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NEW ZEALAND'S RESPONSIBILITY BUDGETING AND ACCOUNTING SYSTEM AND ITS STRATEGIC OBJECTIVE: A COMMENT ON JONES AND THOMPSON (2000)

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ABSTRACT: *This comment on Jones and Thompson (2000) draws on extensive and largely invisible secondary regulation to suggest that the strategy designed into New Zealand's responsibility budgeting and accounting system seems to be privatization. It also explains that government departments are quasi-investment centers, with chief executives held responsible for assets but prevented from being able to replace assets by resource-eroding processes designed into the system. Because New Zealand's financial management system has evolved over time and much of that evolution has been through secondary regulation, the need for careful attention to current sources of information is emphasized.*

Jones and Thompson (2000) explained responsibility budgeting and accounting as part of a remote control governance "framework of structural, procedural, and monitoring/ reporting relationships" (205) intended to ensure that managers' actions are consistent with an organization's adopted strategy (206). This remote control framework increases managers' discretion by releasing them from detailed rules, and increases their decision-making authority. It does so, however, in the context of incentives intended to align managers' interests with the organization's strategies, and the use of financial measures to monitor performance (208).

Clearly, Jones and Thompson view a responsibility budgeting and accounting system as a device which enables an organization to achieve its chosen strategy. This view of accounting is consistent with ideas of accounting processes as tools of a dominant set of interests (Olsen et al. 1998, 442; see also Lehman 1992, 78, 83, 145). It contrasts with the accounting profession's preferred depiction of accounting and financial reporting as a technical, rather innocuous and neutral activity.

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Some of the examples Jones and Thompson used to illustrate their explanation of a responsibility budgeting and accounting system were drawn from New Zealand's public sector financial management system as explained by Scott and Gorringe (1989) and Schick (1996). New Zealand’s financial management system has evolved over time, with much of that development occurring through the almost invisible secondary regulatory powers delegated to the Treasury by the Public Finance Act (s. 80). This comment on Jones and Thompson draws on a detailed analysis of New Zealand's financial management system, which includes the secondary regulation (Newberry 2002), to elaborate on their explanation of that system and then to identify the strategy, albeit an unstated one, that seems to have been designed into New Zealand's system.

RESPONSIBILITY CENTERS AND TRANSFER PRICES

Jones and Thompson argued that all responsibility centers should be investment centers which receive competitively neutral prices but noted that most of New Zealand’s government departments are quasi-profit centers, and only a few are investment centers (212, 218). An understanding of New Zealand’s financial management system requires deriving another type of responsibility center from Jones and Thompson's terminology and explanations, one which occupies an intermediate position between a quasi-profit center and an investment center. Managers of a quasi-investment center would be responsible for assets and subject to a capital charge in the same manner as for an investment center but, in the manner of a quasi-profit center, their revenues would be notational (212).

Until 1994, New Zealand's Public Finance Act 1989 suggested that departments are either investment centers or quasi-profit centers, depending on the mode of appropriation. Mode C appropriations were appropriations for prices, while mode B appropriations are appropriations for full cost and therefore act as notational quasi revenues.[1] With two modes of appropriation, the conditions and restrictions imposed on a department were intended to depend on the mode, but the idea was impractical because it assumed that a department would receive either all mode B appropriations or all mode C appropriations but not a mix of both, even though such a mix was both feasible and likely. Scott and Gorringe (1989) preceded the July enactment of the Public Finance Act 1989 but by October 1989 the idea of departments as either quasi-profit centers or investment centers, depending on the mode of appropriations, had been abandoned. Jones and Thompson's comment that too few departments have been classified as mode C (218) is misleading. No government department in New Zealand's public sector has ever been classified as a mode C department and none have received mode C appropriations. All departments receive mode B appropriations and they are therefore mode B departments. Jones and Thompson’s explanation which allows them to conclude that departments are quasi-profit centers excludes consideration of the secondary regulation.

