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The Impact of GAAP on Fiscal Decision Making: A Review of Twelve Years' Experience with Accrual and Output-based Budgets in New Zealand

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1. Introduction

This paper reviews the theory and the rhetoric for accrual accounting and budgeting by government. Reference is made to generally accepted accounting practice (GAAP) in New Zealand. An historical summary is provided of 12 years of accrual budgets and, using this as a base, assessments are made of the actual benefits that have been achieved.

2. The rationale for the use of GAAP in the public sector

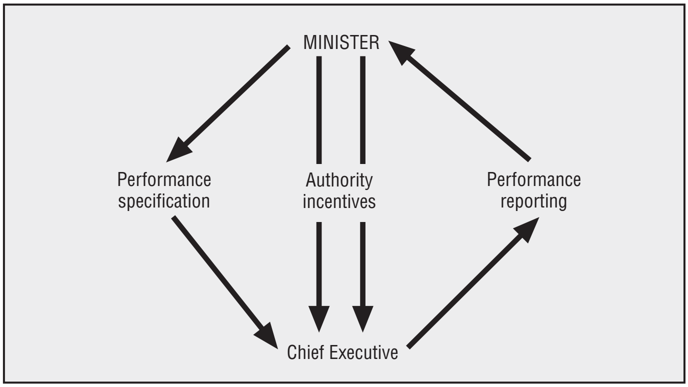
The pioneers of the financial management reform process in New Zealand believed that accounting policy impacts on the organisational performance of the government and its sub-entities, and, ultimately, on the performance of the economy as a whole. They believed that good economic performance and organisational performance depended on correct policy choices (decision making) being made and the necessary mechanisms (accountability) being in place to achieve those choices. If a government is either unable to ensure that its choices are beneficial, or does not have reliable implementation mechanisms in place, it is constrained in its ability to perform.

Choices and mechanisms are a function of the underlying quality of information available and of the incentives for those who make and implement policy choices. Other factors aside, consistently high quality information enables government to make consistently better policy choices. High quality information is also a vital component of any accountability mechanism.

The strength of any accountability mechanism, such as that between ministers and departmental chief executives, is determined by the nature of and relationship between performance specification, the delegation of decision-making authority, incentives on the agent, and performance reporting against specification (see Figure 1). High quality information is critical for effective performance reporting.

Financial decisions can be characterised as coming from a purchaser's perspective (where issues of value for money are important) or from an owner's perspective (where the decisions concern buying and selling assets, their financing, and maximising the return or reducing the risk from assets held). For both sets of decisions, accrual and output-based financial information is important.

Figure 1. **Accountability mechanism**



Source: New Zealand Treasury.

External financial statements and internal financial information provide the government with a comprehensive picture on which to base decisions. The quality of external financial statements relies on the quality of the accounting policies[1] and assurance over the reliability of the information provided.

Assurance over accounting policies is obtained from a set of generally accepted accounting practice (GAAP) developed by an independent and competent standard setter. Assurance over the reliability of information is determined by an independent and competent auditor adhering to appropriate assurance standards. Without independent and competent standard setters and auditors, there can be no adequate response to attacks on the credibility of the financial information produced by the government, which in turn undermines confidence in the quality of financial decision making by government.

While internal financial information is not subject to the same rules as external financial statements, it will normally be consistent with GAAP, particularly where the internal information supports the external financial statements. Such is the theory that drove the use of GAAP in financial reporting in New Zealand. How has the theory worked in practice?

3. Implementing accrual budgeting

The budget represents the key financial decision-making process in government. It pulls together decisions on the amount of revenue to be raised, the allocation of resources to the purposes of government, the extent of investment and divestment in its capital, and the nature of debt-financing activity.

Each budget process will have its own unique characteristics that will inevitably lead to differences between years. These will reflect the political environment, the macroeconomic environment and the more detailed priorities of the government.

The first budget process using output-based information in New Zealand was for the 1991/92 financial year. There have been 11 budgets since then, each operating within a different environment and addressing different topical imperatives and strategic priorities. The economy has passed through a full economic cycle. In this part of the paper, an historical overview of these 12 budgets will be given, followed by some lessons that have emerged from that experience.

3.1. 1991 budget: fiscal crisis

The 1991 budget process was influenced by the election in October 1990, a change of government and a deteriorating economic and fiscal outlook. On coming into office, the government formed by the National Party faced an alarming fiscal situation with fiscal deficits moving from 4.8 to 6.3% of GDP over the next three years. The new government was determined that this fiscal situation would not be managed through increases in tax revenue. It therefore focused on expenditure in a three-pronged strategy: to reduce government spending; to channel resources to high priority areas and away from low priority areas; and to seek greater value for money.

Departments were generally in the throes of moving to the new accounting systems and reforms. They were still getting used to the new language of outcomes, outputs and inputs; their accounting systems were generally in the state of chaos that so often characterises a changeover of systems; and there remained more than a few pockets of resistance to the cultural changes that the management reforms were attempting to achieve.

In an economic announcement just prior to Christmas – a matter of weeks after taking office – the new government announced a series of measures, including a framework for social policy reform. This package cut some benefit entitlements and vividly demonstrated to the public service the degree of commitment ministers gave to expenditure reductions. In the New Year, the Prime Minister called chief executives and ministers together to urge the importance of fiscal restraint. As one chief executive later remarked:

> *Process… begun in such a novel way: the invitation to attend a meeting at which the Prime Minister himself would give us our marching orders. The assemblage of ministers definitely gave a lasting impression of determination, and this presumably sustained those who worked through a seemingly irrational programme of late nights and protracted negotiations.*[2]

Much of the real decision making fell to the newly formed Cabinet Expenditure Control Committee and the associated Officials' Committee on Expenditure Control (OCEC). OCEC was given the task of reviewing the budgets of all departments. Its instructions from Cabinet noted that substantial savings were required and that ministers should identify areas of lower priority expenditure. OCEC was to identify three tiers of savings options, from those which could readily be achieved, through to those which involved more complex or legislative issues. OCEC was not to make decisions on the political acceptability of specific options. This was to be left to ministers.

Where was accrual accounting in this process? The financial management reforms had led to a process where each output class was defined for appropriation purposes and costed to an extent not seen before. From a previous regime of 56 programmes where expenditure led to an uncertain amount of government activity, the players in the process now had a comprehensive schedule of 774 costed outputs and other items where there was a clear specification of expected results. This level of information provided assurance at both ends. The bureaucracy took comfort that the base level of information being provided gave a much greater chance of fair treatment, and less likelihood of arbitrary cuts. At ministerial level, the decision-making process became more straightforward, as departments promised efficiency savings rather than see the level of their output cut.

Many efficiency savings were readily generated as departments now had far greater authority over the input decisions. Departmental managers were freed from using centralised monopoly suppliers at the same time that overhead costs associated with the production of their outputs was made clear to them for the first time. This generated a flurry of activity to reduce overheads by outsourcing and better tailoring of functions such as payroll processing, cleaning and other accommodation costs.

There was a clear consensus that the newly generated information on outputs was valuable:

The new focus on outputs brought about by the (Public Finance) Act meant ministers had genuinely meaningful information about the services produced by their departments and were in a position to make informed trade-offs between competing priorities.

Ruth Richardson, Minister of Finance[3]

The greater availability of information, and the much better definition of what departments actually do, made the 1991 process a good deal easier than it would have been in the older systems.

Bill Birch, Minister of State Services[4]

This process was aided by the clearer definition of what departments do and produce.

Marie Shroff, Cabinet Secretary[5]

Ministers became increasingly comfortable with the concepts. They generally found the budget information useful as a management tool. The focus on outputs clarified for ministers what they were purchasing with a particular expenditure.

Howard Fancy, Deputy Secretary to the Treasury[6]

The 1991 budget saw much greater emphasis on outputs and the quality of expenditure... The assessment also covered aspects such as the extent to which costs could be trimmed without affecting quantity or quality of outputs being purchased.

