

REFORMING FINANCIAL MANAGEMENT IN THE PUBLIC SECTOR: LESSONS U.S. OFFICIALS CAN LEARN FROM NEW ZEALAND

BY IAN BALL, TONY DALE, WILLIAM D. EGGERS, AND JOHN SACCO

Executive Summary

In governments across the world, public-sector financial systems are being transformed more fundamentally than at any time in decades.

The changes taking place—in governments from Wellington, New Zealand to London, England—respond to a number of deficiencies of government accounting and financial-management systems, specifically,

- *Accountability* is unclear.
- *Goals and performance* requirements of government departments are *poorly specified*.
- *Incentives* often *encourage dysfunctional behavior* (for example, year-end spending).
- *Assets* are *poorly maintained*, and changes in value or depreciation are poorly recorded.
- *Losses and long-term liabilities* are *hidden* by cash-based accounting systems.
- *Responsiveness* to changing circumstances is *slow*.
- *Global competitive forces* that demand efficiency for survival are often ignored in designing governmental financial systems.

Moreover, an important consideration for fiscal policy is intergenerational fairness. By allowing governments to hide both their liabilities and the real state of their finances, traditional government financial reporting enables governments to pass off present costs to future generations.

These problems are receiving attention in state and local governments in the United States. In response to the inadequacies of traditional government accounting and financial management, the Governmental Accounting

Standards Board (GASB), which is charged with setting standards for government financial reporting, proposed major changes in government financial systems. Part of the change includes moving from traditional modified cash accounting (officially called modified accrual) to the business model of accrual accounting.

As U.S. state and local governments begin the transition to new and improved financial and accounting systems, they could find no better model for how to get from the traditional to the new than in New Zealand. New Zealand has moved further than any other government in the world in revamping its financial management, accounting, and budgeting systems.

New Zealand's reforms have four main features:

- Adoption of accrual accounting and budgeting;
- Introduction of a capital charge and decentralized authority to buy and sell assets;
- Output-based management and budgeting; and
- Devolution of financial decision making coupled with increased accountability.

Together, these reforms have had a dramatic impact on the New Zealand public sector. Thanks in part to these reforms, the quality of financial information has vastly improved, efficiency has increased, assets are managed more proactively, accountability is stronger, and public disclosure of information has improved immensely.

For U.S. policymakers embarking on overhauling and modernizing their financial management and accounting systems, the highly acclaimed New Zealand reforms offer powerful lessons. This study concludes with *seven strategic lessons* on financial-management reform for U.S. policymakers.



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Part 1

Introduction

Getting financial incentives right is essential in management reform. In government, no less than in the marketplace, money is a powerful signal; it prods entities to produce more or less, to care about costs or to ignore them, to be more or less efficient, to take risk or to avoid it. The old command-and-control system gave managers the message that risk would not be rewarded, that inefficiency would not be penalized, that what mattered most was complying with present rules and restrictions.

—Allen Schick, *Professor of Public Policy, University of Maryland*¹

When Stephen Goldsmith was elected mayor of Indianapolis in 1992, the city had a great credit rating and slick, four-color glossy financial reports rivaling those of Fortune 500 companies. But when he starting asking around to find out how much it cost to fill a pothole, plant a tree, or clean out the sewers no one could tell him. Without this data, it was impossible to know whether city services were being delivered efficiently, and he couldn't accurately compare the costs of public-sector delivery with that in the private sector. Explains the mayor, "We used standard government accounting principles that prevented our managers from stealing money, but did nothing to stop them from wasting it. . . . As a direct result, city employees neither knew nor cared about their costs of doing business."² We have heard similar refrains from hundreds of public officials and elected officeholders.

A. Problems with Public-Sector Accounting Systems

The problems Mayor Goldsmith encountered with his city's accounting and financial-management systems upon taking office were not unique to Indianapolis. They are common to government accounting and financial-management systems all over the world. Six major deficiencies are characteristic of government financial systems:

- *Accountability* is unclear.
- *Goals and performance* requirements of government departments are *poorly specified*.
- *Incentives* often *encourage dysfunctional behavior* (for example, year-end spending).
- *Asset levels* are *poorly maintained*, and changes in value or depreciation are not required to be recorded.

¹ Allen Schick, "The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change," State Services Commission, Auckland, New Zealand, 1996, p.63.

² Stephen Goldsmith, *The 21st Century City: Resurrecting Urban America* (Regnery Gateway Publishing: Washington, D.C., 1997), pp. 59–60.

- *Losses, long-term liabilities, and future revenues are obscured* by modified cash-based accounting systems.
- *Responsiveness* to changing circumstances is *slow*.
- *Global competitive forces* that demand efficiency for survival are often ignored in designing governmental financial systems.

B. The Current Movement to Reform and Reinvent Government

In response to these widely acknowledged inadequacies, there is a growing movement to overhaul government financial management, reporting, and accounting systems. Australia, Great Britain, and Canada are among the nations undertaking a complete overhaul of their financial-management systems.

In the United States, the Government Accounting Standards Board (GASB), which establishes standards of financial accounting and reporting for state and local governments, is taking a lead role in pushing public-sector entities to adopt financial and accounting practices more closely aligned with the private-sector business model.

GASB's new financial accounting standards for state and local governments would take effect the first fiscal year after June 15, 2001. These require, for the first time, that state and local governments use accrual accounting at a government-wide level, meaning that both short- and long-term assets and liabilities must be fully reported for the government as a whole. This contrasts with the present accounting system in which only the government's cash and other current financial resources are recorded, and then only by separate funds (except for enterprise funds). Recording the value of all assets and liabilities constitutes a sea change in government financial reporting and management, making it difficult for governments to hide liabilities and pass on current costs to future generations without public scrutiny.

Because GASB operates under the principle of "due process" and "general acceptance" for its standards, its proposed new standards have been thoroughly discussed and debated for years among state and local auditors, comptrollers, financial officers, elected officials, bond raters, lenders, citizens, and other interested parties. Within the past two years the standards have come close to gaining general acceptance.

In addition to transforming government accounting, state and local governments in the United States are moving to improve financial management in general. In the budgeting area, for example, there is a movement to expand the focus beyond inputs for the budget (i.e. number of vehicles and number of employees) towards a "performance-based" or "output-based" management and budgeting model. This approach was first pioneered by the city of Sunnyvale, California in the 1970s and since then numerous cities and states have experimented with performance-budgeting models.³ Few other U.S. governments, however, have moved as far as Sunnyvale in basing budgeting and management decisions on outputs, instead of inputs.

³ For example, the state of Texas has a fully performance-based budget system.

The History of GASB's Movement to Accrual Accounting

Growing acceptance of GASB's proposed standards for a government-wide and accrual approach took decades to emerge. One of the important events leading to the consideration of the government-wide accrual approach occurred in 1984 when GASB was created. GASB was designed as an independent standards-setting board to serve a wide range of user needs, not just government officials. To provide GASB with visibility and stature, it was given equal status with the Financial Accounting Standards Board (FASB), the rule-making body for the business sector.

The rule-making body replaced by GASB came under the auspices of the National Council of Governmental Accounting (NCGA). Historically, NCGA and its predecessors rejected a government-wide accrual-type model in favor of a cash-based fund model. The cash oriented fund approach was considered most appropriate for government policy-making needs. However, with mounting fiscal turmoil experienced by several major cities in the 1970s and with growing opposition to NCGA as a private rule-making body, NCGA relinquished rule-making authority to GASB.⁴

Three years after being organized, GASB took an important step in the movement to the government-wide accrual model by developing a new framework for state and local financial reporting called Concepts Statement No. 1 (1987). It established several goals as the foundation for financial reporting. These were:

- Interperiod equity (also called intergeneration equity).
- Efficiency.
- Compliance.

Although GASB did not say accrual was imperative, the first goal, and to some extent the second, could not be achieved without some type of accrual accounting and government-wide reporting. For interperiod equity to be assessed, all costs have to be matched against the revenue for the year; otherwise, payment for promises and commitments made today could be passed on to future generations.

Following the Concepts Statement No. 1 in 1987, GASB took a partial approach to broaching a government-wide and accrual model. In 1990, GASB set accrual standards (Statement 11) for the revenue statement (formally called revenue, expenditures, and changes in fund balances) but not the balance sheet. In 1993, this partial effort (Statement 11) was put on permanent hold until GASB could develop a full-reporting model. Finally, in 1997, GASB decided to offer a major government-wide and accrual element to address the issue of long-term assets and liabilities and to be of value to a wide spectrum of users.

