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Accountability and Transparency in the Public Sector: The New Zealand Experience

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Abstract

This paper describes the reforms introduced in the New Zealand public sector since the mid-1980s. The reforms included corporatization and privatization of most state-owned enterprises, the shift from a cash-basis to an accrual-basis accounting system and the compilation of a balance sheet for the central government and its entities, performance-based arrangements for the delivery of core government outputs; and institutional changes in expenditure control mechanisms. The paper also summarizes the impact of the reforms on government revenue and spending patterns, and discusses lessons learned from New Zealand's experience.

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Summary

During the decade 1985–94, New Zealand implemented one of the most comprehensive reorganizations of the public sector in the postwar period. The reforms, which were a unique blend between microeconomic theories and organizational science, were remarkably successful and greatly enhanced the capability of the government to focus on macroeconomic issues. As a result of the reforms, transparency and accountability now pervade New Zealand government operations, and the focus of fiscal policy has progressively shifted toward ensuring stable and responsible policies over the long term. In addition, New Zealand is the only country in the world presenting a full set of fiscal accounts, including a balance sheet, based on accrual accounting

This paper describes the reforms introduced as New Zealand moved from the initial corporatization and privatization phases to the financial management reforms of the core government and the Fiscal Responsibility Act, with a view to highlighting the lessons to be learned from New Zealand's experience in terms of public acceptance, sustainability, and sequencing of reforms in the public sector. Since accountability and transparency became the key words of the reform agenda at an early stage, most of the measures were comprehensive and did not envisage any exceptions. This facilitated public acceptance of the reforms and was crucial to sustain them across four terms of governments. Public acceptance and political sustainability, in turn, dictated the sequencing and the pace of the reforms.

I. INTRODUCTION

During the decade 1985–94, New Zealand implemented what has come to be viewed as one of the most comprehensive reorganizations of the public sector in the postwar period. Their objectives were: to improve accountability and transparency in government operations; to reduce the pervasiveness of the state in the economy; and, ultimately, to enhance efficiency in the provision of public services. As a result, the focus of fiscal policy has progressively shifted from short-term stabilization considerations toward ensuring stable and responsible policies over the longer term. Moreover, New Zealand is now the only country in the world presenting fiscal accounts, including a balance sheet, based on accrual accounting.

Over the same period, the fiscal balance shifted from a deficit of about 9 percent of GDP to a surplus of 3 percent, while gross public debt declined substantially. The improved fiscal situation resulted, in part, from the reforms in the public sector which helped to contain expenditure and increase tax revenues. Reforms in other areas—liberalization of the trade and capital accounts, including the elimination of all export incentives, deregulation of financial and foreign exchange markets, explicit inflation targeting, and deregulation of industrial relations—and cyclical developments also played an important role in improving the fiscal performance.

The paper is organized as follows. Section II describes the initial phases of the reforms which consisted of corporatization and privatization, and provides some background on the foundations of the changes. Section III discusses the reform of the financial management system within the "core" government,[2] including the shift from a cash-basis to an accrual-basis accounting system that led to the compilation of the Crown balance sheet,[3] which is discussed in Section IV. Section V presents the Fiscal Responsibility Act as the culmination of earlier reforms, while Section VI summarizes the impact of the reforms on government spending patterns. The last section discusses whether the New Zealand experience can be transferred, in full or in part, to other countries.

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[2]The core government includes the departments and ministries, and the offices of parliament.

[3]The Crown encompasses the core government and all entities in which the government has a majority interest.

II. RETURNING THE GOVERMENT TO ITS CORE

Like many other OECD countries, the size of the public sector in New Zealand had been steadily growing since World War II until the mid-1980s.[4] As a share of GDP, government expenditure had risen from around 28 percent in the early 1970s to over 41 percent in 1984, spurred by a large welfare system; the overall deficit had been increasing from around 1 percent in the early 1970s to 9 percent of GDP in 1984, with gross public debt at 64 percent of GDP; and public sector employment covered 31 percent of total employment. Moreover, for a number of historical reasons—a small private sector, public works promotion, and control of natural resources—the public sector had become involved in a wide number of trading activities, ranging from printing services to banking and telecommunications, which were hardly profitable and, according to Treasury's estimates, accounted for about 12 percent of GDP and 20 percent of gross investment. These activities were mostly structured along the lines of government departments with policy advice, regulatory, and trading functions, or as statutory corporations with special privileges and obligations, in each case accountable to ministers or to a departmental head, who in turn reported directly to a minister.

Prior to the reforms, the financial management system relied on program budgeting where cash appropriations were based on inputs. The Treasury held central control of disbursements and issued most departments cheques on receipt of vouchers authorizing spending, along with detailed instructions on their spending. All investments required cabinet approval and little flexibility was allowed to managers to vary their input mix. Budgeting was mainly based on adjusting the cost of existing programs for inflation and adding the costs of new proposals. Although departments were required to prepare three-year forecasts of their spending, decision making was typically on an annual basis.

A. Corporatization

Following the removal of protection and subsidies from the private sector, it became evident, by comparison, that the public sector remained sheltered from those changes.[5] The reasons for government departments' poor performance, in particular, were identified by the Treasury in its 1984 post-election briefing as: the lack of clearly identified, nonconflicting

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[4]There are no state governments and the role of local government is restricted to urban and rural services, largely financed by property taxes.

[5]The phasing out of import licensing requirements had begun in 1983. In the aftermath of the 1984 elections, financial markets, including foreign exchange trading and interest rates, were deregulated, credit guidelines and export credit guarantees eliminated, minimum prices on agricultural products abolished, and restrictions on road and rail carriage removed.

objectives; the inadequacy of control mechanisms to assess performance; excessive emphasis on inputs; restrictions on managers' power to manage; and a protective operating environment, consisting of special assistance and restraints on competition (Box 1).[6]

Box 1. New Zealand: Microeconomic Foundations of Reforms in the Public Sector

A number of economic theories that had been developed since the late 1960s were used to analyze the problems of governance and efficiency in government departments and state-owned enterprises. The public choice approach combined with agency theory was applied to highlight the limits of public intervention. The contestability paradigm was drawn upon to stress the benefit of competition and market mechanisms in allocating scarce resources.

The **public choice approach** and the theory of bureaucracy address problems within complex organizations. One of the findings is that public officials tend to behave in self-interested ways by maximizing objectives not related to the public interest they are meant to serve. In order to overcome these problems, emphasis is put on the importance of measuring output and on performance-related incentives. Further development of these analyses has helped to refine the theories of regulation by clearly envisioning the possibility that regulation could be captured by interest groups. From this arises the opportunity of separating regulatory functions from policy advice and commercial functions.

These findings were later analyzed as a **principal-agent** relationship. Typically, the principal, in this case a minister, wants to induce his agent, say a department head, to behave in a way that is beneficial to the principal. The problem is that the principal's knowledge is imperfect; either he cannot see what the agent does, or he cannot interpret his actions. In the provision of public goods, a principal-agent relationship exists also between the electorate and the executive. Monitoring the performance of the agent and ensuring that this is in conformity with the principal's targets is at the core of incentive contracts. These require that in a principal-agent situation a contract be defined so as to delegate decision making by enhancing transparency and accountability and minimizing agency costs, that is, costs associated with the structuring, administering, and enforcing of such contracts. Contracting out and performance agreements (see Box 4) are among the mechanisms to address these shortcomings and to reduce the power of government departments as monopoly suppliers by reproducing contestability conditions.