The Public Finance Act 1989 interprets the cost of outputs as their full cost (s. 2). It requires mode B departments to pay any reported surplus to the Crown (s. 14), but it does not require them to pay a return on assets. Departments must manage their own cash but they are prohibited from investing surplus cash. The Treasury sweeps departmental bank accounts and conducts all investing activities, paying interest receipts to the Crown (s. 23). Departments have the flexibility to reorganize balance sheet composition, and so they can purchase and dispose of fixed assets within the balance sheet (s. 11). With the exception of the freedom given to departments to reorganize the balance sheet, it might appear from the act that mode B departments are quasi-profit centers.

Jones and Thompson referred to Anthony's Project Prime as the source of ideas for the restrictions imposed on investment centers and quasi-profit centers. Anthony had advocated the use of historical cost accounting to report assets in combination with a capital charge but no depreciation. Jones and Thompson stated that the full costs for mode B departments include depreciation but exclude taxes and a return on funds employed, and that mode B appropriations reimburse departments for their output costs incurred. Unlike Anthony's Project Prime model, the secondary regulation requires New Zealand's government departments regularly to revalue assets, with the revalued asset base used to determine both depreciation expense and a capital charge expense which departments must pay, with both included in the full cost of outputs. The capital charge was imposed as a surrogate for interest, taxes, and dividends although it has no private sector counterpart (Robinson 1998), and it is calculated at a rate that is intentionally biased high (Lally 1993; Newberry 2002). These developments occurred in the context of rhetoric about competitive neutrality, but with departments' reported asset values also biased high in relation to the freedom allowed private sector counterparts, the effect is higher depreciation expenses and high capital charges.

The granting of an appropriation to a department should not be taken to mean that a department is reimbursed as Jones and Thompson suggest. There is, necessarily, a retrospective aspect to appropriations because it is illegal to incur costs without an appropriation. Through secondary regulation, however, a distinction has been drawn between an appropriation as permission to incur expenses, and any reimbursement of those expenses. The amount of money provided to a department for outputs is, as Jones and Thompson advocate, prospectively calculated, with that calculation based on prospective full costs to give notational prices. If departments' actual costs exceed the prospectively calculated amount they may receive additional appropriations, but they will not receive additional reimbursement.

Despite the obvious high biasing of output costs, competitive neutrality rhetoric was used when ministers were advised to check departments' output cost calculations (called prices) against other suppliers' prices as a means of ensuring value-for-money. That rhetoric continues today (see for example, Treasury pricing guidelines, 1999, www.treasury.govt.nz/publicsector/#guidance). The advice to the minister of finance in the early 1990s was that these pricing requirements would make unnecessary any higher level intervention to force private sector involvement. Stated less subtly, the requirements seemed likely to inflate departments' output costs to such an extent that alternative providers would be encouraged to enter the market, an objective that is acknowledged in the Treasury's pricing guidelines.

When the government's obvious, and fairly open, privatization intent became politically unsustainable in 1993, the price comparison aspect of the financial management system was driven to a more detailed level by focusing on output components. With the support of a Coopers and Lybrand report (1995) recommending that the costing of output components was good practice, price comparisons at this output component level were proposed. At this more detailed level, ministers' involvement became unnecessary because officials could operate the system. Arguably, this depoliticized the system’s privatization intent, allowing privatizing initiatives to continue while concealing them from public scrutiny.

Chief executives' performance agreements require them to demonstrate cost efficiency by showing that the full cost of each output component is less than the price from possible alternative suppliers. If the department cannot produce at a lower cost, then contracting out seems to be expected. Further review processes have been devised in which central agency officials (Treasury, State Services Commission, and Department of the Prime Minister and Cabinet) may check these output component costs. The comments noted above about the intentional high biasing of costs together with the competitive neutrality rhetoric apply equally at this output component level.