Nonetheless, GASB felt that the fund approach served some users and proposed to allow both the accrual-based government-wide and cash-based fund approach to constitute the financial reporting model. Because two approaches were included, the reporting model is called the dual perspective. Although the dual perspective is still undergoing changes, adopting business-like accounting standards for state and local government has more support than anytime in decades.

⁴ Although GASB's main efforts have been on financial reporting they have not completely ignored other facets of the financial-management systems. To help address the efficiency element of Concept Statement No. 1, GASB published a document called Service Effort and Accomplishment Reporting (SEA, 1990). The document laid the groundwork for performance measures that went far beyond the traditional revenue-expenditure and asset-liability oriented approach to assessing the operating results and health of the government. SEA delved into the question of assessing the efficiency and effectiveness of delivering goods and services to residents. GASB's SEA document, and GASB's present efforts to explore incorporating performance measures into annual reporting, are only part of this movement in the United States. However, beyond financial statements, GASB has limited influence to change either the performance measures or budgeting facets of financial-management systems.

To develop a broad and integrated financial-management system, accrual accounting, output-based budgeting and performance measures, devolution of decision making, and strict accountability mechanisms represent the future of public-sector financial management. For lessons on how to implement these reforms in a comprehensive, holistic manner, governments all over the world are increasingly looking to New Zealand—which has moved further towards a business model of financial management than any other government in the world, with impressive results.

C. The New Zealand Model

Before it introduced its reforms in the 1990s, New Zealand’s financial-management system had the same problems as most other governments. Previously, the New Zealand government had operated a conventional cash-based, centralized, government-accounting system, within a fund-based structure. The system was developed in the late 1960s and had been influenced by the Planning, Programming, Budgeting System (PPBS) model that was also popular in government budgeting in the United States. The system was program-based within a relatively centralized management system.

The fiscal position of the New Zealand government at the time was typical of many governments world wide. A significant proportion of tax revenue was dedicated to meeting annual financing costs. Long-term deficits and accumulated debt were at highly constraining, and possibly unsustainable, levels.

In response to the inadequacies of traditional government accounting and financial management, New Zealand made sweeping reforms. The revolutionary and innovative reforms include:

- Budgeting, accounting, and appropriations are now all done on an *accrual* basis.
- There is a *charge for the use of capital*. The charge rate is benchmarked to the private sector (adjusted for the impact of taxation).
- All budgeting and management is done according to *outputs not inputs*.
- *Managerial discretion* is *significantly greater* than in other nations.
- *Accountability* mechanisms have real teeth, with incentive mechanisms more systematic and rigorous than perhaps any other nation in the world.
- The reforms apply some simple general principles across the whole of government to achieve a *high degree of internal consistency*.

These financial reforms did not occur in isolation. They were part of a movement to make the New Zealand economy more competitive as well as to make the government more competitive and accountable. The financial-system innovations occurred in conjunction with significant deregulation of the economy, restructuring of government activity, a large reduction in government’s share of the GDP, and extensive corporatization and privatization. A recent U.S. General Accounting Office (GAO) study indicates that New Zealand privatized far more as a percentage of GDP in a shorter space of time than other nations studied.⁵

⁵ GAO/AIMD-96-23, *Budget Issues, Privatization/Divestiture Practices in Other Nations, Canada, France, Mexico, New Zealand and United Kingdom*, U.S. General Accounting Office, 1996.

Part 2

Key Features of the New Zealand Reforms

The ideas underlying the New Zealand reforms apply to any government. They represent good management practices—what one would expect to see in any well-managed organization, public or private. New Zealand’s reforms themselves are not unique, but their comprehensiveness and internal consistency are. The key to the New Zealand reforms, and to governmental reform in general, is recognizing that fundamental change in the performance of government requires changing the incentives facing people within government.

New Zealand shows the extent to which accounting, budgeting, and financial-management reforms can be successfully applied in the public sector, provided that they are part of a well-designed system. For the United States, and other governments, the New Zealand reforms present a challenge: *If a government can be run in this fashion, why would we continue with outmoded conventional practices?*

Key New Zealand Reforms

- Adoption of accrual accounting
- Authority to buy and sell assets and use of a capital charge
- Output-based budgeting and management
- Devolution of decision making and increased accountability

A. Accrual Accounting

1. Concept

Alone in the world, New Zealand now operates its entire financial-management system on an accrual basis, using essentially the same accounting policies and rules used by companies in the private sector. The quality of internal financial information is now comparable with that of a large well-run corporation and the external reporting is arguably superior. These changes have received widespread acceptance within the bureaucracy.

All budgeting, whether internal to departments or for the government (as a whole), is now on an accrual basis, meaning the expected impact on assets and liabilities of the government are fully reported, rather than simply reporting the current cash inflows, outflows, and cash holdings of the government. Moreover, monthly budget reports, appropriations, and financial reporting by each department and the whole government are all on a full accrual, rather than cash, basis. As a result, the full per time-period cost of an action is projected and tracked, not simply the cash outlays. Said another way, in the accrual approach to budgeting, efforts are made to make the budget more actuarially sound—known future expenses and income that create liabilities or assets, respectively, and are caused by decisions in the current period, are estimated and placed in the budget.

In order to keep track of budget expectations and actual financial impacts, the annual financial statements of the New Zealand government are produced within three months of year-end. In each period since the inception of the accrual accounting, the financial statements have received a clean audit opinion. In addition, the government produces and publishes annual financial statements on a full-accrual basis, normally within one month of year-end.

A key to the success of the accrual reforms in New Zealand was simultaneously moving the appropriations, budgets, and end-of-period financial statements for government departments to an accrual basis. This enabled plans and the budgets to be measured against actual results. It also avoided conflicting objectives between the budgeting and accounting systems.

The Difference Between Cash and Accrual Accounting

Cash accounting: Records receipts when it is banked and payments (sometimes referred to as expenditures) when cash is paid. *It does not record many of the impacts on assets and liabilities* that will result from the consequences or events associated with the transaction. For instance, with cash accounting, money borrowed via a long-term arrangement is recorded as a cash inflow. The long-term liability is not brought into the financial statements until it is due and payable. Under accrual accounting, the money raised is both an inflow and a liability.

Accrual accounting: Recognizes events and transactions when they occur, regardless of when cash changes hands. *By recording accounts payable and receivable, and thus the change in value of the assets and liabilities, it keeps a running tally of what an organization owns and owes in economic terms.* If a government promises pension benefits in the current period and must pay retirement claims in future periods, the liability and expense is recorded when the event occurred. When the cash is actually paid, the liability is removed.

Accounting Spectrum: Cash and accrual are important focal points in the discussion of accounting and financial reporting. However, there are variations on each. In governments, the approach can be a modified-cash approach. For instance, governments often record short-term liabilities (those payable with current assets) but only list long-term items “off balance sheet.” These systems are called modified-accrual although they are closer to cash.

Accrual also can vary by the extent of changes and events recognized. More and more, accrual recognizes a wider range of changes and events such as the rise or fall of security prices or the promise of stock options, even though the securities have not been sold or options exercised. The phrases, cash and accrual, are, nonetheless, indicative of the difference between a system that basically waits until cash changes hand versus a system that records events when the event occurs.

With the accrual logic used in New Zealand, the Statement of Financial Performance (also known as the Operating Statement or the Profit and Loss Account) shows the financial results of an organization’s activities for a period. That is, were sufficient revenues recognized to cover all expenses? The Statement of Financial Position (also known as the Balance Sheet) shows all financial items the organization owns and owes at a certain point in time, providing insights to the organization’s ability to pay its entire debt. A Statement of Cash Flows is also provided to reconcile the accrual accounts with changes in cash balances. It provides a picture of cash inflows and outflows. Cash flows constitute an important part of understanding sources and disbursements of cash plus future ability to survive. The cash view is important; however, on its own it is inadequate to assess financial health and performance.⁶

⁶ R. Norman, (forthcoming), “Accounting for Government: How New Zealand Built an Accounting System That Tells the Full Story About a Government’s Finances” (Wellington, New Zealand: Victoria Link Ltd).

2. Why Shift to Accrual Accounting?

a. Background: Public and Private Financial Reporting Drift Apart

Public-sector and private-sector accounting grew apart over a long period of time. While public-sector accounting has remained on a cash basis, the private sector developed generally accepted accounting practices (which included accrual accounting) in response to several key commercial and political pressures.

First, the distancing of owners and lenders from managers, driven by the development of financial markets, created a need for better and more transparent information on how well departments are run. Second, growing competition drove the requirement for better management information on which to base decisions (such as price setting).

Key Benefits of Accrual Accounting

- Shows more realistically the impact of decisions.
- Brings in a longer-term perspective of governmental policies.
- Provides information that, in association with nonfinancial data, is necessary to accurately judge the cost of decisions.
- Enables full allocation of costs to outputs.
- Provides information and incentives needed for efficient management of public resources.