Contestable markets are defined as markets open to entry for potential entrepreneurs who face no disadvantages vis-à-vis incumbent firms and who can exit the market without loss of any cost that entry required to be sunk. This paradigm suggests that in a market which approximates perfect contestability, the public interest may be better served by a policy of laissez-faire rather than active regulation by administrative or antitrust legislation. However, contestability does not mean that an unrestrained market automatically leads to optimal resource allocation. Removal of entry-exit barriers alone may not be sufficient and contracting out may generate problems, such as monitoring and measuring the performance object of the contract, or create considerable exit costs from the contract when substantial sunk costs have been incurred. In addition, it may be difficult to write and administer a long-term contract in the presence of uncertainty and incentives toward rent-seeking behavior.

[6]A number of authors have explored the microeconomic foundations of the reforms in New Zealand. For an early survey, see Scott and Gorringe, 1989.

To address these shortcomings, in December 1985 the Minister of Finance announced in an economic statement to the House of Representatives[7] the following five general principles for the reorganization of state trading activities:

- the state should not be involved in activities that could be more efficiently and effectively performed by private businesses;
- separate noncommercial functions from trading organizations which would operate along the line of private sector companies;
- managers would be required to run them as successful enterprises and would be fully accountable for using inputs, pricing, and marketing their products within performance objectives set by ministers;
- enterprises would be required to operate without competitive advantages; and
- enterprises would be set up on an individual basis depending on their commercial purposes, restructured under new boards of directors hired from the private sector.

The reorganization of state trading activities was given effect by the **State-Owned Enterprises (SOE) Act**, which was passed in September 1986 (Box 2). The SOE Act provided the basis for converting old trading departments and corporations into enterprises along private sector lines, subject to the same antitrust and company law as private enterprises. As a result, in April 1987, the first nine SOEs were formed from a number of large government departments while five existing public corporations were brought within the framework of the act. By the end of 1993 the number of corporatized state-trading activities reached 31. A number of departments were abolished while others, mainly in charge of regulatory functions, were replaced by new agencies.

In contrast to other countries, the regulatory environment aimed at promoting a contestable market whenever possible. This strategy was suggested by two branches of economic theory: regulation theory and the contestability paradigm. According to the former, regulation tends to be captured by interest groups; the latter argues that incumbent firms would operate at output and price levels that would emerge under a competitive structure if a realistic threat of other firms entering that same market existed. This would require that entry and exit regulations be minimized, if not completely removed. As a result, special regulatory structures were not introduced as a substitute for competitive pressures in the case of industries, such as gas and communication, where the incumbent SOEs enjoyed a dominant position.[8]

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[7]As reported in Jennings and Cameron (1987).

[8] For a detailed account of the debate spurred by the contestability theory in the design of the New Zealand Commerce Act of 1986, see Bollard, 1994.

Box 2. New Zealand: The State Enterprises Act of 1986

The **Act's main objective** was ..."to promote improved performance in respect of government-trading activities and, to this end, to:

a. specify principles governing the operations of state enterprises;
b. authorize the formation of companies to carry on certain government activities and control the ownership thereof; and
c. establish requirements about the accountability of state enterprises and the responsibilities of ministers."

The principal objective of **each state enterprise** is to "operate as a successful business." This requires that state enterprises be (Section 4):

a. as profitable and efficient as comparable businesses that are not owned by the Crown;
b. a good employer; and
c. an organization that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavoring to accommodate, or encourage these when able to do so.

As to the **provision of noncommercial activities**, the Act provides that (Part I, Section 7):

"Where the Crown wishes a state enterprise to provide goods or services to any person, the Crown and the enterprise shall enter into an agreement under which the state enterprise will provide the goods or services in return for the payment by the Crown of the whole, or part, of the price thereof."

The Act provides for the appointment of a Board of Directors, accountable to the Minister of Finance, and a further responsible minister who would hold the shares and who would, in turn, be responsible to parliament for the performance of the enterprises. Ministers are not allowed to sell such shares without explicit parliamentary approval.

The **accountability provisions** of the Act (Part III) require that the Board of Directors of every state enterprise deliver to the share-holding ministers an annual **statement of corporate intent** which includes, inter alia, corporate objectives, the scope of the activity, the accounting policies, the performance targets, estimated returns, and commercial valuations. As to the **accounting requirements**, the Act also requires boards to deliver annual consolidated financial statements and operating reports, which include a statement of the dividend payable to the Crown, and a comparison of the performance of state enterprises with the relevant statement of corporate intent. The responsible minister is required to lay before the House of Parliament the statement of intent for the year and the succeeding two years, along with the annual report and audited financial statements for the preceding year.

The process of corporatization produced some dramatic changes in enterprise performance. According to Duncan and Bollard (1992), who analyzed the performance of the initial 14 SOEs, unit costs, prices, and tariffs were in general reduced, quality of service increased, and profitability improved, although there was considerable variation in performance. Much of the improvement in efficiency was attributable to the requirement for managers to pursue clearly-identified commercial objectives. In many cases, competition, or

the threat of it, provided an important incentive, even in areas where public enterprises were regarded as having a dominant position.[9] Corporatization also resulted in substantial declines in employment; the workforce in the initial 14 SOEs was practically halved by 1992.[10] These losses were, however, somewhat offset as many former staff became subcontractors to the companies; in other cases employment increased in competitor firms. There is also evidence that after the initial reductions second-round effects actually increased employment in some sectors.[11] From the budgetary perspective, remitted profits and dividends doubled from 1986 to 1988 (about half a point of GDP) and by 1989 government subsidies had ceased, except for railways.

Despite its success, the New Zealand model presented a few shortcomings. Incentives and monitoring mechanisms were somewhat limited by the absence of tradeable shares for SOEs and the lack of a real threat of takeover or bankruptcy, as these enterprises were permitted to issue bonds, but not voting equity securities. Further, although their debt was no longer formally guaranteed by the government, the perception of an implicit guarantee remained and, along with that, the presumption of political interference. In addition, the relevant legislation did not spell out the penalties for failure to meet the agreed targets. While SOEs had been on the same footing as private enterprises, their particular status put them at a competitive disadvantage by imposing costs over and above those faced by comparable private sector organizations. These derived from their social responsibilities and were particularly evident in the industrial relations area, which continued to be subject to the provisions of the State Service Conditions of Employment Act of 1977. Also, a predetermined return on equity capital and/or dividend policy was an additional limitation to management.[12]

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[9]For instance, Telecom cut the real price of a number of telephone services by over 20 percent in 1989; CoalCorp's nominal prices in 1990 were 20 percent lower than those charged by its predecessor, State Coal Mines, in 1987; and NZ Post improved on-time delivery of high-priority mail from 80 percent to over 95 percent in the period 1987–90.

[10]Employment in seven of the initial SOEs was reduced by 35,000 staff. From 53 departments with approximately 86,000 staff in mid-1984, the public service was reduced to 35 departments and 34,000 full-time equivalent staff by December 1993, partly owing to the transfer of some 23,000 public servants to SOEs.

[11]Roger Douglas, Minister of Finance during 1984–88 in the Labour government, claims that, in spite of the high level of job losses in the case of Telecom, employment in the telecommunication sector actually increased by 3,000 see Douglas (1993).

[12]For a more comprehensive discussion of the SOE model's shortcomings, see Jennings and Cameron (1987).

