/8	Treasury views on central agency ownership responsibilities	Treasury
20/12/99	T99/61	Value for money in the public sector	Treasury
23/12/99	FM/2/12/8	Views on central agency ownership responsibilities	Treasury
2000	late 2000?	The State Services Commission's response to the Treasury working paper of 30 March 2000: "It's information Jim, but not as we want it"	S.SC
21/1/00	T2000/101	Shared services	Treasury
24/2/00	TC2000/2	Updating the fiscal provisions for government decisions	Treasury
29/2/00	FM/2/12/8	The ownership interests of ministers and the SSc role	Treasury
9/3/00	T2000/349	Work plan to progress shared services	Treasury
30/3/00		"It's information Jim, but not as we want it"	Treasury
18/5/00	FM/2/3/2	Improving the mgmt of the ownership interests in public service depts: report back on the pilots of CAP	Treasury
22/5/00	EXG(00)39; FM/2/3/2	Improving the mgmt of the ownership interests in public service depts	Treasury
24/5/00	EXG(00)M7/5; FM/2/3/2	Improving the mgmt of the ownership interests in public service depts	Treasury
31/5/00	T2000/1117	Previous reviews and practical benefits of capital charge	Treasury
30/6/00	FM/2/19	Departmental incentives for good financial management	Treasury
30/6/00	T2000/1361	Departmental incentives for good financial management	Treasury
25/7/00	FM/2/19	Capital charge paper	Treasury
9/8/00	FM/2/19	Interest retention implemented as a differential capital charge	Treasury
27/8/00	FM/2/19	List of issues for discussion on incentives	Treasury
8/9/00	FM/2/3/2	Invitation to CAP critical indicators brainstorm	Treasury
27/9/00	FM/2/3/2	"raw" notes from the brainstorm	Treasury
27/9/00	FM/2/19	Departmental incentives	Treasury
16/10/00	FM/2/19	Proposals: interest retention, multi-year app'ns and capital charging	Treasury
17/10/00	FM/2/19	Retention of interest income	Treasury
20/10/00	TC2000/14 DH/6/2/1	Proposals for improvement to departmental incentives	Treasury
11/00	FM/2/19	Better working capital management: consultation document	Treasury
2/11/00	FM/2/19	Proposals for improvement to departmental incentives	Treasury
10/11/00	FM/2/19	Proposals for improvement to departmental incentives	Treasury
13/11/00	FM/2/19	Proposals for improvement to departmental incentives	Treasury
15/11/00	FM/2/19	Better working capital management	Treasury
20/11/00		Vote Branch managers: 30 November 2000, Action points	Treasury
22/11/00	FM/2/19	VBM paper FYI	Treasury
23/11/00	CO(00)12	Guidelines for changes to baselines	Treasury

24/11/00	FM/2/19	Document 2	Treasury
30/11/00	FM/2/19	FEC financial review	Treasury
5/12/00	T2000/2442	Improving incentives on depts for good financial management	Treasury
7/12/00		CAP Analytical framework	SSC
8/12/00	FM/2/2	Capital charge	Treasury
8/12/00	FM/2/2	Minutes BCC: see incentives	Treasury
13/12/00	FM/2/2 (EXG(00)M20/1	Improving incentives for good financial management	Treasury
14/12/00	FM/2/3/2	Specification of outputs and classes of outputs (from OAG)	Treasury
18/12/00	CAB(00)M42/11	Improving incentives on departments for good financial management	Treasury
21/12/00	TC2000/16	Capital charge rate and changes to the incentive regime	Treasury
21/12/00	FM/2/2 (TC2000/16	Capital charge rate and changes to the incentives regime	Treasury
21/12/00	FM/2/2 (CAB(00)845)	Improving incentives for good financial management	Treasury
21/12/00	TC2000/18	Memorandum accounts for fully cost-recovered outputs	Treasury
21/12/00	TC2000/17	Multi-year appropriations	Treasury
undated	Current 8/01	Chief executives performance reviews annual process	S.SC
14/2/01		Presentation to conference on managing successful policy reforms: accountability for strategy, capability and performance	S.SC
8/3/01		Value Wheel	Treasury
26/3/01	FM/2/3/2	Output agreement guidelines - latest revision	Treasury
29/3/01	FM/2/3/2	Overview comments "CAP pilot project accountability documents overview	Treasury
29/3/01	FM/2/3/2	SOI comments "CAP pilot project accountability documents: guidelines on the development of statements of intent	Treasury
17/5/01	CFIS	Debtor Crown in Departmental balance sheets	Treasury
28/6/01	Ferguson	Capability problems and the budget system	S.SC
7/01		The core elements of New Zealand's public sector management model as originally formulated: a quick guide for Treasury managers and analysts	Treasury