Accrual accounting is designed to provide critical information to owners and lenders. If major pieces of equipment are becoming obsolete, or long-term liabilities are accumulating, owners and lenders want to know now, not when the equipment is sold or scrapped, or when the liabilities come due. The absence of similar pressures in the public sector caused the stagnation of public-sector accounting. Legislators typically focus on whether money is spent as appropriated.

b. Problems with Cash Accounting and Current Financial-Management Practices

Cash accounting satisfies the annual compliance interest of legislators, but unfortunately has a number of serious drawbacks, including:⁷

- Failure to accurately represent the amount of resource usage. For instance, a large capital acquisition will distort expenditure upward in the first year but the usage of that asset will not be recognized in following years.
- Failure to take account of future commitments, guarantees, or other contingent liabilities. A liability will not be recognized until the cash is paid to settle the debt.
- Concentration on cash payments alone, sometimes resulting in an unnoticed deterioration in fixed assets.
- Control of the inputs purchased rather than the outputs produced.
- Distortion of incentives by encouraging managers to underestimate the costs of programs and to spend their full annual appropriations.

⁷ Amended from The New Zealand Treasury, *Government Management: Brief to the Incoming Government* (Wellington, New Zealand: GP Legislation Services, 1987), p. 81.

Table 1: Sample Operating Statement and Balance Sheet

Million	Traditional Cash Accounts	Accrual Operating Statement					Accrual Balance Sheet								
		Revenue	Expenses	Surplus	Assets	Liabilities	Net								
Opening position						+100	+100	+200	+100	+200	+300	-100			
a Taxes of \$100m due															
- \$90m banked															
- \$10m owed						+90	+10	-	+100	-	-	+100			
b Personnel paid - \$75m salaries - \$75m pension liability															
c XYZ Ltd (a state enterprise) sold for \$100m	+100	-	-	-	-	+100	-	-100	-	-	-	-			
d Foreign debt repaid (\$100m)	-100														
e Exchange rate falls by 10%															
f Judgement to clean up contaminated sites (\$120m)															
Results & closing position	+15	+100	-150	-10	-120	-280	-180	+115	+10	+125	+175	+110	+120	+405	-280

* This example is adopted from the *Public Finance and Accounting Review*, 2004, pp. 10-11. For instance, how quickly does the Audit Department collect outstanding debts? How much property does the Ministry of Defense own? (Is this level suitable?) Cash accounts, which exclude most assets and liabilities, are inadequate for answering these questions. Only accrual-based financial statements provide the necessary information in a systematic manner.

As “purchaser” of services from departments, the government is looking for quality of goods and services at the best competitive price. While nonfinancial measures are generally necessary to measure quality, accrual accounting provides the information, in association with the output quality and other nonfinancials, on which to compare price. Once again cash accounting is inadequate because some elements of resource usage (e.g., depreciation) are not fully allocated to outputs.

e. Public-Private Competition and the Costing of Outputs

Where a department is competing to provide goods or services, all costs must be allocated to the goods or services, otherwise prices may be understated and taxpayers will unknowingly subsidize public providers of goods or services. Subsidies or hidden costs make the public provider’s price artificially low, which means taxpayers don’t get as good a deal as they could with fair competition, and private suppliers may be driven out of the market. Accrual accounting lets virtually all costs be allocated to an output: cash accounting does not.

A Week in the Life of a Small Government: An Illustration of the Differences Between Cash and Accrual Accounting

Consider the operating statement and balance sheet in Table 1. It shows how cash accounting would report a \$15 million *surplus*, while the accrual operating statement shows a \$180 million *deficit*. The \$195 million difference is that cash accounting ignores the pension liability (\$75 million), the fact that the asset already had a value worth its sale price (\$100 million), the exchange rate change (\$10 million), and the judgement liability (\$120 million), as well as the taxes owed (\$10 million) and the debt repayment (\$100 million).⁹

The treatment of the pension liability transaction is particularly illustrative of the differences between cash and accrual accounting. Although the \$75 million pension obligation accumulated that period may not be discharged for many years, under accrual accounting, the amount obligated (often the actuarially-calculated present value of the future obligation) is recorded as an immediate expense. Only if the entire amount is funded can the liability be avoided. If none of the \$75 million is funded, the full amount becomes a liability. In 1975, the New Zealand government negotiated a nil pay increase with the public-sector unions in return for an improvement to the pension plan (subsidized by taxpayers). The change to the scheme had little or no cash cost at the time. The total actuarially valued liability, however by June 30, 1996 was NZ\$8.1 billion or 9.3 percent of GDP. Accrual accounting would have made the cost of the scheme apparent immediately rather than many years later.

f. Intergenerational Equity

Intergenerational fairness is important in fiscal policy. It reflects the degree to which the government today is paying the costs of services today, as opposed to shifting costs to other periods. Accrual accounting provides a longer-term perspective for judging the impact of policies. For example, without accrual accounting, decisions on pensions that create pension liabilities may not fully consider the impact of the liabilities on future budgets.

3. A Critique and Defense of Accrual Accounting

The use of accrual accounting in the public sector is typically criticized on several grounds:

a. Costs

Critique: The implementation and operation of an accrual accounting system is expensive. Whereas a traditional cash-based system can be operated by a handful of accountants supported by clerical staff, this is not true of an accrual-accounting system. The New Zealand Audit Office estimated the total cost of financial-management reform for the six years between 1987 and 1992 to be NZ\$160-180 million (approximately 0.1% of government expenses during this period).

Response: Standard commercial accounting systems can now be used by government entities. Learning from private-sector accounting management and from early reformers like New Zealand will push down transition costs for U.S. governments. Standardization also brings with it lower risk—who hasn't heard of a financial fiasco involving a government entity purchasing a customized computer system? In addition, finance staff

⁹ This assumes the asset sale was at book value whereas in practice a gain or loss on sale would usually occur.

now move freely between the public and private sectors ensuring a flow of skills and ideas. It is also possible that considerably fewer clerical staff will be required.

b. Objectivity

Critique: Some argue that accrual accounting is less objective than cash accounting—either money is in the bank or it isn't.

Response: Cash accounts are in no way immune to manipulation, as observers of federal, state, and local government finances are aware. In fact, accrual accounting policies and rules have developed over the centuries and are embodied in GAAP, while cash accounting rules are thin and uncodified. The boundary between operating and capital transactions under the cash and fund system is particularly open to manipulation. For instance, uniforms last more than a year, and are therefore treated as a capital transaction, funded by borrowing. They may be kept out of the general fund and thus not seen as a burden on taxes in the year of purchase. With accrual accounting, cash information is still reported, so there is no loss of information.

c. Comparability

Critique: Cash accounts are used to compare fiscal settings across governments and through time. As very few governments have produced fully consolidated accrual accounts, and have done so only for a relatively short time, there is a loss of comparability.

Response: Adopting accrual accounting doesn't preclude the preparation of traditional cash-based government accounts, for example, on an International Monetary Fund Government Finance Statistics (GFS) basis. (It appears likely that the IMF may also be moving its GFS series to an accrual basis.)

d. Familiarity

Critique: Some critics suggest that users of government accounts, such as debt-rating agencies, are unfamiliar with the format and content of accrual accounts.

Response: This argument is unconvincing when one considers that while any local merchant is familiar with an accrual balance sheet, considerably fewer people are familiar with Government Financial Statement accounts. If cash accounting provides a good basis for accountability and decision making then why don't commercial enterprises use it? Or, more importantly, why do governments require corporations to report on an accrual basis?

Having said all this, cash information is useful, and this is why cash flows are recorded within accrual accounting and why accrual financial statements always include a statement of cash flows.

4. Results of New Zealand's Accrual Accounting Reforms

The adoption of accrual accounting is an unqualified success in New Zealand's reform process. A survey of government managers revealed that of the many public-sector management reforms that have occurred in

New Zealand, the accrual reforms received the highest grade.¹⁰ The survey author notes that “accrual accounting is being adopted increasingly by a number of nations, developed and developing, and [the New Zealand reforms] appear to have improved the ability to identify inefficiencies in the costing and provision of public services and enhanced accountability.”¹¹

Another study found that the financial-management reforms helped New Zealand improve its compliance with measurements of aggregate fiscal discipline from 26 percent in 1984 to 94 percent in 1994.¹² According to the authors, “prior to the reforms, most public financial statements and budgetary documents were not available to the general public for scrutiny and, even if they were made available, they could not be easily understood even by accountants and financial experts in the private sector. Consequently, government performance was largely nontransparent. The adoption of accrual accounting changed this dramatically.”¹³

5. Lessons for U.S. Governments

a. Change Can be Accomplished Relatively Quickly

One lesson from New Zealand is that change can be accomplished quickly. Legislation requiring departments to develop accrual accounting systems was passed in early July 1989. It gave departments two years to move from their existing situation to the new full accrual basis: all but three of approximately 45 departments effected the change successfully within one year.