B. Privatization

Addressing the limitations of the SOE model required introducing potential competition and transferable and contestable ownership. For these as well as budgetary reasons, the Treasury became a strong advocate of privatization. From the budgetary perspective, many public enterprises were in need of fresh capital injections to face restructuring costs and investment, or to diversify into areas outside government-trading activities. Also, given the still high level of public indebtedness, many saw privatization as an opportunity to avoid charging the budget with additional transfers to SOEs and, at the same time, to reduce public debt. In the seven-year period between 1988 and 1994 inclusive, government asset sales (including 21 SOEs) brought in a total of $NZ 13 billion, equivalent to an annual average of about 4 percent of GDP, compared with about 1 percent experienced in the United Kingdom. With few exceptions, notably Telecom, privatization receipts have been used almost exclusively for debt reduction. Partly as a result of this strategy, gross debt declined from 63 percent of GDP in March 1988 to below 55 percent by end-1994.

A range of privatization techniques was used. In general, privatization was carried out through two main approaches: shares were sold when the operations of an enterprise were of a clearly-defined commercial nature; and assets were sold where operations were of a less commercial nature. In the latter case, many operations had to be either redefined by first disposing of assets and then proving their commercial viability. After some initial partial sales, it was eventually agreed that operations had to be divested in full to avoid the possibility of capture by minority shareholders and conflict between the government as a regulator and the government as a shareholder. As to the modalities, sale by tender was generally preferred given the thinness and scarce sophistication of the local capital markets. Moreover, the government preferred selling to single buyers as these were typically prepared to pay a premium for control. In two cases (Air New Zealand and Telecom), the government held on to a "kiwi" share to keep a veto right over changes of the Articles of Association so that control could be maintained over the privatized entity.[13]

The New Zealand privatization program differed in some respects from similar programs carried out in other countries. For instance, privatization was never seen as a tool to increase the distribution of share ownership, or to develop the stock market; as a consequence, and contrary to the UK experience, there have been no full market flotations and there was no use of a voucher system like that in eastern European countries. To address the limited size of the local financial market, the government accepted foreign buyers even for those sectors usually labeled as "strategic." Rather than setting up *ad hoc* regulatory

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[13]In the case of Air New Zealand, the foreign partner insisted on the kiwi share to guarantee landing rights; as to Telecom, this required that the existing network and free local calls for residential users be maintained; urban-rural price differentials be contained; and increases in residential telephone rentals be limited to the rate of inflation.

structures, the government avoided selling public sector monopolies to the private sector without first taking steps to enhance competition. Finally, the privatization program was facilitated by the radical liberalization of the capital markets during the preceding few years.

III. MANAGEMENT REFORMS OF THE CORE GOVERNMENT

In 1988, attention turned to reform of the organization of government services. Following corporatization, it became clear that not all of the government departments could be turned into profitable enterprises. The problem was then how to make them more responsive and efficient. The Treasury, in its 1987 brief to the incoming government, further developed the arguments made in its 1984 post-election briefing and, based on the experience gained through the SOE Act, identified four key aspects of the management process:

- the relationships between ministers of the Crown and the chief executives of their departments;
- the degree of autonomy of chief executives in managing their departments;
- a distinction between the output of services a department produces and their outcome, or success in achieving social goals; and
- the need for a system of financial accountability based on accrual accounting.

These aspects were addressed by the ensuing program of financial management with the passage of two mutually reinforcing legislative acts: the State Sector Act of 1988 and the Public Finance Act of 1989, and their successive amendments.

The **State Sector Act** (SSA), which took effect in April 1988, initiated the reforms in the core public sector (Box 3).[14] It included a comprehensive reform of departmental management structures and of the state personnel and industrial relations regimes by establishing new accountability relations between heads of departments or chief executives and their respective ministers.[15] The act ended permanent tenure for departmental heads, turning them into "chief executives," employed on individual five-year contracts, and directly accountable to the minister for their performance. By introducing individual contracts, the SSA can be seen as a precursor of the **Employment Contracts Act** (ECA) of 1991.

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[14]For an extensive account of the genesis of the Act, see Walsh (1991).

[15]Prior to the SSA, the industrial relations within the public sector were highly centralized and administered under the State Services Conditions of Employment Act of 1977. The State Service Commission (SSC) was the legal employer of most public sector employees. Wages and salaries were determined through negotiations between the SSC and public sector unions and were based on the principle of "fair relativity" with the private sector. Department heads enjoyed security of tenure until retirement.

Box 3. New Zealand: The State Sector Act of 1988

The State Sector Act (SSA) of 1988 repealed the Service Sector Act of 1962, the State Services Conditions of Employment Act of 1977, and the Health Service Personnel Act of 1977. It applied the provisions of the Labour Relations Act to the state sector, giving public sector unions collective-bargaining rights identical to those of their private sector counterparts although union membership was voluntary in the public sector.

The Act created a new office of chief executive of government departments and a new group of senior officials called the Senior Executive Service (SES). Both are appointed on five-year renewable contracts, the former by the State Services Commission (SSC) and the latter by chief executives. The SES was intended "to constitute a unifying force at the most senior levels of the public service."

The Act transfers prior personnel functions of the SSC to the **chief executives**, with the SSC's role changing to one of a monitoring agency required to review the performance of each department and its chief executive "to promote, develop, and monitor equal employment opportunities policies and programmes" (Section 6). The SSC remained, however, the employer party for the negotiations of terms and conditions of employment, although it is required to consult with chief executives (Section 70) and may delegate to them.

Chief executives were given the right to appoint staff, with the obligation to give preference to the person best suited for the position (Section 60), to notify vacancies "in a manner sufficient to enable suitably qualified persons to apply for the position" (Section 61), and to notify appointments to members of the department (Section 64). According to the Act, the SSC is required to secure the agreement of the Governor-General to remove a chief executive from office for just cause or excuse (Section 39). The SSC is responsible to the appropriate minister for reviewing the performance of chief executives (Section 43). The SSC must secure the agreement of the Minister of State Services as well as that of the Prime Minister for the conditions of employment of each chief executive, with the exceptions of the solicitor-general, the controller and auditor-general, the commissioner of police, and the commissioner of the SSC (Section 38).

In 1991, the SSA was amended to incorporate the provisions of the Employment Contracts Act (ECA) of 1991. The State Services Commissioner retained his responsibility "for negotiating ... every collective employment contract applicable to employees of any department of the public sector" (Part IV, Section 68). In practice, however, the Commissioner delegates to a chief executive his powers (Section 70), incorporating, therefore, the enterprise-level bargaining at the core of the ECA.

Since 1988, most government agencies and departments have been affected by restructuring—a process that is still largely ongoing. Although it varied greatly depending on the specific policy objectives, there have been a number of common features:

- policy advice functions were separated from operational units responsible for their administration;
- funding for public services was separated from their purchasing and provision;
- monopoly privileges were removed so that competition was allowed among government-owned providers of public services and private providers; and

- responsibilities among government departments were reallocated in order to group similar functions, avoid conflict of interest, and disassemble conglomerate organizations that had been difficult to manage.[16]

In light of the changes introduced by the SSA, the existing appropriation process rapidly became obsolete. This, as well as other reforms in the financial management area, was changed by the **Public Finance Act** (PFA), which became effective in July 1989. To enhance the accountability relationships and chief executives' managerial efficiency, PFA introduced the distinction between outcomes and outputs, whereby the ministers purchase **outputs** (goods and services, including policy advice) from a number of sources, including their own departments, in order to achieve their **outcomes** (ultimate policy goals). According to the act, the chief executives are responsible for producing these outputs as agreed in annual **performance agreements** while the ministers remain responsible for the outcomes (Box 4).[17] By way of this distinction, the minister had, at the same time, a purchaser and an ownership interest in the department.

