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# Co-operation versus Non Co-operation in R&D Competition with Spillovers

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# The Australian Budgeting System:
# On the Cusp of Change

**Marc Robinson**

**ABSTRACT**
Australia in the late 1990 adopted a purchaser-provider model of performance budgeting – so-called "accrual output budgeting" – which attracted considerable international interest. By 2003, however, the system was in headlong retreat. This paper examines the key difficulties experienced by this system, and links these to the system changes now being made. It speculates on the possible future of performance budgeting in Australia. It draws on extensive interviews and examination of budgetary process documentation in a number of Australian jurisdictions.

**INTRODUCTION**

In the late 1990s, the Australian national government (the 'Commonwealth') and most state governments adopted a budgetary system known generically as accrual output budgeting (AOB). The system drew its inspiration from the similar budgeting system introduced in New Zealand in the mid-1990s (Schick, 1996). AOB aimed to transform public budgeting across the board into a process whereby government 'purchases' outputs from its agencies, on a basis which emulates the functioning of competitive markets. In this purchaser-provider relationship, agencies were to operate like independent businesses. Government would act as a 'demanding' purchaser, striking hard bargains with its agencies. Requiring agencies to operate like independent businesses would, it was thought, create a "new competitive world" (Boxall, 1998) by placing government-owned agencies and potential private suppliers of publicly-financed services on an equal competitive footing. It was expected that agencies would, as a consequence, experience unprecedented pressure to improve productive efficiency.

AOB completely overhauled the parliamentary budget appropriations mechanism, introducing a 'payment for outputs' appropriation. In principle, the magnitude of each agency's payment for outputs appropriation would be determined by the planned quantity of agency outputs (of specified quality) and the per-unit 'prices' of each type of output[1]. The shopping list of outputs to be delivered during the year would be stipulated during the budget process, and would be outlined either in the annual budget papers and/or in contracts (called 'purchasing agreements' at the national government level) between the government and the agency.

Consistent with the 'market' model driving AOB, budget-dependent agencies were for the first time required to produce full business-style statements of financial performance reporting their operating result (i.e. profit or loss) for the year. In this business-style financial reporting, the 'payment for outputs' received by an agency would be treated as 'revenue', and the operating result would then be equal to the difference between this revenue and the costs of producing outputs. Thus if an output "costs exceed funding, agencies incur an operating deficit" (Queensland Treasury, 1998: 12).

It was anticipated that the distinction between revenue and costs would become a crucial pillar of the AOB system, just as it is fundamental to the market mechanism. This would not happen immediately, because in the initial implementation phase of AOB the unit prices paid for outputs would, for reasons of practicality, be based upon their cost. However, it was intended that there would be a rapid transition to a position where output prices would be set on the basis of what might be called the *efficient* cost of production, which would be measured by cost benchmarking or by market price references. As the Commonwealth Finance department (henceforth 'Finance') put it: "departmental output appropriations will progressively be based on market (or benchmark) prices, rather than accrual based input costs" (DOFA, 1999: 27). This would mean that if an agency's actual cost of production exceeded the 'efficient' cost, it would run an operating deficit the magnitude of which would be indicative of the extent of its productive inefficiency. This approach represented an attempt to emulate the efficiency discipline imposed by a competitive market, in which market price does not necessarily cover the cost of production and competition over time drives prices down to minimum average cost.

The importance of the distinction between revenue and costs would be further reinforced by the intended introduction of what might be called 'payment for results'. This meant that agencies would only be permitted to recognize their budgeted payment for outputs appropriation as 'revenue' in their financial statements – and perhaps only receive the funds – when and to the extent that they actually delivered outputs. The Victorian government early on set up a mechanism of delivery 'invoicing' in an attempt to put this principle into practice (VDTF, 1998: 302-3; Robinson, 2002a). When introducing AOB, the Commonwealth Finance department announced its intention also to move to position where "recognition of Departmental output appropriations" would "reflect agencies [sic] delivery of their outputs" (DOFA, 1999, p 43).

The purchase-provider model also led to the introduction of an entirely new distinction between *agency outputs* and *administered expenses*. The former referred to services or goods the delivery of which the agency controlled[2] and for which it and its minister could therefore be held accountable. The latter covered items where the agency was required to make payments but had no management control over any services involved. Judges' salaries paid out of the budget of an Attorney-General's department are an example of an administered expense, since under the principle of separation of powers, neither departmental officials nor the relevant minister exert management control over judges' performance. Under AOB, agency outputs are covered by the 'payment for outputs', and there is an entirely separate budgetary appropriation for administered expenses. Agencies are also required to produce separate financial statements for these two categories of expenses. The intention of these arrangements was to intensify performance pressure in relation to those services the quantity and quality of which were within the control of agencies and their ministers (i.e. the agency outputs).