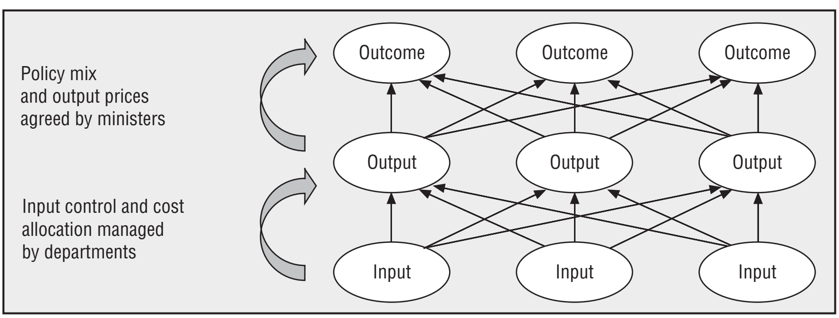
Maris O'Rourke, Chief Executive, Ministry of Education[7]

On balance, there is no doubt that the financial management reforms are positive.

Roger Blakeley, Chief Executive, Ministry for the Environment[8]

The common theme was that a better, more integrated budget process was made possible by using outputs and output costs as the common unit of measurement. Not only was the process more integrated but also the responsibility of ministers and bureaucrats was clearer, as demonstrated in Figure 2.

Figure 2. **Outputs as the central unit in budgeting decisions**



Source: New Zealand Treasury.

To illustrate the powerful effect of this new information, it is useful to consider the two sets of information in Table 1 regarding the Vote: Customs (the funds allocated to the Customs Department), extracted from the estimates of appropriation for the Government of New Zealand.

Of course, Table 1 represents a tiny proportion of the information provided to decision makers in the budget process, but it indicates how the process can be affected by the way the information is provided. In 1988/89 for example, the Customs Department was voted NZD 74 million, of which 54% was labelled as "corporate service". From the budget process and published reports there was no way of telling whether such an appropriation had any direct link with the government's objectives or were delivering value for money.

Table 1. **Vote: customs**
Thousands NZD

Prior to the reforms Voted expenditure 1988/89 Programmes		Ten years on, after the reforms Voted expenses 2000/01 Output classes	
Corporate service	41 701	Policy advice	2 095
Compliance	26 572	Intelligence and risk assessment services	2 593
Technical services	5 719	Clearance of international passengers, crew and craft	19 837
Total appropriated expenditure	73 992	Compliance checking of import, export and excise transactions	19 711
		Revenue collection, accounting and debt management	2 435
		Surveillance, search and containment	3 750
		Investigation of offences	6 561
		Prosecution and civil proceedings	762
		Trade, business facilitation and advisory services	2 244
		Total appropriated expenses	59 988
		Assets	20 381
		Liabilities	6 439
		Taxpayers funds (net worth)	13 942

Source: New Zealand Treasury.

The new information on the balance sheet also supported a longer-term focus in decision making. To assess the most appropriate size of the department's balance sheet and, therefore, the extent of any necessary capital contributions and withdrawals, a view had to be formed on the ongoing capacity of the department to provide services in the future.

In this first year of the new system, the tight timeframes and the lack of familiarity with the new levers to control public expenditure meant that decision making was rushed and officials were harried. This prevented full scrutiny and meant that there was no opportunity to revisit issues. Some deadlines were missed, and there remained concerns over inadequate output specifications. There was a lack of integration with other budget processes, in particular the social policy reform package and the production of some of the budget documents.

Another manifestation of the difficulties in the process was a conflict between the desire to budget at a departmental level using the detailed costing information on an accrual basis, and the need to aggregate on a cash basis for fiscal reporting, which had not then moved to an accrual basis. The conversion model in Box 1 provides an indication of some of the detailed reconciliation difficulties.

This reconciliation was necessary as all the elements of the budget were on an accrual basis except for the overall fiscal forecasts, which used the

Box 1. **Calculation required to move from total output expenses to the net fiscal impact of a department**

Total output expenses

– Depreciation/amortisations
– Capital charge
+ Movement in prepayments
+ Movement in inventories
+ Movement in creditors and payables (except creditors for fixed assets)
+ Movement in other short-term liabilities
+ Movement in employee entitlements

= Cash disbursed in the production of outputs

+ Cash disbursed in the purchase of fixed assets
– Cash provided from the supply of outputs to other parties
+ Goods and services tax on outputs supplied to the Crown
+ Payments on behalf of the Crown
– Receipts on behalf of the Crown

= Net fiscal impact

requirements of SNA and GFS[9] to determine the overall fiscal aggregates. From the point of view of aggregate fiscal control, it was difficult to track the impact of individual decisions on the overall numbers and to know at any point whether sufficient savings had been made to reach the fiscal targets.

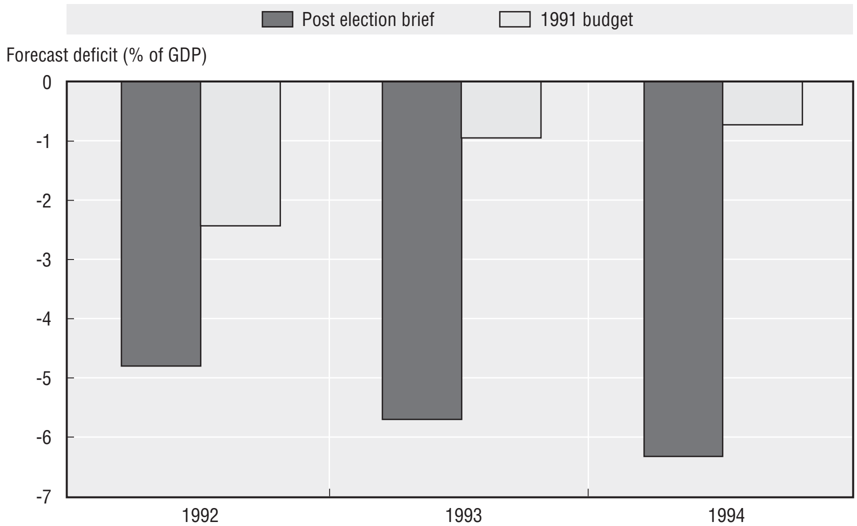
The budget was presented to Parliament on 30 July, one day before the statutory deadline. Many late hours had been worked and, while the process might have been termed a success, by no means could it have been termed stable.

The overall result of the process can be seen in the extent of the movement from the forecasts in the Post Election Briefing in October 1990 and the budget delivered on 30 July 1991. The challenge would be to deliver on the savings.

3.2. 1992 budget: fiscal consolidation

By 1992, the government was now fleshing out its economic strategy of stable and balanced macroeconomic policies, strengthening international linkages, encouraging enterprise and innovation, and investing in a more skilled and adaptable workforce and fair and affordable social policies. Its fiscal strategy also was broadened from a focus solely on expenditure reduction, to include tax policies aimed at maintaining and enhancing the tax base and improving its balance sheet through asset sales and debt reduction.

Figure 3. **1991 budget: fiscal crisis**



Source: New Zealand Treasury.

The importance of this last point was reinforced by the NZD 2.6 billion foreign exchange loss recorded in the very first accrual financial statements, prepared for the six-month period to 31 December 1991. This represented over 70% of the operating loss for the period and reinforced ministers' commitments to pay off foreign exchange debt.

The concern for the budget process was how to continue to reap the advantages that had been gained in 1991 while reducing the stress involved. The aim was to keep the fiscal momentum in the long post-budget period when departments and ministers could potentially develop policy options with insufficient regard to overall economic imperatives.

Previously, New Zealand budgets could be characterised as a bid and review process. Departments (and ministers) prepared draft budgets in October/November and again in April/May. These budgets were prepared using information of uncertain quality. For the out-years, departments were left to calculate their own budgets which, although subject to challenge from the Treasury, tended to be accepted. Departments would get a proposal approved on the basis of the first-year cost, when the full-year cost included in the out-years was higher. Not surprisingly, there was concern about the quality of these forecasts, which unnecessarily distracted debate at the highest levels of government and undermined ministers' confidence in the quality of advice being provided.

Also, a bid and review process was biased against expenditure restraint. It gave departments and ministries a chance at each stage of the budget to introduce new initiatives and relitigate allocations previously agreed. Many of these bids were only removed at the end of a protracted negotiation process where, in the absence of adequate pricing models for most departmental outputs, the central agency gatekeepers were at an information disadvantage. In summary, the bid and review process led to inflated estimates, an unstable basis for decision making and extensive involvement in detail by officials and ministers in settling the starting point for each budget round.