The requirements for better management of assets and improved financial information, including full specification of the costs of departmental services, led to the introduction of **new reporting requirements**. All departments, as well as SOEs and Crown entities, are required to prepare annual financial statements in which accrual accounting replaced cash-based systems (Box 5) in accordance with **generally accepted accounting practice** (GAAP). This is a set of rules approved by the New Zealand Accounting Standards Review Board, an entity established by the **Financial Reporting Act of 1993**. The functions of the

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[16]These features were also at the base of later reforms in the provision of health, education, and other social services. Prior to 1990, the social welfare system combined targeted and universal benefits as the result of the comprehensive reform program undertaken by the former Labour government during 1985–89. Since late 1990, the National Party Government embarked on a series of measures that effectively cut the value of most benefits, tightened eligibility for income support, and expanded targeting in an effort to contain rising social expenditure. In addition, the funding and purchasing of health care, and to some extent education, were separated from their provision and primary health care subsidies were restricted to low-income families. Finally, all forms of housing assistance have been rationalized into an income-and asset-tested accommodation supplement.

[17]It is worth emphasizing how these reforms were conducive to the Reserve Bank Act of 1989. Price stability was the output agreed upon between the Treasury, responsible for the overall macroeconomic management (the outcome), and the Governor of the Reserve Bank (who is appointed like all the chief executives for a five-year term) in a performance contract, the Policy Target Agreement, against which the governor's performance is assessed. For a detailed account of how the framework for monetary policy has radically changed since 1989, see Kronenberg (1996).

Board are to "review and approve financial reporting standard"; "to encourage the development of financial reporting standard"; and "to give directions as to the accounting policies that have authoritative support within the accounting profession in New Zealand."

Box 4. New Zealand: The Public Finance Act of 1989

The Public Finance Act (PFA) became effective on July 1, 1989. It was first amended in 1991 and last in 1993 to incorporate sections from the Financial Reporting Act of 1993. The Act introduced a number of new concepts, such as the distinction between outcomes and outputs; the separation between the government as a whole, the Crown, who purchases outputs, and individual departments, who provide outputs; performance agreements; a new appropriation classification; and generally accepted accounting practice (GAAP).

The Act (Section 2) defines **outcomes** as "impacts on, or the consequences for, the community of the ... activities of the Government." Ministers individually and the cabinet collectively are responsible for defining the outcomes for which they will be held accountable to parliament and, ultimately, the electorate. **Outputs** are defined as "goods and services that are produced by a department ...or other person, or body." This distinction is the basis for the accountability relationships between ministers and chief executives.

This accountability relation is formalized in **performance agreements.** These agreements, which were first introduced with the SSA and subsequently modified, specify the key areas related to the government strategic concerns requiring the personal attention of the chief executive; cross-reference to the detailed information on outputs contained in purchase agreements; and provides information on departmental compliance with statutory responsibilities and with government policies, and on stewardship of government assets (ownership interest). Guidelines for performance agreements are issued by the State Services Commission, with the exception of purchase agreements for which guidance is provided by the Treasury.

As to the **budgetary procedures**, the 1994 amendment to the Act established seven types of appropriations or votes: output classes, benefits and other unrequited expenses, borrowing expenses, other expenses, capital contributions, purchase or development of capital assets by the Crown, and repayment of debt. The Act also envisages the possibility of multi-year appropriations of up to five years. Departments are not allowed to transfer funds between individual appropriations without parliamentary approval, although the PFA provides for some limited flexibility. Fiscally neutral transfers from one class of outputs to another within a vote can be authorized by the executive as long as any such transfers results in an increase of less than 5 percent and happens no more than once a year for any output class. However, during the year the cabinet may decide that the level of certain appropriations should be changed in the supplementary estimates. If sufficient supply is available under the Imprest Supply Act, the cabinet may agree to the change being met from the Imprest Supply in advance of the Appropriations (Supplementary Estimates) Bill being passed near the end of the year.

During parliamentary consideration of estimates of appropriations, nongovernment members of parliament may, under standing orders, propose amendments. However, these amendments may not have more than a minor impact on the composition of a vote, otherwise the Minister of Finance may veto the amendment. The financial veto procedure also allows private members to initiate proposals involving expenditure or taxation, but gives the government of the day an absolute right to veto such proposals if it considers that they would have more than a minor impact on the fiscal aggregates.

PFA also changed the appropriation system and overhauled the government financial procedures. An **appropriation system based on outputs** and accrual accounting replaced the previous line-item cash appropriation system where single departmental votes were subdivided into programs and further into categories of inputs. Although the distinctions between outputs and outcomes is relatively simple, it did raise a lot of debate about the definitions of outputs.

Box 5. New Zealand: Cash and Accrual Accounting

Cash accounting records are transactions in which cash is the medium of exchange and recorded only when payment is made or received. Transactions in kind and nonfinancial assets and liabilities are not recorded. The only stocks recorded are cash balances held at the end of the accounting period.

Accrual accounting presents a number of advantages compared with cash accounting. It records all transactions and other economic flows, whether in cash or kind, at the time they are incurred. The value of receivables is shown as an asset, the value of payables as a liability. Physical assets and changes in their values are recorded through depreciation and revaluation, as are unrealized changes due, for instance, to exchange rate movements. It therefore encompasses cash accounting insofar as it records cash flows and balances. At the end of the accounting period, the values of all assets, liabilities, and net worth are presented, so as to provide a more meaningful picture of an entity's operations during the fiscal year and of its overall financial position at the end of the period, than that of cash accounting, particularly as regards the medium-term financial position.

Accrual accounting offers a closer linkage than cash accounting to other macroeconomic statistical systems, such as the Balance of Payments Manual and the 1993 System of National Accounts. As to the fiscal accounts, a public sector accrual-based consolidated balance sheet clarifies the long-term impact of current decision by making a clear distinction between current and capital accounts; avoiding budget manipulation through one-off assets sales; and preventing the shifting of costs either off-budget or to other levels of government.

Accrual accounting is being implemented in many countries, although not as comprehensively as in New Zealand. The State of New South Wales in Australia has been in the avant-garde for some years and the Federal Government and other Australian states are following. The United Kingdom is also envisaging the adoption of accrual accounting ("resource accounting") by April 1998 as part of a broader financial management reform. Accrual accounting is also being adopted, although in a piecemeal fashion, in parts of the United States administration. Among developing countries, Fiji is implementing, with technical assistance from the New Zealand government, a full accrual-based financial management system. A recent survey carried out by Efford (1996) indicates that cash basis is still, by and large, predominant among governments in most responding countries, although a significant number of countries, mainly industrialized ones, have indicated the availability of a certain amount of information on accrual basis.

While many countries commonly supplement their cash-based government accounts with accrual information, New Zealand has been the first, and so far the only, country where the government produces its accounts completely on an accrual basis. This make the assessment of the financial performance and position of the government more transparent. In particular, it clearly indicates whether movements in the government's net worth are caused by a shift in the balance between capital consumption and new investment or whether the government is depleting its net worth to sustain current consumption.

for each department in relation to the desired outcomes. In some cases it took a long time to identify and quantify such outputs, while in others the identification is still an ongoing process. One particular area worth highlighting is the definition of output for policy advice. For instance, the Appropriation Act lists nine classes of outputs for the Treasury, three of which consist of policy advice—general economic and financial strategies, taxation, and demand management.[18] The outcome pursued by the government in this case is macroeconomic stability. However, it is evident in this example that the provision of outputs (policy advice) cannot be uniquely associated with a particular outcome (macroeconomic stability) as this is inevitably influenced by many other factors.