Although often justified by proponents on the basis of accrual accounting principles, other features of the AOB financial reporting and appropriations arrangements can only be understood by reference to the market model. The budgetary 'payment for outputs' appropriation is based upon the full accrual costs/price of producing outputs. The most remarkable implication of this is that agencies receive in their 'current' budget allocations funds to 'cover' depreciation on their assets. This practices arises from the conceptualization of the payment for outputs appropriation as the 'prices' paid for outputs – after all, businesses aim to recover all of their costs of production in the prices they set. The 'funded' depreciation then becomes the basis for complicated capital budgeting arrangements which are also intended to emulate business practice. Agencies set aside their depreciation funding as an accumulating pool of internal funding for capital expenditure which, in principle, enables them to maintain and replace their existing capital stock. Armed with this major 'internal' source of capital funding, they only need additional explicit capital funding if they need to increase their capital stock. Such additional capital funding is provided, when and if necessary, through an 'equity injection and loan' budget appropriation. Consequently, the pre-AOB budgetary capital appropriation – which had provided the authorization off almost all of agencies' capital expenditure – disappeared. The model behind this new capital budgeting arrangement was one of a private sector business which would finance part of its capital expenditure internally from retained earnings, and part by recourse to the external capital markets.

Another key 'market' element of the new budgeting arrangements was the introduction in many AOB jurisdictions of capital charging. This involved an annual charge upon agencies set as a percentage (12 percent in the case of the Commonwealth) of their net assets. Conceptually, this was supposed to be the equivalent of the normal profit margin – the 'opportunity cost of capital' – that efficient private sector firms could be expected to earn. The capital charge was intended simultaneously to ensure that outputs reflected all economic costs, and to ensure better investment and asset management decision-making by ensuring that agencies did not regard capital as a 'free' resource.

When interacting with agencies over equity injections, capital charging and the monitoring of agency financial results, the political executive/finance ministry was considered to be acting in an 'ownership' (shareholder) capacity. The dichotomisation of government-agency relationship into those of a purchaser-provider nature and those of an ownership nature was an explicit feature of AOB doctrine.

AOB clearly represented a revolution in Australian public budgeting – a revolution which was, moreover, implemented with a great sense of urgency. Revolutions usually arise as a result of the breakdown of the *ancien régime*, yet this was certainly not the case in respect to the pre-AOB Australian public budgeting system. From the 1980s to the mid-1990s, the Australian government had been an international leader in well-considered public budgeting reforms. The outstanding achievement of these reforms was to create a highly-effective medium-term expenditure framework capable of delivering major reallocations of expenditure in accordance with government-wide policy priorities, within the context of clearly-specified fiscal targets[3].

AOB shifted the focus of budget reform from allocative efficiency (expenditure priority setting) to productive efficiency (production of services at minimum cost), in the belief that there was massive scope for efficiency gains in public service provision. This emphasis upon improving productive efficiency is not unique to AOB, but is a widespread feature of performance budgeting systems which have emerged internationally over the past decade or so.

AOB is not unique in the conviction that, in its pursuit of improved efficiency, the public sector needs to draw substantially on good private sector practice – this is, of course, a key element of the so-called New Public Management. What was distinctive about AOB is how extremely closely it sought to emulate the 'market' (or at least a textbook version thereof) and to re-model budget-dependent government agencies in the business image.

As in New Zealand, the adoption of AOB in Australia was led by bureaucrats (not, incidentally, by politicians[4]) who had an extraordinarily expansive view of the potential role which market-type mechanisms could and should play in social organization, and who tended to be highly dismissive of the proposition that there are significant fundamental differences between public and private sectors. Their outlook went far beyond being merely 'pro-market'.

What follows in this paper is, firstly, a review of key difficulties experienced by the AOB systems and, secondly, an outline of recent changes which represent a retreat from the AOB philosophy. There is, throughout, particular focus on experience at the national government level. The discussion is informed partly by extensive interviews carried out with relevant senior government officials in the mid-2003[5].