What was sought was a way of improving the fiscal profile, which managed pressure from departments for incremental creep on outputs as well as policy pressures for new spending. The fiscal profile also needed to contain incentives in line with the government's desire to control total expenditure, to prioritise and to maximise value for money.

The solution was to adopt the Australian approach – to put in place a centrally controlled system of rolling forward estimates. To get a more robust baseline for budget decision making, a Treasury-controlled rather than a department-controlled baseline would be used. Using this rolling forward estimate, the first out-year would be rolled forward and used as the starting point for the budget. Departments would put a case for changes in their baselines to Treasury and these would be resolved in accordance with the budget guidelines, or by reference to Cabinet.

While there was some concern that departments would not "own" such forecasts, there was an expectation that departments would prefer to plan over the medium term within a relatively predictable baseline for future funding than to squabble through poorly conceived savings exercises driven by short-term fiscal shocks. Ministers and chief executives retained responsibility for preparing detailed financial statements and forecasts once Cabinet had decided on overall aggregates for each Vote.

So the 1992 budget started before the 1991 budget was finished. A considerable amount of work was required to develop a baseline set of estimates that was well documented and reasonably robust. These baselines were established solely on the basis of the cost of implementing current policy rather than for the purpose of achieving savings. There was of course a set of risks around these baselines but these, too, were documented.

Using this base, a more targeted approach was attempted where particular areas of government expenditure received particular attention. Examples of these areas included:

- **Policy advice,** where a benchmarking review of the cost of advice received from government departments was expected to lead to changes in the way purchase processes were managed.

- **Fisheries,** where a simplification of the management regime for the fishing quota management system and related cost recovery measures was expected to yield fiscal savings.
- Options to address the growth in **pharmaceuticals**-related expenditure.
- Seeking efficiencies in the **collection of tax revenues** where a major investment in technology was now expected to yield benefits.
- A review of the overall effectiveness of different **employment schemes**, prioritising them within an overall expenditure limit.
- Major changes in the **transport** area, which involved devolving the regulatory activities of the ministry to largely self-funding Crown entities.

These examples demonstrate that the tools then available to the government enabled a much more precise approach to be taken in looking for fiscal savings. By analogy, a scalpel rather than a hacksaw approach was available for use and was being accepted by ministers.

For other areas, the budget rules were fleshed out. One feature of these rules was that there was no allowance for price increases, except where it was government policy that inflation adjustments should occur according to an established formula (*e.g.* indexation of benefits).

In general, 1991/92 did see a certain amount of unwinding of the decisions of the previous budget. Lower-than-forecast tax revenue and higher levels of income assistance also adversely impacted the fiscal outlook. However, the extra months devoted to the budget allowed greater consultation over decisions, which led to greater ownership of those decisions by Vote ministers and chief executives.

On the whole there was a degree of consensus among the players that the 1992 budget was better planned and managed than in 1991 – and individuals were placed under less pressure. But there remained significant concerns that the strategic level required more attention.

3.3. 1993 budget: fiscal fatigue

The economic recession bottomed out in 1991 and the economy began to move into a long period of growth. Combined with a more favourable economic outlook, there was less strain on this budget. The 1993 budget process was more stable and had more clearly defined ground rules, well-defined phases and a timetable that was achieved with minimal change. Frequent communication with ministers and departments on timetable and process matters kept them informed, even if the purpose of that communication was to confirm that nothing had changed. The catch-cry of the budget was: “No big changes in process from last year!”

Cabinet, helped by a “vision” document entitled “Path to 2010”, established clear budget rules at the start of the process. These ground rules removed a great deal of uncertainty from the process of establishing draft budgets and output plans. Cabinet's decision to reduce baselines by 0 to 5%, based on the impact of the Vote on the strategic priorities of the government and the amount of flexibility within the Vote, reduced the scope for disputes and worked more smoothly than the bilateral ministerial meetings used previously.

There was a considerable degree of collective commitment to these reductions that were clearly driven from the government's strategic decisions. Reducing baselines also worked well in terms of placing the onus on each Vote minister and his/her chief executive to find savings from areas of low priority and to live with those prioritisation decisions. While the strategy was successful in establishing budget parameters and resulted in some alignment of expenditure priorities, it was less successful in helping officials and ministers reach detailed purchase decisions.

From a production perspective, 1993 saw some technological improvements which streamlined data transfer (draft budgets) from departments to Treasury and the electronic transfer of the estimates from Treasury to the printers. From a decision-making process perspective, however, the 1993 budget was most notable for what it signalled rather than what it did. The Crown financial statements had first been published in 1992. They presented a great deal of information on the government's financial position, in a way that was more open and easily understood. To give greater assurance on the quality of fiscal information, the Minister of Finance signalled her intention to move all fiscal reporting, including the forecasts included with the budget, onto a GAAP basis. Also, a requirement on governments to report to Parliament on their longer-term fiscal objectives and progress toward meeting these objectives would be incorporated into legislation. This was the genesis of the Fiscal Responsibility Act that was to be passed in 1994 and which would be the final act in the harmonisation of the accrual accounting and accrual budgeting rules in government.

3.4. 1994 budget: fiscal responsibility

In the general election in November 1993, the government was returned, although with a much-reduced majority. Partly in response to the electoral debate, the Prime Minister replaced the perceived "hard-line" Minister of Finance with one who was perceived to be more pragmatic.

In 1993/94 the economy forged ahead. In the year to March 1994, GDP grew by 5.5%. Strong growth in exports and investment underpinned this growth, which accelerated with rising confidence and falling interest rates (due both to international influences and increasing confidence that the Reserve Bank would manage within the 0 to 2% inflation target). Business investment, consumer spending and residential construction went up and yet no inflation, balance of payments or fiscal problems seemed to be occurring.

These benefits started to show through in tax revenue. Company tax revenue jumped an astounding 25% in the year to June 1994. With such good economic news the government felt able to make use of the principles of responsible fiscal management to announce some challenging targets:

- Reduce net public debt to between 20% and 30% of GDP by 1997/98. Net public debt had peaked at 52% of GDP in June 1992.
- Restore net worth to positive levels by 1996/97. The June 1993 Crown financial statements showed net worth at NZD – 7.7 billion.
- Reduce operating expenses to below 30% of GDP. For the year to 30 June 1993 these were more than 40% of GDP.
- Make no increases in tax rates, but maintain the tax base.
- Manage properly the risks facing the Crown.

Up until now, budgets had been prepared by departments on both a cash and an accrual basis, while Crown flows (*e.g.* taxes, transfer payments) were reported on a cash basis only. In 1994 a quiet revolution was needed to collect, consolidate and analyse the comprehensive set of accrual and cash forecasts that were required.

Budget staff started to take a keen interest in accounting policies and how and when they could be changed or manipulated. The impetus was provided to invest in upgraded information technology to assist the data collection and consolidation processes. Interestingly, policy analysts sought to derive meaning from the new fiscal indicators, operating balance and net worth. They felt there should be some optimality about these indicators in a way that was never sought from the old measures such as the borrowing requirement or public debt. The result was the production of two budgets in one. These were reconciled, and explained to bemused financial media and financial markets.

The process of negotiating the budget, meanwhile, continued much as before. The vision document was further refined and updated as "The Next Three Years", and strategic result areas were developed for departments to use in their planning. Reprioritisation continued, moving resources away from such areas as core government services and defence to social security, education and health. In terms of fiscal results, the efforts of the previous three years finally bore fruit, as the government was able to credibly forecast a surplus for the following year.