Costing of outputs is broadly based on a **profit-center** approach where these are clearly specified. Purchase prices are set so as to cover the full costs of producing outputs, including taxes, depreciation, and any changes in the Crown's net asset holding, and a capital charge, akin to companies' interest and dividend liabilities, on the expectation that departments earn a rate of return on capital (Box 6). Where valuation of outputs is difficult, such as in the case of policy advice or defense, or in the absence of an appropriate market-related benchmark, a **cost-center** approach is frequently adopted, whereby input costs are grouped according to the organizational structure and, in turn, imputed to outputs on the basis of a pre-determined formula.

Box 6. New Zealand: Capital Charges

Since July 1991, departments have been paying a capital charge on their assets. The purpose of this charge is to make explicit the full cost of goods and services produced by departments (output), and to make explicit the opportunity cost of the Crown's investment in departments, adjusted for the same class of risk. The capital charge is calculated as the departmental capital base multiplied by the charge rate. The department capital base, consistent with GAAP, is valued at modified historical cost; the capital charge is the weighted average cost of capital appropriate to the department concerned. The default rate is set by the Minister of Finance at the beginning of each budget cycle with reference to the capital asset pricing model. Although a number of departments have been able to negotiate different rates, these have generally been in line, if not lower than, the default rate. The default rate has, in fact, a built-in upward adjustment to take into account the lower government's borrowing costs compared with the private sector because its credit risk is supported by the sovereign power to tax.

The **government financial procedures** were also reformed by decentralizing financial management and control, including the government accounts system, to individual

[18]The purchase agreement between the Minister of Finance and the Treasury is much more detailed and identifies about 150 outputs.

departments.[19] The PFA, in conjunction with the contemporaneous Reserve Bank Act, abolished the Reserve Bank of New Zealand's (RBNZ) statutory monopoly in the provision of banking services to the government; it established two principal types of bank accounts for public money, a Crown account operated by the Treasury and removed from the RBNZ, and departmental accounts operated by the departments with consequent separation between treasury and monetary policy functions in line with accountability and transparency targets.[20] These reforms created a new role for the New Zealand Debt Management Office (DMO), a branch of the Treasury, which now manages the government's cash flows and interest-bearing assets, in addition to the Crown's debt, within an appropriate risk management framework. The DMO is organized along the lines of a corporate treasury in a large corporation with subsidiaries, and includes a research group, a portfolio strategy function, separate dealer and back-office settlement teams, and a cash management group.

IV. FINANCIAL STATEMENTS

Following the accounting requirements and output budgeting introduced by the PFA, it was, in principle, a fairly conventional accounting exercise to compile a Crown balance sheet. Nonetheless, it did require a substantial amount of work, given that no other government in the world had undertaken such an exercise before, and was achieved in two stages: from July 1, 1991, consolidated financial statements were produced for the "core" government, that is, ministers, departments, and offices of Parliament; from July 1, 1992, the reporting entity was widened to include the RBNZ, as well as all SOEs and other Crown entities. The Financial Reporting Act of 1993 provided the framework, later reinforced by the Fiscal Responsibility Act of 1994, for preparing all Crown financial statements according to generally accepted accounting practices.

The **set of financial statements** produced by the Crown are similar to any publicly-listed company in New Zealand. The set is opened by a **statement of responsibility** whereby the Minister of Finance "accepts responsibility for the integrity of the Financial Statements, the information they contain and their compliance with the Public Finance Act 1989," and the Secretary to the Treasury states that "the Financial Statements comply with generally accepted accounting practice." The other statements are: a **statement of financial performance** (revenues and expenses); a **statement of financial position** (balance sheet, including a measure of the Crown's net worth); a **statement of cash flows**; and statements

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[19]Prior to the reform, the RBNZ had a statutory monopoly with respect to the provision, free of charges, of banking services to the government. This had resulted in an unsatisfactory link between the management of the government's accounts and monetary policy on the one hand, and in little incentive for the government to manage its finances efficiently on the other.

[20]The Treasury, however, still maintains an account at the RBNZ to which all the surplus funds in departmental and Crown accounts are transferred at the end of each working day.

regarding borrowing, contingent liabilities (quantifiable and nonquantifiable risks and contingencies), movements in equity, actual commitments, and accounting policies.

The three main statements are closely linked. The bottom line of the statement of financial performance, or **operating balance**, has become a major focus of fiscal policy, replacing the old cash-based concepts of "financial balance" and "adjusted financial balance" (Table 1 presents the reconciliation between financial and operating balances). It is obtained by subtracting the operating expenses from the operating revenues and by adding the net surpluses or deficits of SOEs and Crown entities to the balance between revenue and expenses. **Operating expenses** include only current items; the sale and purchase of physical assets and investments are recorded separately in the statement of cash flows. **Operating revenues** are classified as "revenue levied through the use of the Crown's sovereign power" (mainly taxes) and "revenue earned through the Crown's operations" (income from investments, sales of goods and services, and unrealized valuation changes of the Crown's commercial forest determined by, for instance, timber price fluctuations).

A positive operating balance affects the **statement of financial position** by adding to the Crown's assets, or detracting from its liabilities, thereby increasing the Crown balance, or net worth (Table 2). The statement of financial position lists not only financial assets and liabilities, but also nonfinancial assets (such as buildings, military equipment, and state highways) and noncash liabilities (such as accumulated employee leave entitlement and unfunded employee pension liabilities). Revaluations of land and buildings, state highways, and military equipment are accounted for in a revaluation reserve fund. The **separate cash flow statement** includes cash flows from operations (such as taxes or subsidies), which affect the operating balance, and cash flows relating to assets or liabilities (such as the purchase and sale of physical assets, or the issuing of currency), which affect the Crown's balance.

The **statement of accounting policies** discloses the accounting criteria for the valuation of the government's assets and liabilities. Ministers of the Crown, departments, offices of Parliament, and the RBNZ are combined using the purchase method whereby corresponding assets, liabilities, revenues, and expenses are added together line by line. The Crown's investment in SOEs and other entities is accounted for on an equity basis, equivalent to the Crown's share of these entities' assets. As to the valuation of the government's assets and liabilities, inventories, investments, and intangible assets are generally recorded at net current value, or the lower of cost and net current value. As for physical assets, land and

Table 1. New Zealand: Reconciliation Between Financial Balance, Net Cash Flows from Operations, and Operating Balance, 1992/93