ECONOMIES AND DISECONOMIES OF SCALE

Jones and Thompson noted that "economies of scale are produced by spreading fixed expenses over higher volumes of output, thereby reducing unit costs" (208). They did not comment on what happens when contracting out reduces the scale of operations. Scott and Gorringe (1989) stated that New Zealand's government departments would be prevented from developing other outputs. Departments losing production volumes of outputs and output components must inevitably incur diseconomies of scale because the fixed costs must be spread over the remaining volumes. Once the loss of these production volumes commences, the resulting diseconomies of scale may be expected to cause both production and financial difficulties because the nature of fixed costs means that they cannot be scaled down smoothly.

When movement to the more detailed output component costing processes was proposed, the potential for this development to cause financial difficulties for departments was recognized. The system’s intent was postulated as expenditure reduction, and this development was considered consistent with that intent. The performance-based portion of chief executives’ remuneration was increased from ten percent to fifteen percent, and the requirement that chief executives demonstrate cost-effective output and output component production was included in their performance agreements. In effect, chief executives' personal incentives were increased to induce them to cause diseconomies of scale and financial distress to their departments.

RESPONSIBILITY CENTER OPERATING RESULTS AND LIABILITIES

According to Jones and Thompson, investment centers should be paid competitively neutral prices and should not be allowed to retain profits. This is consistent with the hard budget constraints advocated for public sector agencies by the World Bank (1995). It applies an assumption that such a budget constraint in conjunction with a prohibition on borrowing allows asset replacement but not expansion, although the validity of this asset replacement idea is, at best, dubious (Clarke 1982). New Zealand’s Public Finance Act suggests that this is exactly the approach adopted, but examination of the secondary regulation reveals that the system's settings operate to prevent asset replacement while privileging off balance sheet financing arrangements which are debt in everything but name.

Prices to Allow Asset Replacement

The price paid to New Zealand's government departments for their outputs is the prospective full cost of outputs and the rhetoric suggests that, consistent with ideas about investment centers, departments should be able to replace their assets. Quite apart from the dubious validity of the ideas about asset replacement, the system operates to prevent departments from replacing major assets and to cause them, eventually, to encounter extreme financial distress. Just two examples of the several processes which cause this effect are the lack of attention to departments' financial condition on the commencement of the reformed financial management system and resource-eroding processes designed into the system via secondary regulation.

First, the idea of departments as quasi-investment centers which are responsible for maintaining and replacing their assets implies that departments should commence this regime from a realistic position, but that did not happen. Although much was said at the time of conversion to the reformed financial management system that departments were bloated and their costs contained excess fat, examination of the financial condition of some departments on conversion reveals that they were in considerable financial distress, often with negative working capital, and they did not possess the accumulated resources needed to contribute to the future replacement of partially worn assets. Second, although departments receive as revenue the prospective full costs of output production, they incur expenses which either must be excluded from output costs, or are viewed as extra output costs over and above the prospective costs. Departments must meet these expenses from within their pre-existing resources; appropriations permit them to incur these expenses but they receive no reimbursement. The number and type of the costs departments must meet from their pre-existing resources inevitably erodes their resources, ensuring that eventually departments will be unable to replace assets. Restructuring costs, for example, imposed either as a result of required restructuring or in an attempt to adjust to resource constraints are classified as other expenses, excluded from output costs, and not reimbursed.

Operating Results and Surplus Retention

When Jones and Thompson argued that a responsibility center should not retain its profits, they did not comment on losses (211). Similarly, New Zealand's Public Finance Act 1989 requires that departments must pay to the Crown any operating surplus, but is silent on deficits (s. 14). The philosophy adopted and developed in New Zealand is that an operating surplus belongs to a department's owner, the Crown, and should be paid in full to the owner. Any operating deficit, however, indicates poor departmental performance and is not the owner's problem. An operating deficit must be borne by the department. This philosophy makes clear the downward pressure on departments' net assets because any surplus must be paid to the Crown and any deficit reduces net assets.