**THE AOB EXPERIENCE: PURCHASER-PROVIDER**

AOB represented a noble attempt to create an environment in which agencies would be compelled to dramatically improve efficiency. Regrettably, the system was conceptually flawed, and the most fundamental flaw lay in the purchaser-provider model. AOB assumed that an output-based version of the purchaser-provider principle – what might be called 'output-purchase budgeting' – was a model suitable for general application to tax-financed services. Unfortunately, this is a mistaken belief. There are a great many services for which this approach to budgeting is unworkable or impracticable, for reasons which have been discussed in detail elsewhere (e.g. Robinson, 2002b, 2002c). These are, in summary:

- Output heterogeneity: this describes services which are characterized by considerable deliberate tailoring in the set of activities delivered to clients/cases in response to differences in client/case characteristics. Output heterogeneity can introduce substantial and unpredictable indeterminacy into the average cost of outputs,

- Contingent capacity services: exemplified by emergency services and the military, these are services government needs to maintain a significant level of service-delivery *capacity*, quite independent of the level of service actually being delivered,
- Many government services are characterized by significant uncertainty concerning the type of output the agency should be delivering, arising either from uncertainty as to the most effective means of achieving a clearly-defined outcome, or from the uncertain or contested nature of the desired outcome itself (Tankersley and Grizzle, 1994). Output-purchase budgeting in this context can lead to a single-minded focus upon efficiency, at the expense of improved effectiveness through strategy changes,
- Many government services which face unpredictable demand fluctuations deal with this at least in part by rationing the level of activity per case/client, which is inconsistent with the idea of paying a pre-specified unit price for outputs of pre-defined quality.

Perhaps the most aggressive attempt to implement output-purchase budgeting in an Australian jurisdiction was at the national level. An "output pricing review" process was initiated, under which the Finance set out to conduct intensive reviews of every portfolio budget over a period of a couple of years in order to determine the appropriate 'prices' it would 'pay' for departmental outputs. Closely linked to this, Finance sought very quickly after the adoption of AOB to implement formularized output funding arrangements, particularly through formal 'purchasing agreements' between Finance and agencies. In the process, however, it became clear that there were many services for which formularized funding based upon unit 'prices' was extraordinarily difficult to implement. As a result, actual formularized funding arrangements were only ever introduced for a relatively small sub-set of the services delivered by the Commonwealth government. Even then, major difficulties arose.

The experience of the Australian immigration department – an agency which produces more services apparently suited to formularized output funding than most other national government agencies –

exemplified some of these difficulties. There was an interim purchasing agreement between Finance and Immigration in 1999-2000, and by 2001 this had developed into a three-year agreement covering 2001-04[6]. The Immigration purchasing agreement contained formularized funding for a wide range of departmental services. It set, for example, unit 'prices' for each of 14 different categories of visa application. There were three different categories of 'removals' of illegal immigrants – i.e. the management of forced repatriations – each of which attracted a different unit price. Yet another type of output subject to this funding arrangement was the detention, under Australia's mandatory detention policies, of illegal immigrants. Here the aim of the purchasing agreement in its initial iteration was to provide automatic formularized funding to cope with unpredictable additional arrivals – at a time when large numbers of 'boat people' were arriving on Australia's coasts. In other words, formularized output funding arrangements were being used not only to drive efficiency improvements, but also to improved budget flexibility.

Even though the purchasing agreement only covered those Immigration services which appeared more suited to the purchaser-provider treatment, the problem of heterogeneity still manifested itself. To take just one example, one of the 14 visa output categories used for funding purposes covered a number of complex types of visa application including spouse visa applications – that is, applications for entry status by persons on the grounds of marriage to an Australian citizen. (Immigration's mandate in respect to such applications is to prevent abuse of spousal entry through contrived marriages contracted solely for immigration purposes.) It became clear, however, that there is such great variability in the extent of investigative activity which spouse visa applications require as to make this particular type of visa application entirely unsuited to funding via a fixed per-case amount. Immigration might, for example, be faced in a given year with a set of spouse visa applications of more than usual average complexity, in which case it would find itself under considerable financial pressure to investigate cases with less than adequate thoroughness.

The automatic funding for mandatory detention also came, paradoxically, to be seen as a problem by many of those who had initially championed it. They came to feel that the surge in 'boat people' arrivals required a radical change of policies in the direction of deterrence, and that formularized funding had the undesirable effect of reducing the pressure on Immigration to undertake the policy re-think needed. This illustrates the problems which can arise in output-purchase funding systems when there is uncertainty about the nature of the outputs the agency should be delivering.