The entire government moved its financial reporting to an accrual basis in December 1991, as required by the Public Finance Act, but it was not until 1994 that the budget was on this basis. Since 1994, the government’s entire financial-management system has been on a full accrual basis. While the whole process, from initial policy development to implementation, took seven years, one major change, moving departments onto an accrual basis, effectively took less than two years.

1989	Public Finance Act passed. Departments begin move to accrual accounting (first five go live). (July)
1990	All departments except three on accrual accounting. (June) Final departments go live. (December)
1991	Capital Charge introduced. (July) First Crown financial statements. (December)
1992	First annual Crown financial statements. (June) First consolidated Crown financial statements and Public Finance Amendment Act passed. (December)
1993	First annual consolidated Crown financial statements. Purchase agreements and nondepartmental

¹⁰ D. Stace, and R. Norman, *Reinvented Government: The New Zealand Experience*, Center for Corporate Change, Auckland, 1995.

¹¹ C. Cangiano, *Accountability and Transparency in the Public Sector: The New Zealand Experience*, Washington D.C., International Monetary Fund, 1996.

¹² J.E. Campos and S. Pradham, “Evaluating Public Expenditure Management Systems: An Experimental Methodology with an Application to the Australia and New Zealand Reforms,” *Journal of Policy Analysis and Management*, Vol. 16, No. 3, 1997, pp. 423–445.

¹³ *Ibid.*, p. 432.

	output specification. (June) Financial Reporting Act. (September)
1994	First accrual budget for Crown and Fiscal Responsibility Act passed. (June) First Crown financial statements with full budget actual comparison. (June)

b. Comprehensiveness

The major difference between the New Zealand accrual reforms and what is currently favored by GASB in the United States is that New Zealand moved its entire financial reporting, accounting, and budgeting system to an accrual basis. GASB, on the other hand, is currently moving towards recommending an incremental approach to financial reporting—budgeting and accounting reforms have to be implemented by state and local policymakers. At least for the time being, governments would report government-wide financial statements on an accrual basis, while individual governmental funds continue to report according to the current modified-accrual method. The rationale for keeping funds on their current basis while moving government-wide statements to full accrual is that different users of the financial reports have different needs; those who are more interested in short-term finances may find the fund perspective most useful, while those wanting a longer-term perspective are likely to find the government-wide accrual statements the most relevant.¹⁴

Part of the rationale for GASB's limited approach is that financial reporting standards should be “evolutionary, rather than revolutionary” and that “established practices that provide useful information should be retained.”¹⁵

Despite the long-enunciated and supported tradition of evolutionary progress, the partial inclusion of accrual in the dual-perspective approach has elicited some controversy among GASB's user audience. For example, the Government Finance Officers Association (GFOA) objects to the new standards, saying that: 1) the reforms will be costly, 2) government accountants will have a very hard time implementing the changes, and 3) there simply must be an easier way to improve financial management.¹⁶ GFOA claims that the information provided by accrual accounting is “of no demonstrable value to decision makers.” Many elected officials would not agree with that statement.¹⁷

c. Policy Recommendations

How far should U.S. state and local governments go in shifting to an accrual system for the financial statements, and, for that matter, using accrual accounting across the financial system? How far should GASB go in proposing more comprehensive reforms?

¹⁴ GASB, *Governmental Accounting Standards Series, Exposure Draft: Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, January 31, 1997, p. 59.

¹⁵ *Ibid.*, p. 64.

¹⁶ Jeffrey L. Esser, “GFOA and the GASB reporting model,” *Government Finance Review*, Vol. 13, No. 3, 1997, p. 3. Esser is executive director of GFOA.

¹⁷ The project director for this report quoted GFOA's statement to a meeting of state legislators from all over the nation then asked for a show of hands from those who agreed with the statement. No hand was raised.

U.S. governments typically link budgeting, appropriations, accounting, reporting, and even auditing systems, but do not integrate them into a single financial-management system. Parts of the financial-management system can be on cash, others, modified accrual, and still others, accrual.

A major obstacle to eliminating or dramatically changing the cash-oriented funds or moving budgets to an accrual format is that legislatures budget largely on a cash basis and funds are designed to reflect and check for compliance with cash-oriented legislative budgets. In America's federal system, GASB cannot mandate legislative bodies to budget on an accrual basis.

In the U.S. environment of states' rights, checks and balances, strong interest groups, and independent accounting standard setting, comprehensive solutions to the range of financial-management issues are more difficult to implement than in parliamentary systems like New Zealand. *A realistic accrual-reform agenda* for the United States would create a system of financial reports based on accrual accounting and:

- Place the main reporting emphasis on the accrual-based, government-wide financial statements. This will focus users on how the government as a whole is doing financially. GASB is already moving in this direction.
- Add a statement of cash flows to the government-wide perspective. A statement of cash flow provides the picture of where money is raised and where it was spent for the year. In other words, a statement of cash flow gives the shorter-term perspective. Private nonprofit organizations in the United States, which share some characteristics of government, have dropped funds, moved to entity-wide reporting, use a statement of cash flow, and rely on accrual.
- Require that governments, as a part of GAAP, change the legislative budget (or budgets and authorizations) to an accrual basis. Funds or departments would then use accrual accounting and be easily comparable to the accrual-based budgets. The administrative translation of nonaccrual legislative budgets to accrual budgets could begin as pilot projects.
- Use full accrual for funds or departments, treat departments like subsidiaries, and use commercial methods to consolidate the accrual-based funds to the government-wide approach. Consider placing the funds in the notes or in Required Supplemental Information (RSI).¹⁸
- Meet legal compliance with the legislative budget with one report, in the notes or RSI, that compares the legislatively adopted budget (or budgets) with the actual, using whatever method the legislature employs.

All of these changes should be directed to a goal of putting financial-management systems on an outcome basis, moving away from today's input-oriented systems.

This approach would allow state and local governments to move toward a comprehensive accrual approach to financial management, yet provide a budgetary compliance report to address legal demands of the legislative body. These ideas are somewhat controversial, but with fast-paced, world wide financial changes taking place, GASB may need to adopt a more revolutionary, rather than evolutionary posture. Right now, as

¹⁸ For example, in the GASB proposed reporting model, the management discussion & analysis is RSI. RSI does not have to meet the same high auditing standards as the required information in the financial statements. Often, if information is deemed relevant (helpful to the decisions of readers) but weak on reliability (i.e., two people might reasonably come to different conclusions) the information is placed in the RSI category. The RSI category is also used to keep down the cost of preparing and auditing information.

it struggles with basic accrual issues that have already been accepted by other governments, GASB is facing pressure to be even more aggressive with accrual.

Issues of deferred compensation for executives, market-to-market for securities and other assets and liabilities, and aggressive reporting of contingencies are all serious accounting issues in U.S. political and financial circles—and GASB’s recommendations go a long ways toward addressing them. The idea that governments are so different from market operations that they must rely largely on cash-based compliance reporting is outdated. Governments are involved in markets in so many ways that accounting issues relevant to markets are relevant to governments.

Whether legislatures would tolerate seeing their nonaccrual budgets being converted to an accrual basis is open to question. Legislative tendencies to promise now and pay later would be challenged. One good way to move towards an accrual-driven financial system would be to establish an administrative pilot converting the legislative budget to an accrual budget and making the central financial report accrual oriented. The pilot can generate valuable lessons on using performance information and moving to outputs.

It will not be easy for GASB and state and local governments to make a comprehensive accrual-based financial system part of their agendas. But a solid commitment to accrual for the financial statements would likely have a spillover effect on other aspects of financial management. The visibility of liabilities and activities in the balance sheet would make evident the value of the change.

B. The Capital Charge and Decentralized Authority to Buy and Sell Assets

Key Benefits of the Capital Charge

- Provides an incentive to reduce levels of investment and restructure the asset holdings of the department so more efficient structures can be found.
- Makes explicit to the government the cost of maintaining its capital investment in departments.
- Allows management of resources to be made at the departmental level, instead of having to continually be referred to higher levels.
- Ensures that prices for goods and services produced by departments reflect full production costs. (This allows the department’s output production costs to be compared with those of other producers).
- Forces managers to include the cost of capital when comparing the cost of services produced by government entities with the cost of private-sector provision.