	$NZ mn.	In percent of GDP
Financial Balance	-1,789	-2.3
plus: Currency realignment	-34	-0.0
Adjusted Financial Balance (AFB)	-1,823	-2.4
minus: Items included in AFB but not in net cash flows from operations	-287.0	-0.4
Purchase of physical assets	-679	-0.9
Sales of physical assets	392	0.5
Reserve Bank surplus	...	...
plus: Items included in asset sales and purchases above but not in AFB (Sale of assets to Crown research institutes and other Crown entities)	174	0.2
plus: Items included in net cash flows from operations but not in AFB	161	0.2
Cash flows from operations of RBNZ, and housing agency account	144	0.2
ECNZ cumulative preference shares	...	...
Asset sale clawbacks - Synfuels	...	...
Other operating revenue	17	0.0
Net Cash Flows from Operations	-1,201	-1.6
plus: Items included in operating balance but not in net cash flows	382	0.5
Non-cash expenses	-287	-0.4
Unrealized losses from changes in the value of commercial forests	766	1.0
Net losses on foreign exchange	-309	-0.4
Depreciation	-839	-1.1
Writedown of Fletcher Challenge Limited shares	-74	-0.1
Net deficit attributable to SOEs and Crown entities	775	1.0
Movements in pension liabilities	-664	-0.9
Other non-cash items	58	0.1
Movements in working capital	344	0.5
Decrease in taxes receivable	-16	-0.0
Increase in payables	413	0.5
Decrease in other receivables	-64	-0.1
Decrease in inventories	11	0.0
Other deductions	325	0.4
Gain on sale of Bank of New Zealand	283	0.4
Asset sale clawbacks	183	0.2
Loss on sale of assets	-99	-0.1
Other investing and financing items	-42	-0.1
Operating Balance	-819	-1.1

Source: New Zealand Treasury, 1994 Economic and Fiscal Outlook.

Table 2. New Zealand: Central Government Statements of Financial Position, 1990/91-1995/96

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
	(In millions of New Zealand dollars)					
Total Assets	43,711	42,021	52,207	54,419	54,487	58,921
Cash and bank balances	151	464	77	70	210	344
Investments	6,792	6,385	8,017	8,175	6,746	9,273
Marketable securities and deposits	5,571	4,871	7,506	7,947	6,523	9,062
Other investments	1,221	1,514	511	228	223	211
Advances and receivables	10,497	8,095	7,106	7,595	9,235	8,239
Advances	5,052	3,665	2,784	2,989	4,782	3,457
Receivables	5,445	4,430	4,322	4,606	4,453	4,782
Inventories	324	424	448	340	326	336
SOEs and Crown entities	5,876	6,659	15,929	16,569	16,420	18,487
Total physical assets	20,033	19,938	20,612	21,648	21,532	22,235
Physical assets	12,493	12,712	12,553	13,080	13,432	13,925
Commercial forests	534	235	1,001	712	646	551
State highways	7,006	6,991	7,058	7,856	7,454	7,759
Intangible assets	38	56	18	22	18	7
Total Liabilities	54,066	57,101	59,902	60,047	57,646	55,577
Payables and provisions	4,125	3,251	3,184	4,138	3,824	4,070
Currency issued	n.a.	n.a.	1,400	1,529	1,620	1,675
Borrowings	43,185	46,674	47,478	46,429	44,096	41,500
Pension liabilities	6,756	7,176	7,840	7,951	8,106	8,332
	7					
Total assets less total liabilities	-10,355	-15,080	-7,695	-5,628	-3,159	3,344
Accumulated operating balance	-10,355	-15,504	-8,269	-7,539	-5,074	-1,550
Revaluation reserve	0	424	574	1,911	1,915	4,894
Crown Balance (Net Worth)	**-10,355**	**-15,080**	**-7,695**	**-5,628**	**-3,159**	**3,344**

Source: New Zealand Treasury, Economic and Fiscal Outlook, various issues; and Financial Statements of the Government of New Zealand, various issues.

1/ Starting in 1992/93, the reporting entity includes all SOEs and Crown entities as well as the Reserve Bank.

buildings, commercial forests, and national parks are assessed at the best estimate of their net current value, and state highways and military equipment at their depreciated replacement cost. Depreciation is provided on a straight-line basis at rates calculated over the asset's estimated useful life. The government includes, among its liabilities, the future pensions of past and current public employees (under the contributory Government Superannuation Fund schemes), but excludes future payments of New Zealand Superannuation, and other social welfare benefits, which are noncontributory benefits financed from general taxation and paid at rates determined from time to time by the government. Also excluded from the asset side is the government's power to tax, as the valuation problems would be severe.

V. THE FISCAL RESPONSIBILITY ACT

With the passage of the **Fiscal Responsibility Act** (FRA) in June 1994, New Zealand has taken an innovative institutional approach to fiscal policy, balancing principles of responsible fiscal management with a degree of policy flexibility. As the culmination of earlier reforms, it emphasizes transparency and accountability, and imparts a strong medium- and long-term orientation to fiscal policy. Rather than prescribing quantified fiscal targets—the international experience was found to be disappointing (Box 7)—the FRA imposes fiscal discipline by setting out five principles for responsible fiscal management as legislative benchmarks. These principles are:

- "Reducing total Crown debt to prudent levels" by ensuring fiscal operating surpluses every year until this is accomplished;
- "Once they are achieved, maintaining these levels, by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues";
- "Achieving and maintaining sufficient levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future";
- "Managing prudently the fiscal risks facing the Crown;" and
- "Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years."

The FRA permits the government to depart temporarily from these principles, provided it explains its reasons and indicates how, and within what time frame, it plans to

Box 7. New Zealand: International Comparison of Fiscal Responsibility Legislation

Fiscal responsibility legislation is designed to provide a statutory framework for future governments to be accountable for discretionary changes in policies. It does not necessarily imply the setting of mandatory fiscal targets, nor define what is proper fiscal policy, but calls for accountability and transparency, and frequent and high quality reporting. As most of the legislation on quantitative targets is based on a cash accounting and reporting environment, the disappointing performance of such legislation to date may be attributed to the short-term focus of such an accounting environment. Fiscal responsibility legislation based on accrual accounting is fundamentally different as it shifts the focus to the long term. New Zealand is, so far, the only country with fiscal responsibility legislation based on accrual accounting, although similar legislation has been proposed in Australia by the governments of the State of New South Wales and the Australian Capital Territory.

Federal approaches to deficit reduction in the United States initiated with the Balanced Budget and Emergency Deficit Control Act of 1985 (commonly referred to as the **Gramm-Rudman-Hollings Act**). This Act set specific targets for each fiscal year from 1986 through to 1991, aiming at eliminating the deficit by that date. Those targets, however, were not achieved because the Act: did not include effective provisions for enforcing automatic cuts to meet targets; protected most important programs from cuts; and did not contain a mechanism to take account of the impact of forecast revisions on the deficit. Because of the short-term focus of the Act, deficit targets resulted in a range of practices designed to shift outlays between years and off the budget. The Act subsequently was ruled unconstitutional and amended in 1987. The successive **Budget Enforcement Act of 1990** shifted the focus from deficit targets to controls on receipts and expenditures on a multi-year basis. It imposed caps on discretionary spending and sequestration procedures to cut overspending on both discretionary and mandatory spending, largely health, social security, and welfare entitlement controlled by permanent laws. Nonetheless, sequestration has not been used in recent years, and only for relatively minor amounts in the past. On assuming office in 1993, the current administration enacted multi-year deficit reduction programs, the **Omnibus Budget Reconciliation Act**.

The **Maastricht Treaty on European Union** is the only example of a "supra-national" control of fiscal policies. The criteria against which a country demonstrates a sustainable financial position are that its budget deficit should be no more than 3 percent of GDP and its debt not more than 60 percent of GDP, to be measured by the European Commission. Penalties, such as fines and non-interest bearing deposits with the Community, are set for those countries which will adopt a common currency if they breach the criteria.