3.5. 1995 budget: fiscal surplus

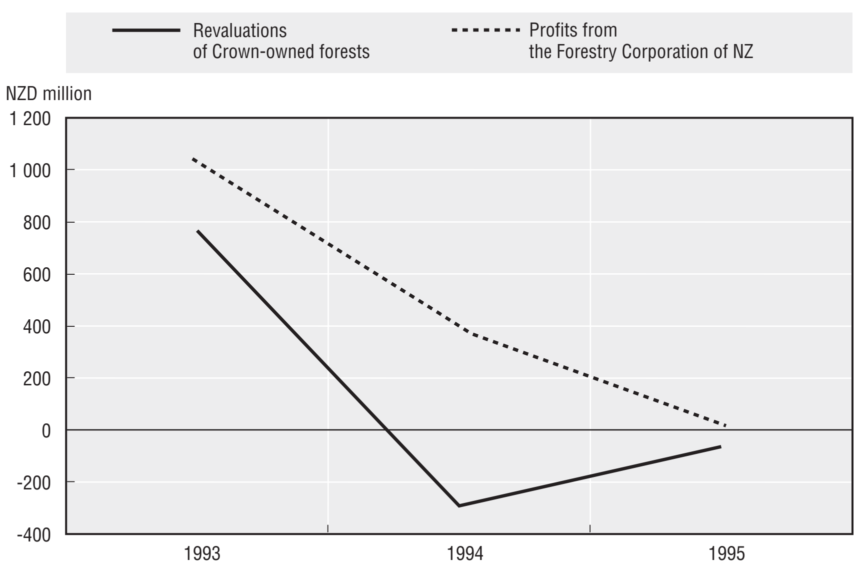
Real GDP growth was now hitting 6%. The definition of the problem had now changed. It was a problem of banking rather than squandering the gains as the prospect of fiscal crisis receded and the importance of budget constraint seemed to diminish.

The importance of the targets, particularly the net debt target, was now a predominant factor in settling the budget strategy. If ministers could maintain the discipline on expenditure, then the debt target could well be reached sooner and major tax cuts could be announced in the 1996 budget.

The strategic thinking of the government continued to advance with further refinement of the "strategic result areas" that had been developed the previous year. Money was put aside for health and education and a small "pot" was provided for other initiatives that could be demonstrated as advancing these strategic areas. These initiatives were not included in the baselines initially submitted, but as separate proposals which, once agreed, would then be added to the baselines. A group of gatekeeping ministers sifted through these proposals and made recommendations to the Cabinet as a whole. The proposals made clear the increase in output that the government was purchasing as a result. In general, other pressures were met by maintaining the reprioritisation process within Votes.

In terms of managing the risks, the presence of volatility in the balance sheet continued to be felt. For example, the New Zealand Government faced a large exposure to log prices, as a result of its large holdings of timber rights in addition to its ownership of a large forestry company (see Figure 4). This exposure was made transparent in the financial statements as the price of timber fell through the mid-1990s.

Figure 4. **Impact of falling log prices on operating balance**



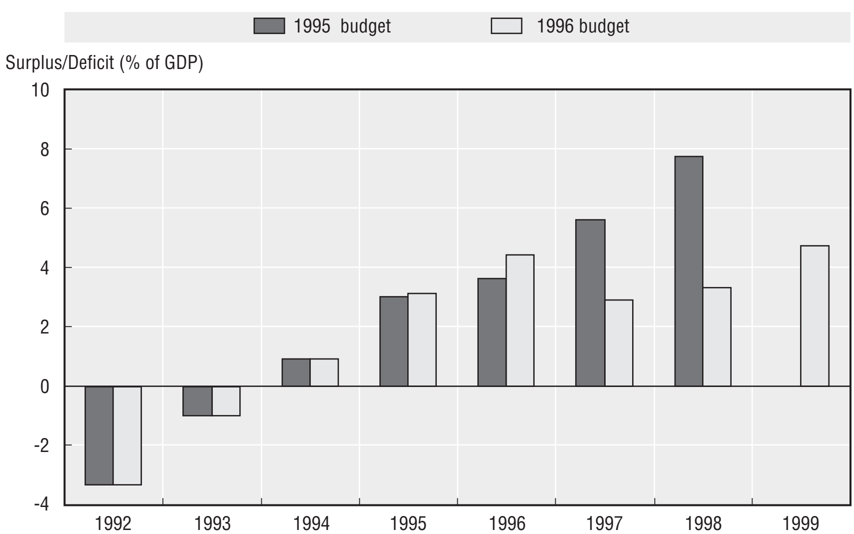
Source: New Zealand Treasury.

The immediate accounting of these falling returns, coupled with the reporting of losses due to foreign exchange debt, were factors leading to the decision to sell the Forestry Corporation of New Zealand – despite political concerns associated with privatisation in the coming election year. The proceeds from the eventual sale were sufficient to enable all foreign exchange debt to be hedged. The final result produced the most positive forecasts yet – forecasts that were again exceeded. The stage was now well set for tax cuts.

3.6. 1996 budget: sharing the gains

The 1996 budget was presented for the year 1996/97 on 23 May 1996. It announced a tax reduction and social policy programme costing more than around 8% of GDP over three years. A household with one taxpayer with an income of NZD 25 000 and two dependent children would receive an additional NZD 61 per week by July 1997 (NZD 81 if there were three children). The health sector received an additional NZD 713 million, education NZD 419 million, public debt was forecast to be reduced by 2% of GDP, and the government was able to announce that net foreign currency debt would be eliminated. The effect on the projected budget surpluses was dramatic, although budget surpluses were still forecast at about 3% of GDP.

Figure 5. **1996 budget: Effect of tax cuts and social policies**



Source: New Zealand Treasury.

The critical challenge for the budget process was to integrate the development of the tax cuts and social policy package (the "hand-up" package) with the rest of the budget process. The more settled nature of the budget process aided this considerably.

The other feature of this budget process was the increasingly strident calls by many in the bureaucracy for increases in the price of outputs. No price increases had been permitted for many of the outputs of the government over the previous five years. Input cost pressure, particularly from wages, was building up as the government continued to make no allowance for price increases and many departments were complaining they could no longer make efficiency gains to cope. The Cabinet agreed to a four-pronged strategy in response to these demands:

- The onus was on the department to prove that a price increase was warranted by drawing on benchmarking information and demonstrating there were no further efficiencies to be obtained from current operations.
- The proposal for price increases would undergo detailed scrutiny.
- If price increases were warranted, ministers would then make a separate decision on the volume of outputs and the source of those outputs to determine the changes in baselines.
- Ministers would make these decisions as part of the new initiatives process of the budget cycle, to allow an assessment of trade-offs among spending options.

This decision became the genesis of the "Output Price Review" that would become a feature of future budgets.

3.7. 1997 budget: coalition decision making

The 1996 general election was held under an MMP[10] electoral system for the first time. No party achieved a majority and after some two months of negotiation a centre-right coalition government was formed between New Zealand First and National. A detailed coalition agreement was settled that contained fiscal parameters requiring that no more than NZD 5 billion of additional expenses and NZD 900 million of additional capital spending would be incurred in the three-year term. Key elements of this agreement were:

- the reinstatement of a universal provision for superannuation;
- a commitment to a referendum on a compulsory savings scheme to boost savings and address intergenerational affordability problems;
- an increase in net health expenses, including the elimination of part-charges for secondary care provided through the public health system, and free doctor's visits and pharmaceuticals for those under age five;
- an increase in education and housing expenses;
- a deferral of the tax cuts for one year.

A new position of Treasurer was created to be responsible for economic policy and budget strategy, while the Minister of Finance would be responsible for government spending and financial management. The leader of New Zealand First was the Treasurer while the leader of the National Party was the Prime Minister.

To make this agreement operational, a general framework was developed for counting changes in the fiscal position against the NZD 5 billion and NZD 900 million fiscal limits. Thus, additional expenses as a result of policy decisions counted, but additional expenses due to revisions in forecasts (say of taxes or the unemployed) did not. This has since become one of the main features of the budget process because:

- it starts from the early and public commitment of ministers;
- it directly relates to ministerial decision making (each new initiative "counts" towards the limit);
- to some extent it quarantines ministers spending windfall gains (or making cuts where there are windfall losses) due to demand-driven or valuation changes.

The previously established baselines were a critical factor in enabling this approach to work. One effect of the change was that the 1997 budget made explicit the full cost of the three-year programme the coalition government had set itself.

Economic growth had weakened in 1996, in particular with employment out-turns lower than forecast and levels of savings higher than had been anticipated. This, combined with the increased spending, meant that the 1997/98 forecast budget surplus dropped to 1.5% of GDP before rising to 1.8% and 2.3% of GDP in the out-years.

Statistics New Zealand underwent an output price review in 1996/97, the first department to do so. When its first balance sheet had been established, this department had in place a relatively old mainframe-based system to meet its data processing needs. Working off a low base, the department had not been able to generate sufficient income to update its information technology. The situation was compounded by the department's inability to meet third party revenue targets, with consequent periodic injections of working capital being required to adjust for the resulting deficits.