1. The Concept of the Capital Charge

Prior to the 1990s, New Zealand departments were not renowned for their stewardship of assets. As Alan Gibbs, a private businessman who headed up several government corporation boards of directors, relates:

*The Government was extremely extravagant with capital. One of the first things we did was collect up all the excess bulldozers, bits of machinery and gear and toys that the Forest Service had accumulated with the extra money it was getting, and we put it in a big yard. . . there was acres and acres of it—and we had a huge auction. This was equipment that would make your eyes fall out, it was beautiful new plant and it was totally unnecessary.*¹⁹

In keeping with the overriding framework of the reforms, managers are given more freedom to manage but are also held more accountable for results. On one hand, chief executives are given the authority to buy and sell assets without a specific appropriation from Parliament, enabling them to choose the right mix of capital. On the other hand, they are subject to a capital charge that forces them to prioritize asset purchases and gives them an incentive to sell surplus assets. The capital charge essentially applies an interest rate to all capital, creating an actual cost for using capital. The charge creates an incentive to balance a capital expenditure against its usefulness in achieving the agency's goals.

In the private sector, investors and lenders supply capital to private-sector organizations in return for dividend and interest payments (the “cost of capital”). Paying for capital makes firms weigh the merits of alternative investments and choose the ones that provide the most benefits.

In New Zealand, the capital charge serves as a proxy in the public sector for the cost of providing capital to departments. When the government spends money on a capital project, it has less to spend on other priorities. The capital charge, combined with outcome goals, forces government managers to make more efficient and effective capital investments and frees up tax dollars for other uses.

The calculation of the capital charge is performed semi-annually and is based on the department's net worth (equity). On net, however, the capital charge does not cost the central government anything.

2. Results of Reform

a. Better Asset Management

The capital charge is designed to encourage better asset management from New Zealand public managers by providing incentives for departments to: 1) extract the greatest value from the use of their assets, and 2) periodically review whether assets are necessary to the department's mission. For example, tracts of vacant land serving no open-space objectives or underutilized buildings will cost the department money. The capital charge provides a powerful incentive to sell or lease these assets.

¹⁹ Alan Gibbs, Former Chairman of Forestry Corporation, as quoted in Marcia Russell, *Revolution: New Zealand from Fortress to Free Market* (Auckland: Hodder Moa Beckett, 1996), p. 126.

Studies of the capital charge show that most chief financial officers of departments say it has led them to pay greater attention to asset utilization. They also say it provides an incentive to return unneeded or inefficient capital to the government.²⁰

In 1993, Price Waterhouse was commissioned by the Treasury to survey the effects of the capital charge. In its report, Price Waterhouse stated that “[our] overall conclusion is that the capital charge regime has been very successful in making explicit to chief executives the costs of owning assets.”²¹ This has been of particular relevance where third-party charging is concerned. Says the study: “There are sufficient examples of the way in which the charge has influenced behavior to state unequivocally that the concept has been successful and that it is important to continue the regime and where possible improve upon it.”²²

Among the examples provided in the Price Waterhouse report were:

- The case of the Ministry of Transport, where, “the realisation that it was unlikely that capital costs on a number of airports could be recovered in landing charges led to active steps being taken to dispose of such assets.”²³
- The reduction of the Ministry of Agriculture and Fisheries’ (MAF) working capital through prepayment of accounts receivable. MAF charges fees for providing meat inspection services to slaughterhouses. The industry agreed to pay MAF’s inspection fees in advance, which reduced MAF’s capital charge. In return, MAF agreed to reduce the level of its fees.

Another study, in 1995, found that thanks to the cash-management and capital-charge reforms, better use of supplier credit and improved utilization of cash saves the government around NZ\$31 million per year in interest costs.²⁴

b. Rationalization of Capital

The capital charge encouraged managers to take a hard look at the benefits of assets relative to their cost. For example, it had a significant impact on the Foreign Affairs Ministry. When capital was considered a free good, the ministry had accumulated over \$400 million worth of assets overseas. Once the capital charge was put in place and ambassadors were forced to pay interest on this capital, they quickly realized that they had a substantial amount of money tied up in very expensive property and began to look for ways to economize.

In some nations, for purposes of diplomacy, it made little difference how luxurious the embassy and its surroundings were. For example, in Singapore with land values rising quickly, the foreign ministry sold the old colonial building which had housed the embassy offices for a tidy sum and moved to a high-rise office building.²⁵

²⁰ This conclusion, however, is subject to the proviso that the difficulty of obtaining new capital provides some incentive not to return capital. Some departments believe that it is preferable to retain the capital on your balance sheet, and incur the capital charge, in order not to have to go through a rationing process at a later point when a capital injection may be required.

²¹ Price Waterhouse Management Consultants, “Capital Charging Regime for Government Departments—Survey of Benefits and Issues,” August 1993, p. 1.

²² *Ibid.*, p. 1.

²³ *Ibid.*, p. 13.

²⁴ R. Morris, “Public Sector Management—Looking Back and Looking Forwards,” paper presented to the IIR Conference on Public Sector Financial Accounting and Management, Wellington, 1995.

²⁵ Jim Howell, New Zealand Consulate General to Los Angeles, interview with author, July 1996.

In another case, when the New Zealand ambassador to the United States arrived at the embassy in Washington, D.C., he noticed that the artwork there was extremely valuable. He decided that he didn't want to pay the capital charge on the artwork out of his budget, so he sent much of it back to New Zealand and asked for less-valuable art.

c. Decline in Requests for Capital

Another effect of the capital charge is that requests for additional capital have dropped off. Because department heads know they will have to pay the additional charge, they have a disincentive to seek a capital injection unless the department is confident it can pay the additional capital charge. New capital must pay for itself by increasing productivity.

3. Lessons for U.S. Policymakers

Unlike the New Zealand government or the private sector, state and local governments in the United States do not have to show the full cost of acquiring, constructing, or leasing capital assets. Only annual cash outlays are reported in government accounting and budgets—liabilities, accrued interest, and depreciation is not recorded. As a result, many U.S. governments have too much or the wrong kind of capital assets.

GASB's proposed reforms suggest a new treatment of capital assets for government financial reporting, both at the time of acquisition or construction, and during the useable life. As a result, U.S. state and local governments will have a better (but not true market) picture of all the costs of capital.

Under the GASB proposals, at the government-wide reporting level, any debt related to the acquisition of capital assets would be a long-term liability, and any accrued interest would be an expense. For capital assets constructed by the government, an estimated interest rate would have to be calculated and included as a cost. Capital leases would also result in long-term liabilities and interest charges.

Once the liabilities and interest charges are incorporated into the financial statements, an accrual system will allocate the cost of the capital asset (usually, minus salvage value) to the time period when it is used. GASB is currently leaning towards giving governments an option of two different approaches. They may either: 1) report the capital asset at historical cost and have an annual use charge (depreciation) applied against current-year operations; or 2) adopt a preservation maintenance approach whereby only governments that can demonstrate they are maintaining infrastructure can charge maintenance-preservation costs as expenses rather than depreciation. These governments would be required to disclose information about the condition of those assets for a period spanning several years.

By showing debt as a long-term liability, accrued interest as an expense, and periodic use as an expense or liability, GASB is *building in a cost of borrowing*. As a result, governments will have to reveal if they are covering all liabilities; otherwise their net worth will be negative. Governments will also have to generate sufficient revenues to cover the annual interest and period charges.²⁶ At that point, they are essentially paying for the cost of borrowing.

²⁶ To limit situations where governments might manipulate the value of the capital assets to assure a positive amount in the net assets, GASB is dividing the net asset section (similar to equity section in business) into capital assets minus related debt (and perhaps depreciation) and unrestricted net assets. While the total in net assets may be large because of

Capital Charge Effects

Example 1: Capital-operating mix A department is considering investing in a computer system which will reduce its clerical processing costs by \$90,000/year. The system will cost \$1,000,000. Assume that the capital charge rate is set at 10 percent/year. Should the department purchase the system?

The changes in annual expenses will be:	\$
Reduction in direct clerical-processing expenses	-90,000
Increase in capital charge expense (\$1,000,000 x 10%)	+100,000
	+10,000
Total increase in annual expenses	+\$10,000

Based on this limited analysis, the department should not purchase the system. If the cost of capital were not explicitly recognized in the evaluation, the department would buy the system. [A more detailed analysis would require a discounted cash flow (DCF) under the old and new situation. The DCF from the computerized system might be sufficiently large to offset the capital charge.]