8/01		SSC view on capability problems and the budget system	S.SC
	VAs' A-Z guide	Outputs, output classes and changes to output classes	Treasury
undated	FM/2/6	Guidelines for preparing CE performance agreements	Treasury
undated	Website	Proforma for the 2000/2001 chief executive performance agreement	S.SC
undated	Current 8/01	Public service chief executive performance management	S.SC
undated	FM/2/6	Template for 1999/2000 relationship letters	Treasury
undated	FM/2/6	Template for 2000/01 relationship letters	Treasury
undated	Web-site	Treasury's 2000/01 core performance expectations	Treasury
		Treasury circulars	
18/4/90	TC1990/5	Operating leases, finance leases and hire purchase agreements	
25/10/90	TC1990/13	Incentives for departmental performance: capital charge and interest regime	Treasury
7/6/91	TC1991/4	Capital charging regime for government departments	Treasury
6/11/92	TC1992/4	The capital charge/interest regime update	Richardson
24/12/92	TC1992/11	Delegation of authority to write off Crown assets	
6/9/93	TC1993/8	Pricing policy advice: comparative information	Treasury
12/10/93	TC1993/13	Departmental and Crown insurance and risk management	
11/4/94	TC1994/7	Finance leases	
10/8/94	TC1994/11	External reporting requirements: exemptions for smaller departments/offices of parliament	
13/9/94	TC1994/15	Calculation for payment of surplus	
9/8/95	TC1995/8	Departmental other expenses	

11/9/95	TC1995/10	Memorandum accounts for fully cost recovered outputs	
30/4/97	TC1997/5	Purchase agreements for non-departmental output class appropriations	
22/9/97	TC1996/2	Calculation of provision for payment of surplus (replaces TC1994/15)	
25/2/98	TC1997/11	1998 budget process and timetable, part 1	Treasury
7/7/98	TC1998/10	Changes to GSF employer contribution rates	Treasury
15/9/98	TC1998/15	Recognition of employee entitlement liabilities	
11/11/98	TC1998/18	Criteria for baseline changes	Treasury
3/6/99	TC1999/6	Purchase agreements for non-departmental output class appropriations (replaces TC1997/5)	
23/7/99	TC1999/9 BU/5/6/1	Fiscally neutral adjustments	Treasury
18/11/99	TC1999/16	Introductory information for vote ministers	Treasury
24/2/00	TC2000/2	Updating the fiscal provisions for government decisions	Treasury
20/10/00	TC2000/14 DH/6/2/1	Proposals for improvement to departmental incentives	Treasury
21/12/00	TC2000/16	Capital charge rate and changes to the incentive regime	Treasury
21/12/00	TC2000/18	Memorandum accounts for fully cost-recovered outputs	Treasury
21/12/00	TC2000/17	Multi-year appropriations	Treasury
		Treasury Instructions	
		Treasury Instructions, effective from 1 July 2001	
		Treasury instructions, effective from 1 July 1995	
		Treasury guidance booklets	
1992?		A guide to the management of departmental budgeting	
1992?		A guide to the management of departmental fixed assets	
1992?		A guide to the management of departmental purchasing	
1992?		A guide to the management of departmental working capital	
1994		A guide to appropriations	
1994		Improving output costing: guidelines and examples	
1994	1995/96	Purchase agreement guidelines with best practices for output performanc measures	
1999		Guidelines for setting charges in the public sector	
		Cabinet Office Circulars	
13/5/92	CO(92)11	Process for completing 1992/93 CE perf agrmts and dept corp plans	1005Rich
28/8/92	CO(92)15	Guidelines for contracting for services	1005Rich
23/10/92	CO(92)16	Reinforcing the criteria agreed for 1992/93 supplementary estimates	1005Rich
6/8/93	CO(93)9	Purchase advisers for ministers	dpmc web-site
27/8/93	CO(93)11	1993/94 supplementary estimates criteria	1005Rich
15/9/95	CO(95)10	Guidelines for changes to baselines	Treasury
27/6/97	CO(97)7	Counting changes to the fiscal position against the (1996) coalition agreement's fiscal parameters	Treasury
24/11/98	CO(98(17)	Guidelines for changes to baselines	dpmc web-site
30/6/99	CO(99)7	Financial delegations and delegation limits for responsible ministers and departmental chief executives	dpmc web-site
12/7/99	CO(99)9	Requirement to consult treasurer and Minister of Finance on Cabinet papers seeking approval for additional resources	dpmc web-site
20/8/99	CO(99)14	Changes to Cabinet procedures for the approval of proposals with financial recommendations	dpmc web-site
23/11/00	CO(00)12	Guidelines for changes to baselines	dpmc web-site