As mentioned earlier, a key AOB aspiration was the adoption of the principle of 'payment for results'. However, if the "recognition of appropriation revenues" were to "be tied to output acquittal performance"[7], then it would be necessary to be able to objectively measure output delivery performance. For many services, this was very difficult to do, because of the well-known difficulties of performance measurement in the public sector. At the Commonwealth level, this difficulty led to extensive interaction between Finance – which was initially keen to apply to principle of 'payment for results' widely – and the Auditor-General. The latter was concerned that revenue recognition based upon highly subjective assessments of output delivery performance would create wide scope for the manipulation of agency accounts. In this debate, the Auditor-General was in a strong position because of his much-feared power to qualify agency accounts, and Finance was obliged to largely give way. The outcome was a general principle that budgetary outputs appropriations would be recognized as revenue at the time the appropriations legislation becomes law, unless there is a purchasing agreement or something similar which would clearly state how output delivery performance would be measured (DOFA, 2002: 20; ANAO, 2002: 24-25). The other jurisdiction which made a serious effort to implement the principle of 'payment for results', Victoria, experienced its own very considerable practical difficulties, which have been discussed elsewhere (Robinson, 2002a: 89).

In the light of the above analysis, it may perhaps appear strange that the Commonwealth did not accept the "purchaser-provider" label for its AOB system (DOFA, 2001). After all the system's essence was, in the words of the head of the Finance Department, that “the Government will know what [outputs] it is being offered and at what prices …[and] can then actively decide what it wants to buy and how much it wants to pay” (Boxall, 1998). The most plausible interpretation is, perhaps, one which relates to the nature of the interaction between the center (the Cabinet and finance ministry) and line agencies in determining which outputs the government would purchase. A criticism leveled at AOB was that it assumed that the center was potentially capable of detailed decisions about the whole shopping list of outputs that it wished to purchase from agencies, and that this ignored the wealth of budgeting experience which gave the lied to the illusion of ‘comprehensively rational’ centralized expenditure decision-making[8]. This allegation was not without some justification, and was encouraged by the careless language used in some of the official AOB literature[9]. However, AOB proponents were not unaware of the informational limitations facing the center. In their view, AOB did not require the center to specify the whole menu of outputs to be delivered. It was the task of agencies to recommend what should be produced, and the center’s prerogative to modify detailed agency output proposal when and to the extent that it wished. It would appear that this disavowal of extreme allocative centralization was what Finance had in mind when it rejected the “purchaser-provider” label.

Nevertheless, the difficulties encountered in the Commonwealth-level output pricing reviews and purchasing agreements pointed to a different type of informational constraint facing central budget decision-makers. AOB required finance ministries to determine the efficient cost of production of each of the myriad of outputs produced by budget sector agencies. This would have required a monumental effort even if the necessary analytic techniques had been available. However, the AOB enthusiasm for the use of market price comparisons and benchmarking overlooked the considerable limitations upon the practicability of those techniques. Benchmarking can be a most valuable management tool for services where good benchmarking partners are available. However, there are many areas of government where it is very difficult or even impossible to find other organizations sufficiently similar to permit cost-effective benchmarking. Moreover, even where benchmarking is feasible, it remains a costly and demanding process. As for market price comparators, these tend to be available for a very small minority of government outputs.

It is therefore not surprising that the Commonwealth output pricing review process turned out to be not only exhausting, but also ultimately unsatisfactory, to both Finance and the line agencies concerned. Output pricing reviews which were intended to be accomplished in one year extended to two and sometimes three years. Even then, it turned out to be frustratingly difficult to draw strong conclusions either about the scope for efficiency gains or priority-setting issues. Benchmarking to determine efficient cost proved to be very difficult[10].

The failure of the AOB strategy of detailed central review of expenditure efficiency across government is somewhat reminiscent of the earlier failures to recognize the informational constraints upon central budget decision-makers. Where AOB did most seriously underestimate the informational constraints on the center was, instead, in respect to the output 'price-setting' process – in other words, in respect to the central review of *productive* efficiency.

Another fundamental related weakness of the AOB model lay in the conceptualization of agencies as quasi-independent businesses. Even if one is operating – as is the case in Australia – in an administrative environment characterized by large 'super-ministries', there are many areas where inter-agency policy and service delivery co-ordination are crucially important. An ideology which encourages agencies to view themselves as stand-alone entities discourages and undermines such co-ordination. If one were looking for a business analogy, government agencies would be far better compared with divisions of a large firm than with stand-alone enterprises.