Example 2: Sale of surplus assets A department sells a piece of surplus land for \$5 million and returns the cash to the government. The transaction reduces the department’s net worth by \$5 million and its annual capital charge expense by \$500,000 (assuming a 10% capital charge rate). Assuming no loss on the sale, the \$500,000 saving provides the chief executive with several options including the option to propose a reduction in output prices for their services.

An accrual treatment of capital may also help make acquisition policies more prudent. If a government is running a balance-sheet deficit, a caution light should go on. A deficit means that revenues cannot cover expenses. If interest and annual capital asset charges are a sizeable part of those expenses, then the capital investments may not be earning their keep by improving productivity. Inadequate revenue may also suggest that the full faith and credit of the government cannot be relied on to generate new or higher sources of revenue.

C. Output-based Management

New Zealand’s experience has proved that a system of output appropriation provides a workable alternative to the traditional input-based system and can yield substantial advantages for both departmental management and government decision makers.

—Graham Scott, Former Secretary of the New Zealand Treasury²⁷

Key Benefits of Output-based Management

- Gives added incentive to charge for services that give certain parties unusual or specific benefits.

the amount of capital assets typically held by a government, only the unrestricted amount is available for future budget appropriation.

²⁷ G.C. Scott, *Government Reform in New Zealand*, Washington D.C., International Monetary Fund, 1996.

- Allows more discretion and innovation in choosing how much and which kinds of inputs to use to provide services.
- Increases focus on achieving policy goals (outputs and outcomes).
- Reduces ability of legislators to engage in pork-barrel spending.

1. Concept

A third major feature of the New Zealand management reforms was the move from an input to an output focus of control and accountability.²⁸ Inputs are the dollars, workers, and procedures used to produce an agency’s goods or services. Outputs are the goods or services themselves.

Outputs are products (i.e. paving x square feet of roadway for y dollars/square foot), not outcome measures (such as minimizing traffic disruption). They are viewed in exactly the same way as the products or services produced by a private-sector entity, and are priced in a manner similar to market transactions. Government ministers negotiate a price for outputs on the basis of the goods and services supplied—in theory irrespective of input costs. For example: the Minister of Justice might negotiate with the Correctional Services Agency to house x number of prisoners at y dollars, or the department could contract with the police for z dollars worth of crime-prevention programs. The ministers try to choose outputs that will lead to desired outcomes—i.e. crime prevention programs that reduce crime.

The system works best when ministers are active, interested purchasers of services. One former finance minister would literally rip out pages of budget requests when she didn’t want to “buy” the recommended outputs. Gone were all the inputs that went into delivering those outputs.

Chief executives are held accountable for the delivery of outputs, which can be defined in terms of quantity, quality, cost and, when relevant, location, and timeliness. Because of the disagreement over how best to manage and assess performance when markets are not readily available, the relationship between inputs, outputs, and outcomes is demonstrated in Table 3, which illustrates the application of these concepts to a commercial and government example. Most agree that sound management and budgeting should not be based on inputs, but devising a way to choose measurable outputs that one hopes will lead to desired outcomes is tricky.

Table 3 The Chain: Inputs to Outcomes

	<u>Purchase of Motor Vehicle</u>	<u>Government example</u>
OUTCOME (benefit sought)		
Description	Reliable, low-cost transport, safety	Reduction of road deaths
Measures	Personal satisfaction, reduction in cab fares	New Zealand road deaths:
		1994 580
		1995 582
		1996 514

²⁸ As advocated by much of the literature on public-sector management. See, for example, K.V. Ramanathan, *Management Control in Non-Profit Organizations* (New York: Wiley, 1982).



OUTPUT (good or service purchased for which managers are held accountable)		
Description	Purchase of Motor car	Policing services: Traffic Offenses.
Quantity	One Ford sedan	<ul style="list-style-type: none"> Issue between 770,000 and 895,000 tickets and infringement notices
Quality	<ul style="list-style-type: none"> Color (Blue) Airbags Fuel consumption 	<ul style="list-style-type: none"> Provision of a 24-hour operational capacity
Cost	US\$12,000	NZ\$141.841 million



INPUTS (resources used to produce outputs)		
Description	400 lbs of steel, 150 lbs of plastic, 500 semi-conductors, 7 hours of engineer time, 400 rivets etc.	Salaries, vehicles, gasoline, overhead, etc.

2. Outputs Versus Outcomes

The New Zealand management system has been subjected to criticism over its focus on outputs rather than outcomes—after all, governments are interested in outcomes, not outputs. In reality, ministers purchase outputs that they hope will bring about desired outcomes, and department managers use inputs to create the outputs. Outputs are easier to measure than outcomes, so it is easier to hold chief executives accountable to deliver agreed services (outputs). Using outcomes directly to measure performance is problematic for several reasons:

- *Causality* is difficult to determine with any certainty. It is often very hard to show a causal relationship between an outcome and the activities of a particular government department. As Table 3 illustrates, the government purchases outputs (policing services: traffic offenses) in an attempt to achieve outcomes (reduction of road deaths). But road deaths increased against the trend in 1995. The increase was partially due to a combination of bad weather and a large jump (6 percent) in vehicle registrations (due to a buoyant economy and a reduction in tariffs on vehicle imports). Should the chief executive of the police department be held responsible for the rise?
- *Measurement* can be very difficult. For example, how should we measure the success of a suicide-prevention campaign?

- *Time-frames* for outcome achievement can often be very long. It can take many years, possibly decades, before the impact of education or health initiatives can be assessed.
- *Allocating* input costs to outputs already strains the limits of accounting technology. Taking the next step and allocating output costs to outcomes would in most cases be impossible.

These problems mean that outcomes have limited value as the basis for effective accountability relationships in most cases. This is not to say that departments should not be concerned about outcomes in planning the services they provide—they should. In fact, for many services it is possible for governments to contract with a public or private provider for outcomes. One example is welfare-to-work services: a number of governments have entered into outcome-based contracts with private providers in which the providers are only paid for each client that they help to find and to keep a job.²⁹

Nonetheless, as the basis for organizing a budgeting system, outputs are a more appropriate and practical measurement tool than outcomes.

3. Results of Reform and Lessons for U.S. Policymakers

a. More Information Upon Which to Make Informed Choices

Ruth Richardson, a former finance minister of New Zealand, credits the new system with enabling her to win approval for, and implement, a series of significant fiscal decisions in her first (1991) budget. She says, “The new focus on outputs meant ministers had genuinely meaningful information about the services produced by their departments and were in a position to make informed trade-offs between competing priorities.”³⁰

b. The End of Pork Barrel Spending

Budgeting based on outputs and outcomes, coupled with purchase agreements that specify the quality, quantity, price, and timeliness of each output the chief executive is to supply the government, have largely eliminated pork-barrel spending in New Zealand. Because each agency chief executive has complete control over the mix of inputs they use to produce outputs, from road construction to science spending, the mix of projects funded is determined principally on a cost-benefit analysis by the relevant agencies. “With our system, there is no political interference on where the money goes for roads,” says Stuart Milne, Chief Executive of the Ministry of Transport.³¹

Simon Upton, a Member of Parliament, agrees: “I couldn't imagine having people coming through this office all day lobbying for special favors,” says Upton. “Our new system is a good security against corruption in politics.”³²

Sunnyvale California's Output-Based Budgeting System

²⁹ William D. Eggers, *Performance-Based Contracting: Designing State-of-the-Art Contract Administration and Monitoring Systems*, Reason Public Policy Institute, How-to Guide No. 17 (Los Angeles: Reason Public Policy Institute, 1997).

³⁰ Ruth Richardson, *Making a Difference* (Christchurch: Shoal Bay Press, 1995, p. 103).

³¹ Stuart Milne, interview with the author, August 1996.

³² Simon Upton, interview with the author, August 1996.

With detailed information at their fingertips on the quantity, quality, and cost of each service they deliver, the Sunnyvale city council doesn't even bother voting on line items.³³ The council tells each department what results it wants and the department returns to the council with detailed figures on the cost of achieving this output or outcome. The council then, in essence, "buys" the level and quantity of service desired.

Sunnyvale's success with output-based budgeting has been so dramatic that its budgeting system was highlighted in an August 1993 visit by President Clinton. Between 1985 and 1990 the average cost of delivering services dropped 20 percent; one year the city even rebated \$1 million in property taxes.³⁴ In a 1990 comparison with other cities of its size, Sunnyvale found that it accomplished most functions with 35 to 45 percent fewer employees and that Sunnyvale employees tended to be better paid. On a per-capita basis, Sunnyvale's taxes were lower than any city in the survey.³⁵

D. Devolution of Financial Management and Increased Accountability for Results

1. Devolved Decision Making

Integral to other reforms, New Zealand has extensively delegated authority to departmental heads (called "chief executives" in New Zealand). Chief executives are now the employing authority for departmental staff, with the power to determine (in negotiation with employees or their bargaining agents) the conditions of employment and salaries of their employees. There are no government-wide salary scales or conditions of employment.