With trends such as globalisation and deregulation making it harder to collect statistical information, increasing user demand for more timely statistics and shortages of skilled and experienced staff, Statistics New Zealand was an obvious candidate for an output price review. The review sought to answer the questions:

- Was the minister buying the best set of outputs to achieve the outcomes being sought?
- What was the appropriate scope of business of Statistics New Zealand (given that the minister was not required to buy statistics outputs from Statistics New Zealand alone)?
- What was a fair price for the minister to pay for the outputs bought from Statistics New Zealand?
- What degree of business risk was acceptable to the minister as owner?

These were difficult questions. A framework for ministerial purchase decisions was derived, stating that the minister should purchase statistics that were central measures of New Zealand's economic or social performance, strongly market and/or politically sensitive, central for forecasting and policy design or critical to the production of a ministerial output. If the statistics did not meet these criteria, they were deemed to be sufficiently "private good" in nature that they should be purchased by the party seeking the information.

Criteria were also developed to determine how far down the value chain Statistics New Zealand should go in delivering private outputs. The effect of this work would lead to some reduction in Statistics New Zealand's retail activities.

Benchmarking was used to form an assessment of the price being paid. These exercises were found to be complex and resource-intensive, requiring an in-depth knowledge of the business. The findings of these exercises – combined with analysis showing that improvements in the department's human resources capability, strategic and financial management capability and operating environments were desirable – led to the view that increases in output prices were appropriate.

The lesson from the Treasury's perspective was that while such a review provided the necessary understanding to make appropriate pricing decisions, the resource-intensive nature of the exercise meant that it should not be entered into lightly. Departments, on the other hand, saw reviews as a route to source much-needed new funding.

The search was on for more cost-effective ways to establish whether a government agency is efficient and effective. Efforts in these areas have since concentrated on developing self-assessment practices for proving departmental effectiveness and efficiency.

3.8. 1998 budget: catching Asian flu

The expected growth upturn in 1997 did not occur, largely a result of the Asian financial crisis, high short-term interest rates, and droughts caused by

El Niño. The unfolding Asian crisis weakened business confidence and led to significant uncertainty in forecasting for the 1998 budget. The current account deficit had grown to 7.7% of GDP in the year to December 1997 from 3.9% 12 months earlier (although concerns over this were mitigated somewhat as the deficit originated in the private sector and because New Zealand operates under a floating exchange rate regime).

To maintain confidence in the fiscal position in the face of these external developments, the government decided to reduce its spending plans. This strategy was designed to accommodate a range of economic developments while still making progress towards long-term fiscal objectives. Despite this, the budget surplus was forecast to fall to 1.3% of GDP in 1998/99, before increasing to 2.0% and 3.0% in the out-years.

While not included in the forecast figures, the budget documentation signalled the first major change in accounting policy since the establishment of accrual budgets. The management of this change took some care.

The New Zealand Government operated a compulsory accident insurance scheme, which was paid for out of levies collected on employers, the self-employed, employees, motor vehicles and a government grant for non-earners. These levies were assessed so as to fund payments required for the year, rather than to fund the total costs of accidents in that year (pay-as-you-go rather than fully funding). The government had previously considered its total obligation for the future costs of accepted accident claims to be in the nature of a policy commitment rather than a liability. The obligation had been disclosed in the financial statements but not reported as a liability in the balance sheet.

Neither New Zealand's financial reporting standards nor the International Accounting Standards[11] specifically addressed accounting for such an item, although it was clear that the standard setters were tending towards recognition of such items in the balance sheet. In conjunction with changes that included the partial privatisation of the accident insurance scheme, the government concurred with the Auditor General that it would record these liabilities on the balance sheet at 30 June 1999. The impact, when the actuarial work was complete, was expected to reduce net worth by some NZD 8 billion with subsequent negative impacts on the Crown's operating surplus as the discounted amount of the liability unwound.

A critical element of the communications strategy was the announcement and explanation of the intention to change accounting policy well in advance of the change being made, so as to reduce any element of surprise and to protect the hard earned credibility of the fiscal forecasts and statements.

3.9. 1999 budget: recovering from recession

The downturn caused by the Asian crisis was sharper but more short-lived than had been expected in the 1998 budget. New Zealand suffered from a recession in the first half of 1998 with the economy contracting by 1.6%, followed by an expansion of 1.3% in the second half of the year. Easing monetary policies, a strengthening labour market, and a more stable world economy contributed to this recovery. While the current account deficit remained high, the underlying strength of New Zealand's economy allowed a much faster bounce-back than had occurred in the times of equivalent shocks such as the 1972 and 1978 oil crises. Growth was expected to be 2.9% in 1999/2000, 3.5% in 2000/01 and 3.0% in 2001/02.

The political situation was relatively tumultuous in 1998. The Prime Minister was ousted in an internal coup. The coalition government splintered apart in late 1998 through a disagreement over the privatisation of an airport and a number of underlying tensions between the two parties. However, the government formed by the National Party managed to obtain sufficient support from other parties and breakaway members to continue as a minority government.

The economic downturn affected the fiscal results and forecasts. While a surplus of 2.2% was expected for 1998/99, this was expected to move to a broad balance in 1999/2000 before recovering to 0.7% in 1999/2000 and 1.3% in 2000/01.

A key factor behind the 1998/99 surplus was the gain on the sale of Contact Energy Limited, an electrical generation company. This company had been valued in the financial statements at around NZD 910 million, and was sold in two stages: a cornerstone shareholding of 40% was sold to an American utility company; and a public share float was held for the other 60% of the shares. Total sales proceeds were NZD 2.3 billion, generating a gain on sale of NZD 1.4 billion.

This raised questions on the valuation methodology being used to determine the carrying value of the company. The government's accounting policies required a revaluation of assets at least every three years to ensure that relatively current value was reported. Where the lack of a market meant there was insufficient reliable evidence of market values, a current value was generally obtained using an optimised deprival value approach.

The New Zealand experience is therefore that assets that do not directly generate cash and for which market evidence is unreliable are originally valued at depreciated replacement cost (DRC). Subsequently, as financial and asset management techniques are brought to bear to ensure the assets are efficiently and effectively managed, pressure is generated to reduce the reported values of the assets. Subsequent privatisations often generate more proceeds than would be suggested by the resulting reported value.

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There are a number of reasons for this. Initially, under a regime where government managers regard capital as a free good, they are likely to seek to maximise the assets under their control. To the extent that this results in either more assets or more highly engineered assets than are required to provide the desired service potential, the asset will be overcapitalised.

Subsequent use of optimised DRC which adjusts for surplus assets, obsolescence, over-design and site configuration allows managers to adjust values down. However there can be an initial bias against declaring assets to be surplus, technologically obsolescent or over-designed unless forced to do so. The outcome is an initial tendency to overstate optimised DRC, particularly of redundant, little utilised and old assets.

As pressure is put on managers to manage the assets (either through a capital charge or corporatisation process), the established asset value becomes critical in determining the assessment of later performance. The management of that entity then has an incentive to get the assets it will be responsible for valued as low as possible. While central agencies will be looking for a fair value, they will not share an equivalent passion to have the assets valued as high as possible. If negotiations take place between the centre (after a fair value) and the new governing body (after a low value) then overall a low revised value is likely to be arbitrated.

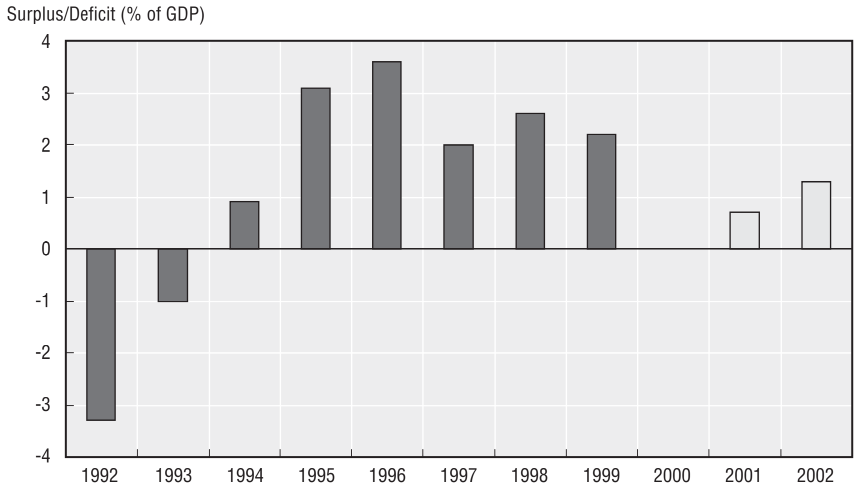
A number of factors may lead to undervaluation being accepted through the audit process. If the goods or services produced by the asset are underpriced this will result in a lower present value than is fair. Factors that could lead to underpricing of services include the path-dependent nature of pricing, the existence of politically strong special interest groups or the desire to maximise access to the services or products. In particular, if pricing decisions do not take account of the cost of capital, then a misleadingly low value-in-use may result.