**THE AOB EXPERIENCE: FINANCIAL REPORTING AND CONTROL**

One of the results of AOB has been to attract great hostility to 'accrual accounting' amongst public servants who are not accountants. Even amongst senior agency financial management executives, there is a notable minority who are quite anti-accruals.

Concretely, some key Commonwealth agency financial personnel express the view that the AOB "accrual" budgeting has "distracted" serious budget decision-making at the ministerial and cabinet levels, because it is often necessary to "de-actualize" budget estimates to facilitate decision-making. The greatest problem in this respect has, it is said, been the requirement for agency to present budget estimates and bids which include depreciation.

The difficulty with 'budgeting' for depreciation is, of course, that depreciation is an expense arising from expenditure which has already been undertaken. It is therefore essentially irrelevant to decisions about agency budget allocations the principle focus of which should be upon whether to incur expenses which involve present or future expenditure. Although the adoption of 'full' accrual accounting for financial reporting purposes does require the recognition of depreciation as an expense in agency accounts, this does not in any way imply a need to include depreciation in agency budget allocations. Indeed, most other nations which have adopted full accrual accounting into the general government sector have not adopted the pretence of budgeting for depreciation. They recognize that financial reporting and budgeting are two different things.

'Funded' depreciation is, as noted earlier, also one aspect of quite distinctive AOB capital budgeting arrangements. It is accumulated to serve as an 'internal' source of capital funding, supplemented when necessary with the new 'equity injections' capital appropriation. The problem with these arrangements is that they are essentially fictional[11]. Once again, moreover, they are arrangements which are not 'accrual' in nature, but which arise from the AOB business model. There is no reason why the move to accrual accounting could not have be accompanied with the retention of the pre-AOB appropriation arrangements under which each agency received an annual capital appropriation which, approximately speaking, covered all of its capital expenditure.

Turning to financial reporting, the AOB practice of treating budget output funding as 'revenue', with the consequent derivation of an operating results (profit/loss) measure, is one which differs fundamentally from the traditional view – still held by the vast majority of governments throughout the world – that budget funds provided to departments cannot be regarded as departmental revenue because they are generally not, in any meaningful sense, raised or earned by those departments. From this perspective, measures of departmental profit or loss are meaningless. Departments are by their very nature 'loss'-making. The AOB approach to financial reporting has certainly attracted criticism in Australia. At the time of the 2003-04 Commonwealth budget, for example, one of Australia's leading financial journalists made great sport of the fact that the Defense Department was forecasting an operating surplus which would make it the most profitable enterprise in the country. This, he opined, was "lunatic", because "the armed services do not earn a cent. They are a cost center"[12]. He was quite right.

Once again, however, there is nothing in accrual accounting per se which requires the mythical characterization of government budget funding as 'revenue', or the treatment of a cost center as if it were a profit center. These are not, for example, elements of the full accrual financial reporting model introduced into British general government under the label of 'resource accounting', under which what is reported is the total 'consumption of resources' (i.e. the accrual cost of services).

One unfortunate consequence of the Australian adoption of an inappropriate business-style model of accrual financial reporting has been that agencies are now obliged to comply with highly complicated private-sector style accounting standards which make agency financial reports largely incomprehensible to lay persons (including politicians). In the private sector, tight and complex codes governing financial reporting are necessary because of the fundamental significance of the profit measure in the business world. The same considerations do not apply to budget-sector government agencies.

It also worth noting that the AOB distinction in appropriations between 'controlled' and 'administered' expenses has proved in practice to be a difficult and confusing one, however simple it may sound in theory. In the public sector, the degree of control exercised, and responsibility for, services, is often a matter of degree. As a result, practice on the classification of expenses as either controlled or administered has been very far from consistent between different jurisdictions.

**THE RETREAT**

By 2003, there is a widespread view within the bureaucracy in Australia that AOB had not been a success. There was also, according to senior officials, considerable ministerial dissatisfaction with the system. As a result of this, Australian public sector budgeting is now in a state of flux. A major re-think has started within the Commonwealth Department of Finance[13]. Part of this was the conduct during 2002 of a *Budget Estimates and Framework Review*, which lead to some significant initial changes in the system. Some of the State Treasuries have also been actively reconsidering their position.