In addition to authority over personnel, chief executives are also given authority to purchase services (inputs) from wherever they decide is most efficient and appropriate. They are not required to use central services for public works construction, office accommodation, purchasing, printing, legal counsel, and the like. They can purchase them from another department or a private firm. And departments charge one another prices for their services equivalent to their full cost of production.

Departments now have full control over the mix, quantity, price, and source of the inputs they employ to do their job and produce their outputs. The main constraint they face is keeping the cost of producing their outputs competitive so that the central government, or other agencies, continue to purchase them.

Chief executives also have fully delegated authority in the design and acquisition of their financial system, both hardware and software. The only requirement is that they be able to provide to the Treasury the information it requires to prepare the government's budget and financial statements. Chief executives also have authority to determine their own internal-control systems, but would normally do this in conjunction with their auditor.

³³ David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector* (Reading, Massachusetts: Wesley Addison Publishing Company, Inc., 1992), p.145.

³⁴ *Financing Local Government*, Vol. 5, No. 19, March 31, 1993, p. 1.

³⁵ Osborne and Gaebler, *Reinventing Government*, p. 145.

Key Benefits of Devolution and Increased Accountability

- Managers are freed to manage, with greater flexibility and autonomy.
- Quicker organizational response to changing developments.
- Enhanced accountability.

2. Accountability Mechanisms

Typically government reformers have found it far easier to release managers from bureaucratic financial controls than to put in place systems to ensure accountability. New Zealand has gone further than any other nation in devising systems of measuring compliance and monitoring accountability. In return for their greater freedoms, chief executives are subject to clear and enforceable accountability mechanisms that include written contracts, performance and purchase agreements, and an output-based budgeting system.

a. Focus on Outputs

Chief executives are accountable for the delivery of a specified set of outputs at an acceptable cost. If they don't deliver the specified outputs or keep the costs at the expected level, they haven't met the terms of their contract. Ministers are responsible for choosing outputs that they believe will bring about the outcomes desired by policy.

b. Financial Management

Chief executives are also accountable for the financial management of their department—an instance of financial mismanagement will reflect on the chief executive's own performance assessment at the end of each period (chief executives have annual performance agreements within a limited-term contract of employment). Chief executives are also accountable for the management of their financial statements, including the balance sheets, meaning they are accountable for the financial results and financial performance of their organizations, in addition to the delivery of a specified set of services.

c. Performance Agreements

New Zealand also developed a performance regime for chief executives. "Jobs for life" were replaced by fixed limited-term employment contracts. Each year a performance agreement for the chief executive is developed in parallel with the budget. The agreement states the outputs for which the chief executive will be held accountable as well as dimensions of the financial performance. At the end of each year, the agreement is reviewed to determine the appropriate action, for example, whether bonuses should be awarded or employment terminated.

Typically, at least 10–15 percent of each chief executive's salary depends on performance, and a bonus of up to 20 percent can be earned for superior performance. In turn, chief executives typically require performance agreements from their senior managers, who do the same for those working under them—creating a pyramid of performance agreements that become powerful levers for driving change downwards.

3. Lessons for U.S. Policymakers

New Zealand’s reformers realized that process reforms in financial management would be difficult to implement if managers at all levels did not have both the power to make change and incentives to do so. In a sense, devolving financial-management responsibility and devising new and powerful accountability mechanisms was a prerequisite to reforming the process of financial management.

a. Incentives for Reform.

A common problem with government-reform efforts in the United States is creating incentives for managers to follow through on reform. Many are protected by civil service, and others view reforms as a “flavor of the week” that will soon pass. Devolving decision making, coupled with accountability for outputs, would give agency managers an incentive not only to enact reforms proposed by higher levels, such as from the National Performance Review, but to be entrepreneurial in exploring new ways to do things.

b. Performance Agreements Work

New Zealand’s reforms show that performance agreements rewarding exemplary performance and punishing failure are effective tools for establishing incentives for managers. Managers will gladly accept greater accountability if they are given more autonomy to achieve what is required of them. Maurice McTigue, a former minister in the New Zealand government, says that very few public employees would support going back to the old system—performance agreements make it very clear what is expected of them and of their peers and give them the ability to achieve their objectives. There is very little squabbling over who is responsible for what, and no one has to carry the burden for a shirking colleague.³⁶

³⁶ Conversations with the Project Director. McTigue is now with the James Buchanan Center at George Mason University.

Part 3

How Have The Reforms Worked Overall?

There should be no going back to the not-so-good old days when managerial initiative was stifled by input controls and compliance with the rules was regarded as more important than accountability for results. New Zealand departments (and other public entities) are much better managed than they were a decade before the reforms were initiated. They are more productive and innovative, more nimble in adapting to changing conditions, and more cognizant of how well they are performing.

—Allen Schick, *Professor of Public Policy, University of Maryland*³⁷

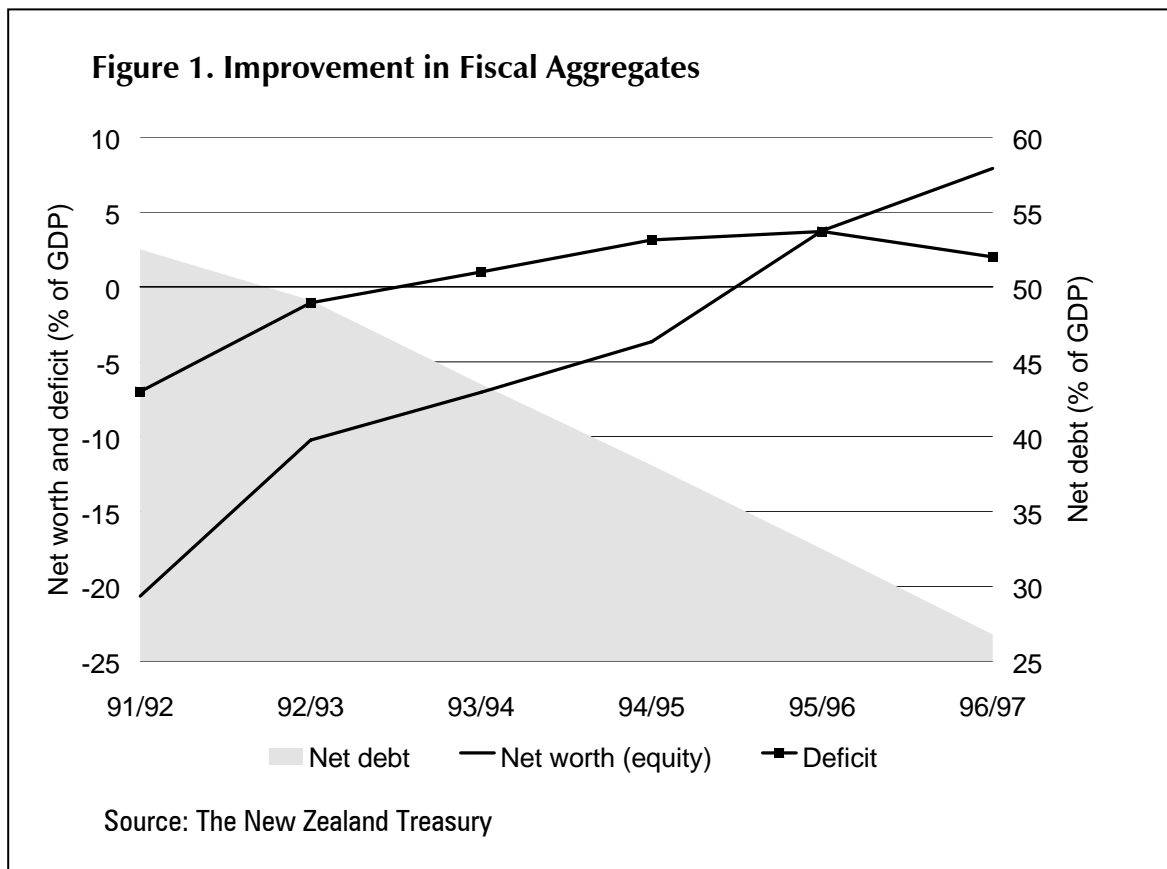
Reactions to the New Zealand reforms as a whole have been almost universally positive. Where deficiencies have been identified, it has been in a positive manner. As Allan Schick notes: “being first means that certain deficiencies will emerge as reform takes hold. One should think of [these] problems as akin to the ‘bugs’ found in state-of-the-art technologies after they have been introduced. There is a need to ‘debug’ some of the reforms, but that is a far different matter than getting rid of them altogether. In fact the bugs have emerged only because of the extraordinary leaps forward in transforming the New Zealand State Sector.”³⁸

A. Improved Fiscal Performance

As Figure 1 illustrates, since 1989 the fiscal performance and position of the New Zealand government has improved dramatically. It moved from deficit to surplus and net public debt fell from 52.5 percent of GDP in 1991/92 to 26.4 percent of GDP in 1996/97. The value of government assets now substantially exceeds the value of government liabilities.