The government may not wish to recover sunk costs in its pricing decisions. To the extent that they are not a factor in the decision on whether to continue to use an asset, or affect the marginal decisions of either users or providers of the service generated, sunk costs will not feature in price setting, nor in the resulting present value calculation.

Finally, if the use of an asset is uncontested, then there is little to be gained in setting a high price barrier for rationing purposes, and a lower price may result. This suggests that under-utilised assets will have a relatively low present value compared to replacement cost whereas others which are well-utilised may be higher. Public sector assets provided for equity of access reasons rather than efficiency reasons may therefore be written down.

Accounting debates over the valuation of assets are, in fact, the result of improving management debate over the use of assets. While such debates may cause conflict, they are also likely to lead to more informed purchase and ownership decisions. The experience has been valuable in the development of a revised New Zealand financial reporting standard on Property Plant and Equipment.

Figure 6. **1999 budget: Fiscal results for the decade**



Source: New Zealand Treasury.

3.10. 2000 budget: new millennium, new government, new direction

The election in November 1999 heralded a Labour-led coalition, taking over the reins from the National-led governments that had been in power since 1990. The new government styled itself as being centre-left in contrast to the centre-right policies of the previous administration. It had campaigned on a number of "credit card commitments" that it immediately put into action in advance of the budget process.

Prior to Christmas, the legislation making the changes to the tax rate and student loans had been enacted, and the superannuation rates were changed early in the New Year. This immediate activity on the commitments, plus the late election followed by the coalition-building activity, meant that there was a late start to the budget process. This made it very difficult to pull together a strategic phase that would drive budget decision making.

Box 2. **Labour's Seven Credit Card Commitments**

- Create jobs through promoting New Zealand industries and better support for exporters and small businesses with an industry policy that will increase spending on these programmes by NZD 100 million a year.
- Focus on patients and not profit, and cut waiting times for surgery by replacing the hospital structure with the establishment of community-based District Health Boards that will consult local people for the provision of local health services.
- Cut the costs to students of tertiary education by eliminating interest on student loans during the period of study.
- Return the superannuation floor rate of 65% of the ordinary time wage (after tax) for married couples to 60%. Guarantee superannuation in the future by putting a proportion of all income tax into a separate fund which cannot be used for any other purpose.
- Restore income-related rents for state housing so that low income tenants pay no more than 25% of their income in rent.
- Crack down on burglary and youth crime by requiring the police to target burglary and be accountable for reducing its incidence.
- Increase tax rates for those earning over NZD 60 000 from 33% to 39% while committing that there would be no rise in income tax on amounts under NZD 60 000 a year, goods and services tax (GST) or company tax.

However, recognising the importance of establishing criteria that would provide a clear framework for prioritising budget proposals, the government established the following six goals:

- Celebrate our identity in the world as people who support and defend freedom and fairness, who enjoy arts, music, movement and sport, and who value our cultural heritage; and resolve at all times to endeavour to uphold the principles of the Treaty of Waitangi.
- Develop an economy that adapts to change, provides opportunities and increases employment, and while closing the gaps, increases incomes for all New Zealanders.
- Restore trust in government by working in partnerships with communities, providing strong social services for all, building safe communities and promoting community development, keeping faith with the electorate, working constructively in Parliament and promoting a strong and effective public service.

- Foster education and training to enhance and improve the nation's skills so that all New Zealanders have the best possible future in a changing world.
- Support and strengthen the capacity of Maori and Pacific Island communities, particularly through education, better health, housing and employment, and better co-ordination of strategies across sectors, so that we may reduce the gaps that currently divide our society and offer a good future for all.
- Treasure and nurture our environment with protection for eco-systems so that New Zealand maintains a clean, green environment and rebuilds our reputation as a world leader in environmental issues.

To deliver these goals and build the capacity of the public sector, the government included in its expense track a fiscal provision of NZD 5.9 billion (GST inclusive) set at NZD 150 million for 1999/2000, NZD 1.2 billion in 2000/01, NZD 1.85 billion in 2001/02 and NZD 2.65 billion in 2002/03. This "fiscal provision" thereby continued with the "cap" idea that the previous government had used to maintain fiscal control.

The much-shortened timeframe for the budget meant there was a need for shorter and more effective communications between Treasury and departments. This was greatly assisted by the development of CFISnet, a Web-based development that came online in December 1999 primarily as a central database for Crown financial information such as actual and forecast data (hence CFIS). It enabled departmental users and Treasury analysts to collaborate online in a secure environment. The site is also used as a central repository for Treasury circulars, contact details, deadline information and other sensitive Treasury news previously mailed in hard copy form to departments.

The benefits of this improved communication became obvious during the 2000 budget process where users were able to exchange, discuss and amend budget information over the Internet, in real time. Information on proposed budget initiatives, previously entered and maintained centrally at Treasury, was entered directly into the database by departmental users as were baseline update details previously supplied on spreadsheets for reconciliation. Estimates of appropriation documents were transferred securely over the Internet and produced completely online. The process for producing estimates documents was more efficient, more flexible and less prone to error.

CFISnet's central database removed reconciliation problems previously experienced through the use of distributed databases and allowed data previously collected on separate systems (such as the cash payment schedules) to be incorporated in the CFIS database and reported on according to CFIS data.

From an economic perspective, the bounce-back from the Asian crisis had proved very strong, and GDP was growing at a rate that was thought to be unsustainable. This fact, combined with the significant increased expenses in the out-years set aside in fiscal provision, meant that the government was facing a forecast track that showed a very positive operating balance in 1999/2000, but a deteriorating position further on. Not unnaturally, this led to pressure to attempt to bring expenses forward, and led to a testing of the accounting rules over recognition of expenses.

The period concept is critical to any accounting framework, be it cash or accrual. This concept assumes that the government's economic activity can be divided into nominated time periods. It requires the preparer of financial statements to determine to which time period each transaction or event relates, and to resolve any difficult allocation problems.

Under New Zealand generally accepted accounting practice (GAAP), rules have been established to determine to which period revenues and expenses relate. Revenues are generally recognised when the right to additional assets is obtained, while expenses are recognised when an obligation is incurred. This has led to an improvement on the previous cash-based accounting frameworks, where the ability to bring forward or delay receipts and payments encouraged the attempted artificial smoothing of financial results, and often led to the development of inefficient fund arrangements, established to mimic accrual accounting.

By requiring a payment to be expensed when the obligation is incurred, New Zealand's current accounting framework focuses on the economic event that denies the government the ability to avoid the expenditure. Prior to then, because the government retains discretion or control over the amount, its net worth and its operating balance are not affected.

For an expense to be reported, therefore, the obligation must have been incurred and there must be little or no discretion to avoid the eventual payment. Under this scenario the creation of a fund or trust, which remains controlled by the Crown or a Crown entity, has no effect on the reported result because the government has not entered into any obligations. Without any transaction with third parties, there has been no event of economic substance, and there will be no change in the reported financial statements. This view was subject to some challenge during the budget process, with the temptation to show expenditure having been incurred earlier than the incurrence of an obligation to a third party, by the creation of a trust in the current year.

3.11. 2001 budget: Lessons from a year in office

The 2001 budget was the second for the Labour-Alliance coalition, and it had a strong flavour of continuity: building on the credit card commitments of the government's first budget, and confirming a fiscal policy approach focused on the need to manage future pressures (in particular, an ageing population).

After a year in office, characterised by a strong emphasis on delivering its key election pledges, the government faced a period of focusing more on its overall fiscal objectives, and finding ways to manage spending pressures within these limits. Two issues were highlighted:

- a desire to improve some of the budget processes in order to help manage spending;
- a greater focus on the long-term aims of fiscal policy.