The most striking change has been the dismantling of the purchaser-provider elements of the system, which are now widely regarded as (in the words of one senior agency financial executive interviewed) an "ideology-driven management fad". At the Commonwealth level, for example, the output pricing review process has been formally dropped as the result of a *Budget Estimates and Framework Review* recommendation that as of 1 July 2003 these reviews be "rolled into a broader input-based cost analysis model involving a detailed analysis of agency expenditure". Benchmarking has essentially disappeared as an element of the central budget process. The 'purchasing agreements' and most other formularized output funding arrangements between Finance and agencies – including the much-vaunted agreement with Immigration – have also disappeared.

The view that AOB placed too much emphasis upon outputs at the expense of outcomes had come to be quite widely held, even within Treasuries and Finance ministries. Representative of the current mood is the decision of the Western Australian Treasury that the "main focus" of its version of AOB system – known as Output Based Management (OBM) "will shift from outputs to outcomes", and their contemplation of a possible name change of OBM to "outcome based management"[14].

The notion of agencies as independent businesses has also lost currency. Across the country, one now hears talk about 'joined-up government' (a slogan imported from the UK). Attention is being given by finance ministries to ways in which co-ordination of related programs which cross agency boundaries might be improved. Symbolic of this new mood is the recent instruction by the Australian Prime Minister to all government agencies that they are to abandon the agency-specific logos where were developed over recent years and return to using the Australian coat of arms in conjunction with the general descriptor 'Australian Government'[15]. There has also been some tightening of Cabinet processes at the Commonwealth level to increase oversight of individual agencies, representing a step back from the model which dominated the early years of the present administration, under which Cabinet was viewed as playing only a broad strategy-setting role.

The Commonwealth had, in fact, taken the independent business model significantly further than the States. One striking aspect of this had been the complete decentralization of banking arrangements, so that agencies managed all of there own funds (including appropriation funding) in their own bank accounts. Arising from one of the recommendations of the *Budget Estimates and Framework Review*, this decentralized banking system has now been abolished, with funds now being held centrally by the finance ministry and released on an 'as needs' basis to agencies.

In respect to the appropriations framework, little has as yet changed. The AOB appropriations categories – output appropriations which include 'funded' depreciations; equity injections/loans; and administered expenses – all remain in place throughout the country. At the Commonwealth level, the *Budget Estimates and Framework Review* did result in the abolition of capital charging, which is now widely viewed as having been an administratively cumbersome waste of time. Nevertheless, significant change in the appropriation framework is highly likely over the coming years. It is of considerable significance in this respect that during the *Budget Estimates and Framework Review*, some within the Finance department seriously argued (unsuccessfully at this stage) for a reversion to something like the pre-AOB capital expenditure appropriation model.

It is clear, in summary, that accrual output budgeting, as originally articulated, is now dead in Australia, even though a number of important elements of the system – particularly its 'reforms' of the appropriations and financial control system – remain. What will take its place is, however, unclear at this stage. It may well be that the performance budgeting model of the state of New South Wales – the one state which has consistently rejected the AOB philosophy – points the way.

**THE NEW SOUTH WALES SYSTEM: A WAY FORWARD?**

NSW is strongly committed to the principle of performance budgeting – that is, to the strengthening of the linkage between budgets and results through the systematic use of performance information in the budget process. It is, however, the one Australian state which has consistently rejected the AOB model. The NSW Treasury has taken the view that the purchaser-provider model is impracticable, that it "tends to focus the attention of both the Executive Government and agencies on outputs, to the possible detriment of outcomes", and that it makes quite unrealistic assumptions about the information available to central budget decision-makers. More broadly, NSW Treasury has rejected the notion that market models are the solution to the public budgeting problem, asserting that the absence or weakness of price signals, and the consequent need for supply rationing, are fundamental realities of government budgeting (NSW Treasury, 2000).

The centerpiece of the NSW approach to performance budgeting is the Service and Resource Allocation Agreements (SRAAs). These are 'outcome-focused' agreements, developed on an agency-by-agency basis and signed by the Treasurer and the relevant minister. An agency's SRAA is intended to articulate its intended outcomes, strategies and the "level of service delivery it can provide" within its budget. Particular emphasis is placed upon the connection between any funding increases and performance improvements. During the budget process, agencies are required to lodge a 'Draft SRAA' which outlines their performance expectations based upon current funding (on a 'no policy change' basis), and a separate 'Budget Proposals' document which contains bids for extra resources together with an indication of the performance targets improvements which the agency expects to achieve with those additional resources (NSW Treasury, 2002).