Through secondary regulation, and in apparent contravention of the Public Finance Act 1989, the Treasury declared its right to define the operating surplus. It requires departments to analyze their reported operating result into components, each of which is considered separately. Any component of the operating result that is a surplus must be paid to the Crown while any component which is a deficit must be borne by the department. This rule ensures that a department cannot do better than to end the year with reported net assets at the same level as the previous year. For this to happen, each component of the operating result would need to be either nil or a surplus. Further, one component is other expenses, while another is the amount of any realized revaluation reserves. A department reporting either of these must inevitably end the year with a reduced level of net assets.

Borrowing and Liabilities

According to Jones and Thompson, New Zealand's adoption of accrual accounting means that the liabilities arising from long-term contracts for the delivery of goods or services must be stated in present value terms (218-219). This too requires clarification. The Public Finance Act prohibits raising a loan without an act of Parliament but excludes from its interpretation of raising a loan contracts for the purchase of goods and services even though such contracts clearly are included in the public securities guaranteed by the taxpayer. The act interprets such contracts as giving rise to commitments, rather than liabilities, and interprets commitments as "*future* expenses and liabilities" (s. 2, emphasis added). These commitments must be disclosed in a statement of commitments as part of the annual report, but they are not recognized in the balance sheet (or statement of financial position as it is called in New Zealand). In effect, these commitments are off-balance sheet financing arrangements which, although notorious in the private sector, are advocated in the public sector because, according to the Treasury, they reduce the Crown's borrowing requirements. Given the stated aims of the Public Finance Act 1989, which include parliamentary scrutiny and safeguarding public assets partly through control over raising loans and securities, the mere existence of this loophole in the act and the fact that commitments are not subject to prior parliamentary scrutiny seems remarkable.

THE STRATEGIC OBJECTIVE OF NEW ZEALAND'S FINANCIAL MANAGEMENT SYSTEM

The Treasury promoted the idea of a responsibility budgeting and accounting system as a tool for use to achieve the government's strategic objectives. New Zealand's key reformers express pride in the system and in the incentives designed into it (see Scott et al. 1997), thus suggesting that the nature of any overall strategy may be deduced from the system's settings. The financial management system's structures and processes are highly consistent with those advocated by Savas (1982, 1987, 2000) to facilitate privatization of the public sector. These include the relentless erosion of departmental resources, the establishment of a limitation of government structure and competitive conditions (which would be all the more advantageous for privatization should departments be handicapped with requirements to report high output costs and output component costs), and the processes which prevent departments from replacing their assets while privileging the private financing arrangements typified by the long term contractual arrangements for the purchase of goods and services. All of these conditions and more are evident in New Zealand's financial management system.

Internationally, public sector adoption of responsibility budgeting and accounting systems is considered a crucial part of New Public Financial Management (NPFM) which is, in turn, an essential component of NPM. Although both NPM and NPFM are widely advocated as providing technical means to improve public sector performance, they emerged following recognition that privatization was politically unpopular as an objective in itself, but may be acceptable under pragmatic circumstances such as public sector inefficiency or inability to provide effective services. According to Savas (2000, 316), "privatization is the new public management." Close examination of New Zealand’s responsibility budgeting and accounting system reveals a system highly consistent with privatization processes, thus suggesting that a privatization strategy has been designed into the system.

The evolution of New Zealand’s financial management system both over time and through the secondary regulatory process means that early explanations of the intended system (Scott and Gorringe 1989) are outdated, while more recent assessments (Schick 1996) may have been conducted without full appreciation of the secondary regulation. This creates difficulties for those such as Jones and Thompson (2000) who focused on responsibility budgeting and accounting, and illustrated their discussion with examples from the above explanations of New Zealand’s system without realizing that their sources did not provide full descriptions of the current state of that system. It is to be hoped that this explanation of the system as it existed at the end of 2001, together with an assessment of the strategy designed into the system, will provide a more up to date and comprehensive base for such assessments.

NOTE

1. In 1994, an amendment to the Public Finance Act changed the interpretation of mode C appropriations from one that implies a price to one that is clearly an expense (s. 2).

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