In **Germany**, the 1949 Constitutional Law (Grundgesetz) requires a current balanced budget, and limits borrowing to investment expenditure. The 1967 Growth and Stabilization Law (Stabilitäts und Wachtumsgesetz) requires a five-year rolling financial plan. In the **United Kingdom**, since 1993 the government operates a Medium-Term Financial Strategy (MTFS) based on monetary and fiscal policy. Within the MTFS, the government's current fiscal objective is to bring the deficit back to balance over the medium term. Six-monthly economic forecasts are required. In **Canada**, the government announced in 1993 a deficit target of 3 percent of GDP by 1996–97. Detailed multi-year spending limits in real terms are set for government departments. In **Japan**, fiscal policy controls relate to legislative restrictions on the issuing of bonds. Bond issues are limited under the Public Finance Law to financing public infrastructure. Deficit-financing bonds can also be issued, but special legislation is required by the Diet. In **Australia**, the Commonwealth government has recently proposed the introduction of a Charter of Budget Honesty aimed at producing better fiscal outcomes through increased transparency in the formulation and reporting of fiscal policy. Although similar in many respects to the Fiscal Responsibility Act, the Charter does not contemplate the adoption of accrual accounting.

return to them.[21] Future governments remain free to select different fiscal objectives, as long as they are consistent with the FRA's principles.

A crucial premise of the FRA is that increased transparency will promote prudent fiscal policy and better fiscal outcomes. To this end, the Act extended the provisions of the PFA and its amendments by making GAAP mandatory for budgeting and forecasting as well as for reporting for the whole government (the 1994/95 budget was the first fully accrual-based budget). It also introduces a number of specific **disclosure requirements** on fiscal policy intentions and objectives as an essential precondition for government accountability and transparency and, ultimately, to raise its credibility. No later than March 31 of each year, that is, three months before the budget is due, the government is required to specify in a **Budget Policy Statement** its broad strategic priorities for the upcoming financial year, its three year fiscal intentions, and indicate its long-term fiscal objectives regarding expenses, revenues, deficit, debt, and net worth; assess how these intentions are consistent with the FRA's principles for responsible fiscal management; and evaluates how they relate to the previous budget policy statement. Presentation of the budget is accompanied by the publication of two other policy documents: the **Economic and Fiscal Update** and the **Fiscal Strategy Report**. The former contains economic and fiscal forecasts prepared by the Treasury relating to the current and following two financial years;[22] the latter include an assessment of whether the update is consistent with the government's intentions of the last Budget Policy Statement, and an explanation if it is not. The Fiscal Strategy Report also projects the paths of all the relevant fiscal variables for a period of at least ten years, stating the underlying assumptions, so as to illustrate the likely future progress toward achieving the longer-term fiscal strategy.

So far, the FRA's implementation has been very successful. Fiscal developments have been signaled well in advance and key ministers are conscious of the meaning of the accrual-based five key fiscal variables—revenues, expenses, accrual operating balance, total debt, and net worth—as opposed to the cash measures used previously. Since predictability and

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[21]This is analogous to the override provisions of the Reserve Bank Act, the successful implementation of which has, in turn, inspired the FRA. In order to comply with the principles of the FRA, the present government has defined "prudent" debt levels to be 20 percent of GDP in the medium term and, to accomplish this, it plans to run annual fiscal surpluses of at least 3 percent of GDP and to reduce expenses to below 30 percent of GDP.

[22]An economic and fiscal update must also be published in December. A separate Pre-Election Economic and Fiscal Update must be published by the Treasury four to six weeks before each general election. Every economic and fiscal update must be accompanied by a Statement of Responsibility to guarantee, inter alia, the integrity of the disclosures contained in the update on the basis of the information available before the day on which the contents of the relevant aspects of the update were finalized.

signaling of economic and fiscal policy are keys to its success, FRA's implementation appears to have received a favorable reaction from market analysts and the media—there was little, if any, discernible market movement in response to the 1995 budget.

VI. THE IMPACT OF THE REFORMS ON THE FISCAL POSITIONS AND GOVERNMENT SPENDING

Undoubtedly, the fiscal situation improved dramatically over the reform period. It is, however, difficult to disentangle the effects of fiscal reforms from those brought about by fundamental reforms carried out in other economic areas such as trade and capital account liberalization, financial and foreign exchange market deregulation, inflation targeting and, finally, industrial relations deregulation. Furthermore, cyclical developments played an important role. In fact, only limited progress was made in reducing the deficit up to 1990, and fiscal balance was not reached until 1994, after the economic upswing of mid-1993. There are indications, however, that after 1991, the full effects of all the reforms contributed to raising tax revenues and reducing expenditures.

The reforms initially required additional spending.[23] Indeed, despite the Labour government's intention, total expenditure as a share of GDP continued to expand until 1990/91, reaching 42 percent of GDP. Expenditure started to decline as a share of GDP only after 1990/91 and was brought to below 38 percent of GDP in 1993/94. This was due to a combination of factors: social expenditure cuts introduced by the National Government starting from 1991 along with a rapidly declining unemployment rate (from 11 percent in 1991/92 to just above 6 percent in mid-1995); the initial payoffs of the financial management reforms in terms of cost savings and enhanced efficiency in the production and delivery of public services; and improved expenditure control mechanisms (see below). On an accrual basis, government expenditures remained broadly stable in nominal terms, implying a sharp reduction as a share of GDP from 42 percent in 1990/91 to 35 percent in 1994/95.

With the new accounting system, a widespread tendency has emerged to underspend the budgeted allocations, as reflected by comparing the central government budgets and outcomes presented in Table 3. This is attributable to an increased capacity on the part of departments and agencies to manage independently their own budgets and resources. For instance, the RBNZ was able to reduce its operating expenses by 46 percent in real

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[23]For instance, as the financial management reforms of the core public sector proceeded, the share of administration expenses out of total financial net expenditure increased steadily from 6 percent in 1984/85 to 10 percent in 1993/94, reflecting costs incurred in the reorganization of departments and agencies as well as additional spending faced by Inland Revenue to meet the implementation costs of the various tax reforms.

Table 3. New Zealand: Central Government Budgets and Outcomes, 1991/92-1995/96 1/