The NSW system bears some resemblance to the British Public Service Agreements (PSA) system. Like the SRAAs, the PSAs document negotiated between Treasury and line agencies as part of the budget process with the aim of strengthening the link between resources and results. There is a particular emphasis upon 'tying new resources to new reform and results' (UK Government 2002: i).

The PSA approach is heavily focused upon performance target-setting, and the great majority of PSA targets are now outcome targets. There are, for example numerical targets for improving the literacy and numeracy outcomes of school children, and for reducing mortality rates from heart disease and cancer (UK Government 2002a). Given that outcomes are what matters most, this is in a sense laudable, and contrasts favorably with the undue AOB emphasis upon outputs. However, it is a widely recognized characteristic of public management that outcomes are not fully controllable, but are greatly influenced by 'contextual factors' such as unpredictable changes in the external environment or variability in client/case characteristics. Dealing with the unpredictable effects of contextual factors is an important challenge for target-setting regimes. The UK PSA regime has frequently been criticized for setting targets too inflexibly, without making sufficient allowance for the possibility that agencies may not be to blame for failure to meet their targets.

By contrast, the NSW SRAA model attempts to systematically take into account the impact of contextual factors upon outcomes achieved. Agencies are required in the preparation of their SRAAs to explicitly identify "key risks that may prevent progress being made towards achieving the desired outcome". Risks are appropriately defined as potential event that can either impact on the achievement of desired outcomes, or upon the planned delivery of outputs and the contribution that outputs are intended to make towards achieving outcomes (NSW Treasury, 2002: 23-26). To emphasize the point, NSW avoids the language of 'targets' in respect to outcomes, preferring instead to refer to outcome "estimates of progress" (NSW Treasury, 2002: 32).

This risk management approach is only one of a number of ways in which the NSW SRAA approach seeks to incorporate sound corporate planning principles. In this respect also, NSW has learnt from the British experience. A common criticism of the PSA approach, particularly in the early years of the system, was that targets tended to become a substitute for, rather than part of, good corporate planning (see, e.g. House of Commons Public Administration Select Committee, 2003: 14).

By contrast to the rushed implementation of AOB, the SRAA system has been introduced and extended gradually over a number of years. As at 2003, it covered 12 budget sector agencies responsible for approximately 70 percent of the NSW budget. Ultimately, it will extend to all but the very smallest of budget sector agencies.

Although it was the first Australian government to adopt accrual accounting in general government, NSW financial reporting and control systems differ substantially from the AOB model, in line with the NSW rejection of the purchaser-provider principle. Budget funding is not characterized as 'revenue' and the bottom line of the agency statements of financial performance reported in the NSW budget papers is not the operating result, but rather the 'net cost of services' (NCS). NCS is defined as the total cost of services minus retained agency 'own-source' agency revenue (e.g. user charges). Moreover, although the reported NCS includes depreciation, there is no pretence of *budgeting* for depreciation. The budget allocations received by each agency are not for the NCS, but for what is known as the *controlled* net cost of services, which explicitly excludes depreciation (NSW Treasury, 2001). Accordingly, the traditional form of budgetary capital appropriation has been retained.

As other Australian jurisdictions turn away from the AOB model, interest in the NSW approach – and, of course, in other international models – can be expected to grow. It is likely, however, to be a couple of years yet before the new direction of performance budgeting in Australia becomes fully clear.

## CONCLUSIONS

Notwithstanding its laudable objectives, accrual output budgeting in Australia was not a success. Although rushed implementation contributed to this, the core problem was the unsuitability of the purchaser-provider model for many public outputs. It is regrettable that the unsatisfactory AOB experience has given accrual accounting a bad name amongst many within the Australian public sector.

By 2003, the process of dismantling AOB had started. Purchaser-provider mechanisms such as the national governments' 'output pricing reviews' and 'purchasing agreements' had largely disappeared. Other problematic elements of the AOB system – particularly in financial reporting and financial control – remain. It is, however, likely that these also will change in coming years.

The future direction of Australian public budgeting is unclear. Enthusiasm for the core idea of performance budgeting – the closer linking of results and resources – will not, however, disappear simply because one particular model of performance budgeting has proved disappointing. The alternative approach taken by the state of NSW may well point to future directions. Despite the disappointing AOB experience, Australian public budgeting systems retain many extremely attractive features, many of which had been refined in the 1980s and early 1990s. Australia continues to offer an attractive model for a medium-term expenditure framework which combines allocative flexibility and fiscal discipline.