3.11.1. Changes to budget processes

The 2001 Budget Policy Statement signalled a focus on improving the value for money taxpayers receive from existing government expenditure. A Value for Money (VFM) review process was established as an early step in the budget process, involving the Treasury and departments examining around 15 targeted Votes to identify opportunities to reprioritise spending between low and high priority areas.

During this period the government also focused more on the capital side of the budget, signalling that it would work on a better framework for capital decision making to avoid surprises and to ensure that investment was aligned with broader government objectives.

Changes implemented over the course of the year focused on the budget process: ensuring that capital decisions were made alongside operating decisions at budget time (rather than on an *ad hoc* basis throughout the year). Departments were also required to provide more detailed capital planning information than previously, setting out indicative capital plans over a five-year period. This information was intended to reduce surprises and give ministers a better basis on which to make trade-offs between competing pressures.

3.11.2. Long-term fiscal policy

The Labour-Alliance government placed a strong emphasis on saving for the future. The Government Superannuation Fund (GSF) was a key part of its policy programme, and work was underway at this time to set the savings track in place.

This future emphasis therefore had a significant impact on fiscal policy. The government updated its long-term fiscal objectives, with a forty-year focus, to:

- clarify the expense objective to give a better sense of the financing role implied by contributing now towards future GSF costs;
- clarify that the operating balance and debt objective are to be met "on average over the cycle" rather than at each point in the cycle, which could have previously been inferred;

- clarify that the operating balance should be sufficient to ensure consistency with the debt objective, after making contributions toward future GSF costs;
- signal in the net worth objective that the change in composition of the balance sheet will move towards a build-up of assets through saving to meet future GSF costs.

The government continued to use its fiscal provisions to help manage spending pressures. It signalled early in the 2001 budget process that a number of unexpected pressures (for example, security requirements in East Timor, and biosecurity issues associated with Bovine TB) required a revision to the NZD 5.9 billion operating limit set in 2000. This limit was increased to NZD 6.1 billion for the three-year term.

The change to the fiscal limit also led the government to think about how it could better manage its fiscal policy by being more flexible about such changes and the impact of changes in the economic outlook. This set the scene for development of new fiscal tools over the year ahead.

Despite the small increase to the fiscal limit, the fiscal forecasts continued to indicate progress towards the government's long-term fiscal objectives. Structural surpluses were expected to increase at a rate sufficient to enable contributions to the GSF and provide sufficient financing for the capital budget so that gross debt remained on track at around 30% of GDP. By 2005/06, the operating balance was expected to be just below 3% of GDP.

Building on the lessons from its first year in office, the government placed an increasing emphasis on using and reporting on a broader range of fiscal indicators than just the headline GAAP numbers. This shift in focus reflected a concern that the volatility of GAAP numbers (in particular the operating balance), in part driven by valuation movements and gains on the sale of assets, could distort the short-term picture of how the government had managed its fiscal position. To address this concern, the OBERAC (operating balance excluding revaluations and accounting policy changes) was devised. The OBERAC strips out from the operating balance the large volatile movements in asset and liability valuations on the basis that, on average, these would be expected to reverse out.

The OBERAC does not replace the operating balance; it sits alongside it to provide more information to users of the government's financial statements. The OBERAC, and some other GAAP-based indicators, are reported in all key summary fiscal tables. The government signalled that other fiscal indicators might be developed if they were considered helpful in communicating the Crown's fiscal performance. For example, a measure of net debt plus GSF assets was reported in the 2001 budget to provide a complete picture of the Crown's overall debt position.

3.12. 2002 budget: continuity and consolidation

As the final budget in a three-year term, the 2002 budget had a strong flavour of looking back, reviewing achievements, and the government asserting itself as a credible fiscal manager by announcing that it had stayed within its (revised) NZD 6.1 billion operating target for the term. That this operating achievement was hailed as a key success highlights that capital had still not become a focal point in scrutinising total government expenditure. Work continued to improve the status of capital as a significant element of overall expenditure. The government used better bottom-up information on pressures to re-phase the timing of its capital provisions. However, a decision was taken to recapitalise Air New Zealand, with an impact of around NZD 900 million.

Even with the capitalisation of Air New Zealand, the position of the government's accounts remained robust. The New Zealand economy weathered the slowdown in global growth well, despite the events of 11 September 2001. The 2002 budget signalled that the government was likely to achieve its long-term debt objective more rapidly than first thought when it set its fiscal objectives in 1999/2000. Net debt and expenses as a percentage of GDP were also lower.

The 2002 budget signalled two major shifts in budgeting and reporting: first, the means by which future fiscal management would be achieved through the budget process; and second, how the government's financial statements were to be presented.

First, the government announced its plans to update its fiscal tools. The underlying premise remained unchanged – that the combined increase in capital and operating spending had to be in line with nominal GDP growth so that debt as a percentage of GDP would remain stable and would move towards the government's objective over the longer term. However, the 2002 budget signalled that the process of setting spending intentions would change. The signalled changes meant that the focus would be on operating and debt tracks and their consistency with overall fiscal objectives (as opposed to the current focus on a set nominal limit for the parliamentary term).

The new approach also provided for more explicit and regular reviews of the new spending levels (at least twice annually), based on updated information on the macroeconomic and fiscal position. Under the previous approach, the "fiscal limits" were supposed to be fixed, apart from in exceptional circumstances such as a major economic shock (*e.g.* the NZD 5 billion limit over the period 1996-99 which was set out in the Coalition Agreement between New Zealand First and National).

Second, the form of the Crown financial statements was altered to reflect changes to the accounting standards underlying the preparation of all financial statements in New Zealand. All Crown financial statements from 2002/03 would record the revenues, expenses, assets and liabilities of all Crown-controlled entities (*e.g.* departments, state-owned enterprises [SOEs] and Crown entities). Previously, only the net surplus, net investment and net worth of SOEs and Crown entities were recorded. In parallel, future statements would also remove the GST on Crown expenses and include the full assets and liabilities of the Government Superannuation Fund (previously only the net unfunded liability was recorded on the balance sheet).

This meant that from 2002/03 the Crown would publish fully consolidated ("total Crown") accounts, and also split out "core Crown" information. The core Crown revenues and expenses are similar to previous accounts, except that they remove GST on Crown expenses. Table 2 outlines the changes.

Table 2. **Changes in Crown financial statements**

Current presentation of consolidation	Future presentation of consolidation
The current presentation shows: • Crown expenses and revenues with net SOE and Crown entity results; • Crown assets, liabilities and net Crown debt, gross Crown debt and net worth. The Crown balance sheet only includes a net investment in SOEs and Crown entities.	The future presentation will show the three institutional forms of: • "Core Crown" (existing information on revenues and expenses less GST on Crown expenses plus inclusion of full GSF numbers); • SOE revenues, expenses, assets, liabilities; • Crown entity revenues, expenses, assets, and liabilities. The sum of these three segments (less internal transactions) is the "total Crown". The core Crown is different from the current presentation owing to the removal of GST on Crown expenses and the inclusion of the full accounts of the GSF.

Source: New Zealand Treasury.

To present a more complete consolidated picture required a significant amount of additional information from SOEs and Crown entities than had been collated in the past. It was a two-year project to determine and resolve all the issues involved in expanding the Crown consolidation. It included designing and implementing the information systems as part of CFISnet to collect the information and consolidate it appropriately, as well as educating all users of Crown financial statements about the changes.

The change to fully incorporate the revenues, expenses, assets and liabilities of SOEs and Crown entities also required a change in how the government's long-term objectives were specified. These changes were required to ensure consistency with GAAP. However, inclusion of SOEs and Crown entities also provided an opportunity to outline more explicitly the underlying nature of the government's fiscal policy approach as it related to various components of the Crown (*i.e.* departments, SOEs and Crown entities). The new form of the objectives presented a clearer articulation of existing fiscal policy, while ensuring that re-specified Crown financial statements did not alter the government's fiscal policy approach. Looking forward, due to the extent of additional material to be included in Crown financial statements, the opportunity for greater transparency of the operations over which the government exerts ownership control are much enhanced.

A further key development in the budgeting process was the announcement of a three-year spending package for the health sector. As one of the government's budget priorities (alongside education and economic transformation), health received a cumulative package of NZD 400 million, NZD 800 million, and NZD 1.2 billion for the three years ahead. This package aimed to provide certainty in the sector, and effectively earmarks a significant proportion of budget spending for the next parliamentary term.