	1991/92		1992/93		1993/94		1994/95		1995/96	
	Budget	Outcome	Budget	Outcome	Budget	Outcome	Budget	Outcome	Budget	Outcome
					(In millions of New Zealand dollars)					
Total revenue	28,051	27,635	27,327	27,629	28,112	29,508	31,941	33,648	34,605	35,059
of which:										
Total tax revenue	26,273	24,843	25,974	25,980	26,486	28,203	29,337	30,213	31,931	32,233
Direct taxation	16,590	15,508	16,358	16,186	16,456	17,987	19,323	19,843	21,193	21,255
Indirect taxation	9,683	9,335	9,616	9,794	10,030	10,216	10,014	10,370	10,738	10,978
Net surplus attributable to SOEs and Crown entities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	307	-553	317	-2
Total Expenditure	29,790	29,174	30,627	29,416	30,390	29,174	30,960	30,400	31,635	31,743
of which:										
Social security and welfare	10,433	10,620	10,889	10,697	10,831	10,528	11,823	11,724	11,897	12,240
Education	4,504	4,467	4,606	4,504	4,763	4,631	4,815	4,803	4,967	4,949
Health	3,847	3,855	3,894	3,874	4,059	4,103	4,842	4,886	5,137	5,228
Finance costs 2/	4,469	4,147	4,348	3,899	3,971	3,557	3,603	3,757	3,547	3,703
Financial/operating balance 3/	-1,739	-1,539	-3,299	-1,787	-2,278	424	1,288	2,695	3,287	3,314
					(In percent of GDP)					
Total revenue	38.5	37.9	35.9	36.3	34.4	36.2	36.9	37.6	38.1	38.2
of which:										
Total tax revenue	36.0	34.1	34.1	34.1	32.4	34.4	33.6	55.8	56.6	35.1
Direct taxation	22.8	21.3	21.5	21.2	20.1	21.9	22.1	22.6	23.1	23.2
Indirect taxation	13.3	12.8	12.6	12.9	12.3	12.5	11.5	11.8	11.7	12.0
Net surplus attributable to SOEs and Crown entities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.4	-0.5	0.3	-0.0
Total Expenses	40.3	40.0	40.2	38.6	37.2	35.9	35.4	34.7	34.5	34.6
of which:										
Social security and welfare	14.3	14.6	14.3	14.0	13.3	12.9	13.5	13.1	13.0	13.3
Education	6.3	6.1	6.0	5.9	5.8	5.7	5.5	5.5	5.4	5.4
Health	5.3	5.3	5.1	5.1	5.0	5.0	5.5	5.6	5.6	5.7
Finance costs 2/	6.1	5.7	5.7	5.1	4.9	4.4	4.1	4.2	3.9	4.0
Financial/operating balance 3/	-1.8	-2.1	-4.3	-2.3	-2.8	0.2	1.5	3.0	3.6	3.6

Source: New Zealand Treasury, Economic and Fiscal Outlook, various issues.

1/ From 1992/93 onward, the reporting entity includes all SOEs and Crown entities as well as the Reserve Bank of New Zealand. Since the budget was prepared on a cash basis up to, and including, 1993/94, for comparability cash-based budget and outcome figures are presented up to 1993/94, and accrual-based figures from 1994/95 onward.

2/ Finance costs include interest and other costs associated with the stock of public debt, but excludes principal repayments.

3/ Financial balance for 1991/92-1993/94, operating balance from 1994/95 onward.

terms over the period 1988 to 1993 by reducing its staff from 570 to 320 while, at the same time, substantially increasing productivity.[24]

In addition to the reforms in the core public sector, there have been institutional changes in government expenditure control mechanisms. In early 1989, a **Cabinet Expenditure Review Committee** was established to develop final expenditure proposals for approval by Cabinet. Its task was to assist key ministers instill fiscal discipline by developing a commitment to the budget process and a better understanding of the implications of particular decisions for fiscal outcomes. In early 1991, an **Official Committee on Expenditure Control** (OCEC) was formed to assist the Cabinet Committee. This was chaired by the Treasury and had representatives from both the Prime Minister's Office and the State Service Commission. Its task was to work closely with departments to identify and assess the saving options. According to Ruth Richardson (1995), Minister of Finance at the time, "it was at this point, above all, that the value of the Public Finance Act became especially apparent." The emphasis on outputs meant that ministers had meaningful information about the services provided by their departments and were, henceforth, in a position to make informed trade-offs between competing priorities.

VII. CONCLUDING REMARKS

The New Zealand experience in reforming the public sector has been remarkably successful and many aspects of the reforms are now regarded as highly desirable objectives to pursue. To date, the experience remains a unique blend between microeconomic theories and organizational science that has ultimately enhanced the capability of governments to focus on macroeconomic issues. The trade-offs between increased delegation and the freedom to manage on one side, and the removal of central control on spending decisions by government departments on the other, along with the shift from input costs to outputs, were essential features of the reforms which ultimately enhanced the government's ability to control expenditure.

Transparency and accountability now pervade the way the New Zealand government operates. This was achieved by subjecting SOEs at first and the whole of the government later to the same set of rules and regulations (including taxation), disclosure requirements, and accounting practices prevailing in the private sector. As a consequence, accounting standards

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[24]Although the RBNZ is not itself subject to either the State Sector Act or the Public Finance Act, it operates under the same principles of accountability. Under the Reserve Bank Act of 1989, the RBNZ cannot avail of the automatic right to the seignorage on currency issues and the Governor of the Bank is required to stipulate a five-year funding agreement with the Minister of Finance. The agreement sets the amount the RBNZ is allowed to spend in meeting its operating expenses related to its noncommercial activities such as foreign exchange dealing, provision of settlement account services, and government banking.

are now disclosed, discussed, and ultimately decided in accordance with the New Zealand accounting profession which is, in turn, closely linked to constantly evolving international conventions. Although the application of generally accepted accounting practice still poses some challenging problems in compiling the Crown balance sheet—such as the valuation of intangibles—it has proven to be an extremely valuable managerial tool to enhance accountability in a decentralized financial system.

The definition of departments' outputs and its separation from political outcomes is crucial to transparency and accountability relationships within the government and between the government and the public at large. This definition is instrumental in clarifying the information requirements in order to appropriately cost the provision of public services and to provide the incentives to perform. In the course of the reform process, it has also led to a critical evaluation of the role of the public sector in the economy and the way it operates. As a result, this role has been substantially reduced and limited to the provision of public services. From the initial corporatization to the financial management reforms within the core public sector, distortions associated with monopoly situations were removed by first allowing contestability conditions to prevail and later privatizing.

There are a number of lessons to be learned from the New Zealand experience in terms of sequencing, public acceptance, and sustainability of reforms in the public sector area. At the outset, reforms were initiated in a situation where there was consensus on the excessive size of the government in the economy and an impending financial crisis. Since fiscal policy was to focus on medium-term permanent improvements rather than on short-term immediate stabilization efforts, the approach was a gradual one. Ex-post, all the reforms within the public sector, appear as a well conceived and mutually reinforcing package in terms of sequencing; in practice, however, the end points became clearer as the reforms proceeded so that most of them were a program-in-the-making. Consensus and credibility building took some time but, since accountability and transparency early on became the key words of the reform agenda, most of the measures were comprehensive and did not envisage any exceptions. This facilitated the public's understanding and acceptance of the reforms, minimized rent-seeking behaviors and, ultimately, was crucial in making the reforms politically feasible. Public acceptance was, in turn, a necessary element to sustain the reform effort across four terms of governments, including the shift from Labour to National governments. The simplicity of the political system was also a critical factor in the success of the reforms. Legislation could be processed and approved in a relatively short time and contributed to the speed of decision making.

Can the New Zealand experience be transferred, in full or in part, to other countries? As always in economics, applying the *ceteris paribus* proviso, the answer would be a qualified yes. First of all, it does take time. Hence, political support and public acceptance are intrinsic ingredients for the success of the reforms. Second, the implementation of some of the reforms may initially increase expenditure rather than reduce it, while others may require unpopular decisions such as divestment. Therefore, what is politically feasible becomes essential in

dictating the sequencing and the pace of the reforms. Third, New Zealand's reforms covered the whole government administration. This was possible given the relatively small size of the government and the absence of any substantial form of state or local governments. Reproducing New Zealand's reforms in countries with more complex administrative structures and political systems would be a greater challenge. Also, reforms in the public sector were part of a broader range of reforms across the whole spectrum of the economic activities, including tax and welfare systems, which mutually reinforced each other and helped create a culture for reform. Finally, accrual accounting is being adopted increasingly by a number of countries, developed and developing, and appears to have improved the ability to identify inefficiencies in the costing and provision of public services and enhanced accountability.

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