## NOTES

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[1] As the Victorian Treasury, for example, put it 'funding will be based on a single quantity and unit cost measure for each output. Major quantity measures should allow a *quantity x unit cost = expenditure* equation to be derived where possible" (Victorian Department of Treasury and Finance, 1997a: 18). In the Commonwealth's purchasing agreements, the principle took a more sophisticated form which combined fixed cost funding component with per-unit payments.

[2] Whether producing itself, or via out-sourcing.

[3] Key elements of this structure included: (1) distinction between 'no policy change' forward spending projections and new policy initiatives, with particular Cabinet attention upon the latter during the budget process; (2) considerable freedom for agencies to reallocate spending within their 'no policy change' budget base. This placed pressure upon agencies to fund new expenditure initiatives by identifying other savings or low priority areas within their own budgets, rather than automatically seeking increased budgets; (3) Cabinet-level Expenditure Review Committee (ERC) to lead the priority-determination process, and to strengthen the finance minister in promoting fiscal discipline and allocative efficiency; (4) highly selective ERC reviews of sectors of the budget, so as to promote inter-agency policy co-ordination and also to ensure that the 'no policy change' budget base was periodically re-examined in the light of overall priorities. A good, easily accessible outline of these systems it to be found in Campos and Pradhan (1996). See also Department of Finance (1992).

[4] The election of conservative government in the States from late 1992 and at the Commonwealth level in 1996 put these bureaucrats in a position where they could effect these changes. Nevertheless, it could not be said that the AOB system was one to which conservative political leaders themselves had any strong commitment. Overwhelmingly, neither they, nor politicians generally, understood the system. For precisely this reason, AOB never became an issue of partisan political controversy.

[5] The main focus of these interviews was the national government. However, the author also benefited from a number of discussions with selected officials in four states. The interviews were, for obvious reason, generally conducted on the basis of non-attribution of specific remarks and information to individuals.

[6] Note that there are interesting multi-year budgeting aspects of this system, which cannot unfortunately be discussed here.

[7] As the Western Australian Treasury put it (*Accrual Appropriations and Capital User Charge: A User Manual*, June 2001, p 13).

[8] As is well known, under program budgeting, zero-based budgeting and similar systems, the illusion flourished that it was possible for the center to determine detailed expenditure priorities on the basis of an overall expenditure plan aimed at maximizing 'allocative' efficiency. Following the failure of those systems, it has been widely accepted by budgeters that good allocative decision-making required the right balance between centralization and decentralization. As the World Bank puts it, "programmatic decisions for budget formulation must devolve to line ministers", while the prime focus of the center should be the determination of sectoral expenditure allocations (World Bank, 1998: 27).

[9] To take a typical example: "under an output-based management regime, the Government, as funder, decides which outputs it will fund, at specified levels of quantity, quality and price" (DTF, 1997b: 11).

[10] Some agency personnel interviewed suggested that an additional reason for the lack of success of benchmarking in certain areas were intra-government benchmarking was attempted (e.g. policy advice) was an uncooperative stance taken by many government departments to sharing cost data

[11] In essence, the position is that all State government agencies, and the few Commonwealth government agencies which have substantial capital budgets, are subject to annual capital expenditure limits which make no distinction

between funding from accumulated depreciation and equity injections (see Robinson, 2002a). The one exception to this is Commonwealth agencies which hold few major assets, and which have relatively low levels of capital expenditure. These are generally permitted to control their own capital expenditure to the extent that it is 'internally' funded from funded depreciation. Because in Australia it is the State governments which are responsible for most public infrastructure (e.g. hospitals, schools, roads), this applies to the majority of Commonwealth government departments. Commonwealth departments which are big capital spenders (e.g. the Defense Department) have their aggregate capital budgets tightly controlled, just like State government general government agencies. It might be thought that at least in respect to those Commonwealth agencies without major capital budget, the AOB capital budgeting arrangements are an improvement. But even this conclusion would be questionable. Prior to the introduction of AOB, the 'running cost' system gave Commonwealth agencies included routine funding for minor capital works which departments could employ quite flexibly.

[12] 'Pierpont' (Trevor Sykes), 'Try the Economics of Defence for a Really Dingbat Parade', *Australian Financial Review*, 14 May 2003.

[13] Associated with major personnel changes – in particular, the replacement of the CEO and of the Head of the Budget division.

[14] WA Treasury Circular, *OBM Implementation - Pilot Exercise*, September 2002.

[15] Australian Financial Review, 24 July 2003, p 5.

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