The government continued its focus on VFM in preparation for the 2002 budget, again using a targeted approach to take a close look at priorities, spending, and pressures in around 15 Votes. This year's process involved meetings between the Minister of Finance and other ministers to discuss areas to examine in each Vote.

4. Some impressions

How to sum up the effect of accrual accounting on the decision-making process in government over the last 12 years? At the start of this paper, two types of financial decision making were identified – from an ownership perspective and from a purchase perspective. Decision making also occurs at two levels – at a macro or ministerial level, and at a micro or departmental manager level.

4.1. Ownership (macro level)

Over the last 12 years significant decisions have been taken on re-organising the set of government rights and obligations that make up the balance sheet. Among these are:

- The decision and subsequent action to fully hedge the foreign currency portfolio against foreign exchange rate movements. (Note: If the government had the same exposure to foreign exchange movements in 1999/2000 that it had in 1991/92, a foreign exchange loss of NZD 2 billion would have been reported this year.)
- The decision to divest much of the Crown's commercial forest assets through the sale of the Forestry Corporation of New Zealand.
- The decision to close the GSF scheme to new members and, more recently, efforts to move the investment portfolio of GSF onto a basis that more closely matches the risks associated with the liability.

- The decision to fully fund the Accident Compensation Commission (ACC) tail over 15 years, thereby creating an asset to "match" the liability for outstanding ACC claims.

At the macro level also, the government's debt and cash management processes have been clarified and improved. Deloittes, in a post-implementation review of cash management, noted that costs were no longer incurred in funding idle balances in departmental official and unofficial imprest accounts, and in reconciling and controlling these accounts. This enabled the closure of regional Treasury offices.

4.2. Ownership (micro level)

At a departmental level, significant and observable improvements in working capital management were identified early in the reform process as a major benefit. The capital charge introduced a new set of incentives around the capital purchases by departments, and allowed a more accurate costing of departmental outputs. Where departments recovered the costs of outputs from third parties, pressure was created externally to achieve efficiency gains. In terms of departments seeking efficiency gains, the limited unit cost evidence available can reasonably be interpreted as providing a measure of support for the proposition of improved productivity.[12]

4.3. Purchase (macro level)

In determining the government's operating budget, the evidence of stronger control of fiscal levels of spending is clear. In general the government has determined the desired level of expenditure in a much more transparent way and has achieved the results sought. In doing so, there has been a significant move of money towards social welfare, health and education away from core government services and defence. The process of prioritisation at the high level seems to be working well – to the extent that commentators have suggested that continuing such resource shifts are unsustainable in the long term.

4.4. Purchase (micro level)

The evidence of success here is not clear-cut. Efforts at benchmarking – for example, the policy advice shadow pricing exercise in 1994 – have dropped away and there is little evidence available that similar types of outputs are compared or benchmarked in a way that was thought inevitable at the time the reforms were initiated. Concerns about the usefulness and robustness of costing systems continue and there also remains a concern that the specification of outputs is not at a sufficient standard to ensure high quality government performance.

Box 3. **Summarising New Zealand fiscal decision making in the 1990s**

Macrolevel ownership

- Fully hedging foreign currency debt
- Reconfiguration of assets and liabilities

Macrolevel purchasing

- Adherence to aggregate fiscal control
- High-level prioritisation of expenditure

Microlevel ownership

- Efficiency gains reducing overheads
- Improved working capital management

Microlevel purchasing

- Limited amount of benchmarking
- Lack of performance measurement standards

5. Concluding comments

What observations or interpretations can be made? First, it is worthwhile to note that the nature of budgetary decision making has not changed. Essentially, the accrual accounting process has informed the decision-making processes and made possible a number of decisions that might previously have been considered to be outside the budgetary process. The objectives of the decisions, however, have not changed, and while improved results are evident (for example, in reducing debt or the unit price of outputs), it is more likely to be the case that these outcomes were facilitated rather than caused by the accounting system.

Associated with that, the fiscal changes achieved by the New Zealand government were due first and foremost to political will. Even a less sophisticated system could have achieved a great deal in the presence of that political will, and a more sophisticated system would achieve very little if the political will to use it were not present.

Using the independently determined GAAP accounting rules for its fiscal forecasts and results has enabled the government to credibly demonstrate its commitment to honest budgeting. Any government faces difficulty in demonstrating commitment to prudent fiscal management when it sets the rules on how it accounts for its results. The independence of the GAAP-setting process allows this difficulty to be addressed. The presentation and format of the financial statements are familiar to all those with a general knowledge of accounting, and recent changes introduced in 2002 further improve the transparency of the Crown financial statements.

A critical element of the success in adopting GAAP has been that the GAAP accounts show both cash and accrual results in an integrated manner, and not as if cash and accrual results were somehow in "competition". A single set of integrated financial statements and forecasts has much more credibility than would occur if a number of alternative presentations were provided.

As a result, debates on fiscal results have largely centred around matters of economic substance rather than on the appropriate accounting form. It is notable also that the pressures for off-budget activities that reduce the integrity of the budget process are precisely the pressures for off-balance-sheet activity in the private sector.

Any budget represents some form of synthesis between top-down and bottom-up approaches. Genuinely meaningful information on what departments produce with the money they are voted promotes rationality in the negotiation process. At ministerial level, the decision-making process is easier, as there is more awareness of the effect of decisions. On the other hand, the bureaucracy is reassured that the base level of information being provided gives a much greater chance of fair treatment and less likelihood of arbitrary cuts.

Change is resource intensive. Only so much can be achieved immediately. In the early years of accrual budgeting, the main pressure on change was in achieving budget documentation that provided the information. Only when this was in place was it possible to concentrate resources on streamlining the processes. The automated checking processes used in New Zealand were simply not possible until the basic structures were in place.

Accrual accounting generates the ability for decision makers to take a longer-term focus. The information presented for the ownership interest, and in particular the balance sheet, raises issues such as the need to hold surplus assets, to invest, restructure or divest. Such decisions have a long-term impact and may in fact take more than one year to implement. Accrual accounting strengthens the information base for reaching those decisions. Such information is vital, as the annual cycle of the budget process could otherwise lead decision makers to focus on short-term issues.

On the other hand, providing information on costing government outputs has not led, as originally envisaged, to the benchmarking and cost comparisons driving decisions to obtain better value for money. The reason may partly be an issue of incentives at departmental and budget officer levels.

Notes

1. Qualitative characteristics include understandability, relevance, reliability and comparability.
2. Judith Aitken (1993), "Departmental Perspectives on the Budget Process", in J.R. Nethercote, Brian Galligan and Cliff Walsh (eds.), *Decision Making in New Zealand Government*, Federalism Research Centre (Canberra) in association with the Institute of Policy Studies, Victoria University and the State Services Commission.
3. Ruth Richardson (1995), *Making a Difference*, Shoal Bay Press, Ltd., Christchurch, New Zealand.
4. J.R. Nethercote, Brian Galligan and Cliff Walsh (eds.) (1993), *Decision Making in New Zealand Government*, Federalism Research Centre (Canberra) in association with the Institute of Policy Studies, Victoria University and the State Services Commission.
5. *Ibid.*
6. *Ibid.*
7. *Ibid.*
8. *Ibid.*
9. SNA: the System of National Accounts (World Bank); GFS: Government Finance Statistics (International Monetary Fund). These systems are used to derive an internationally accepted series of macroeconomic measures.
10. MMP: Mixed Member Proportional. Each voter has two votes. The first is for the local electorate Member of Parliament, and the second for the party of his/her choice. Half the MPs are "Electorate MPs" and the other half are "List MPs". The List MPs' seats are allocated to those parties that achieve more than 5% of the overall vote. The allocation is made so that the overall proportion in the House of Representatives mirrors the overall proportion of Party votes.
11. The standard addressing this issue (IAS 37 Provisions, Contingent Liabilities and Contingent Assets) was not promulgated until the end of 1998.
12. See "Effects of Public Sector Financial Management Reform (FMR) in New Zealand" by Jim Brumby, Peter Edmonds and Kim Honeyfield, paper presented to a Conference of the Australasian Evaluation Society, 30 August 1996.