³⁷ Allen Schick, “The Human Element In Public Sector Management,” in *Future Issues in Public Management* (Wellington, New Zealand: State Services Commission, 1997), p. 67.

³⁸ Allen Schick, *The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change*, Wellington (New Zealand: State Services Commission, 1996), p. 86. University of Maryland Professor Allen Schick’s study is the most wide-ranging review of the New Zealand public-sector management system since the Logan Review in 1991. Schick was commissioned by the New Zealand State Services Commission and the Treasury to produce an authoritative, independent report identifying and substantiating the extent to which public and political confidence in the reforms is justified, and pointing to improvements that could be made. He found that the reforms had greatly improved the efficiency and quality of public services. He pointed to tangible improvements in service delivery for the public, such as faster processing of benefit payments. Schick also noted the degree of consensus on the superiority of the reformed system: “Discussions conducted with more than 100 chief executives, senior managers, and informed observers, as well as with a small number of Ministers and Members of Parliament, reveal broad agreement that the reforms have improved the efficiency and quality of public services by encouraging managerial initiative and rewarding success . . .



The turnaround in the fiscal performance and position of the government was achieved partly through the willingness of ministers to make specific decisions on expenditures but also because there was a system that enforced those decisions and gave ministers confidence that the decision, once taken, would be carried through.

B. Better Control of Public Expenditures

Perhaps the most rigorous attempt to evaluate the effects of the reforms concluded that “the evidence on central government expenditure is consistent with, although it does not conclusively establish, FMR [the financial-management reforms] having made it easier to control public expenditures.”³⁹

C. Increased Efficiency

The same study provides some evidence of efficiency gains, measured in terms of unit cost of outputs from the reforms. For instance, the fall in average unit costs for certain functions in Valuation New Zealand was between 10 percent and 20 percent in nominal terms over five years for a range of estimates.⁴⁰ The

³⁹ J. Brumby, P. Edmonds, and K. Honeyfield, “Effects of Public Sector Financial Management Reform (FMR) in New Zealand,” paper presented to Australasian Evaluation Society Conference, August 30, 1996.

⁴⁰ Valuation New Zealand is a government department that provides market valuations of real estate and other assets to the public sector, supplies property information to businesses and the public, and conducts periodic reevaluations of properties.

Immigration Service accommodated a 25 percent output increase over three years with a 2 percent increase in nominal expenditure. The Income Support Service increased the volume of applications it processed by 60 percent over two years with little increase in operating expenses. The study suggests that the efficiency gains obtained varied significantly across departments, implying that the system effect depends on the quality of departmental management.⁴¹

D. Managerial Acceptance

A 1997 study of the reforms found that the changes most supported by senior public-sector managers included the opportunity to focus on results, the funding switch from inputs to outputs, the introduction of accrual accounting, private-sector competition, and increased autonomy.⁴²

⁴¹ Brumby et. al, recognized in their study the difficulty of reaching unambiguous conclusions on this issue. In particular, time-series comparisons of unit costs of outputs are constrained by the fact that prior to the changes there were neither good definitions of outputs, nor accurate measures of cost.

⁴² R. Norman, "Human Resources," *The Magazine of the New Zealand Institute of Personnel Management*, October 1997.

Part 4

What Made it Work: Strategic Lessons for U.S. Policymakers

The key lesson from New Zealand is that reforming the way governments operate can improve the financial performance, management culture, and quality of services from public-service organizations. (See Appendix 2) Governments in the United States already have demonstrated this themselves, though perhaps in a less comprehensive and radical fashion than occurred in New Zealand.

The New Zealand reforms offer several political and implementation lessons for governments in the United States and around the world.

A. Creating the Right Incentives

Building the system around an incentive structure that rewards desirable behavior by managers, and delegates authority according to performance expectations, is critical. The New Zealand system was also designed to create mutually reinforcing incentives. For example, the capital charge encourages the efficient and effective use of assets and is reinforced by an appropriation process that includes the cost of capital.

B. Delegation

By placing decision-making authority closer to the source of information, decisions are implemented more rapidly. This was most evident in the departmental transition to accrual accounting. The rapid transition could only occur in circumstances where departmental chief executives have complete authority to hire staff, employ consultants, and design and select systems, without having to go through a protracted process of central approval (see Appendix 1).

C. Sequencing

The order and pace of reform was designed to show early gains to the key players (chief executives and ministers). Chief executives obtained significantly enhanced decision-making authority when they entered the new regime (primarily through the financial delegations contained in the provisions of the Public Finance

Act). Ministers experienced early benefits, including major changes to social policy, through their new power to develop and implement a revolutionary 1991 budget.

The sequencing also ensured the credibility of early stages of reform and created a basis for the successful development of later stages. For example, an initial reform was shifting department chief executives to performance-based contracts. Their contracts made implementing financial-management reforms a condition of success; a powerful incentive for them to buy in to the reforms. Another example was introducing the capital charge after departments had established their initial accrual balance sheet positions, and initially compensating department budgets for capital charges. If the charge had been introduced before the accrual valuation of assets, there would have been strong incentives to manipulate the valuation process, which would likely have impeded the reforms.

D. Clarity and Consistency of Conceptual Framework

Reformers need to ensure that the system is driven by understandable, available and high quality information—making transparency, rather than secrecy, the norm. Transparency, in conjunction with the clearly specified performance measures, leads to high quality, frequent, and timely financial reporting.

The reform package must also be internally consistent. Internal consistency can, perhaps more than anything else, explain the successful implementation of such a radically new system of public financial management. In New Zealand the chief executives and ministers understood their respective roles in the system and there was a clear framework for resolving detailed implementation problems as they arose. This kept participants in the reform process from being side-tracked by inconsistent decisions or policy resolutions.

E. Adoption of Generally Accepted Accounting Practices (GAAP)

The efficiencies arising from the adoption of private-sector GAAP were not confined to improved policy making. Outside New Zealand, changing accounting practice has taken many years, particularly for the public sector. In New Zealand things moved much quicker because the adoption of GAAP facilitates the flow of staff and expertise between the public and private sectors. Public-sector finance staff can be hired from the private sector with little need to learn a “government-only” accounting system, and the public sector can draw on systems and development skills already existing in the private sector. Without question, this contributed to the speed with which accrual accounting was implemented.

F. Comprehensiveness

Reforms must be comprehensive. Don't leave out significant areas or there will be powerful incentives for organizations to seek to locate themselves outside the scope of the reforms.

G. Political Commitment

The foundation of the reform process is political commitment by successive governments. Bipartisan support for the reforms created a climate in which chief executives saw little advantage in seeking to delay or impede the reforms, and instead worked towards their successful implementation.

The Public Finance Act of 1989 embedded firmly in legislation the concepts developed in the policy design stage. These included changing the nature of appropriations from an amount of cash able to be spent on a particular program, to an accrual-based measure of resources consumed in the production of a specific set of outputs. The fact that the concepts were captured in the legislation signaled to departments that the government was serious about implementing changes. Result: very little resistance to the reforms.

U.S. Federal Financial-Management Reforms

The U.S. government is experimenting with a range of financial reforms. As in New Zealand, there are obstacles and opportunities. Historically, cash appropriations and accounting gimmicks have been an integral part of the promise now, pay later philosophy. In a long history of minimal accounting and reporting, the federal government has tried management reform after management reform, some coming from the legislative branch, others from the executive branch.

There are some significant differences between the ideas driving U.S. financial-management reforms in the 1990s and those underlying the New Zealand reforms. Unlike New Zealand, the U.S. government does not have a broad, coherent framework for financial-management reform—financial-management reforms evolved in a patchwork fashion:

- The Chief Finance Officers Act of 1990 (CFOA) was focused on obtaining clean audit opinions for the financial statements of the agencies.
- The Government Results and Management Act of 1994 (GRMA) created a requirement for a consolidated financial report for the government as a whole.
- The Government Performance and Results Act of 1993 (GPRA) prescribed developing unit-level performance indicators.

These reforms did not encompass accrual budgeting or accrual appropriations. Nor did they place prices on outputs and structure those prices into budgets and performance contracts. Thus it is still a big step to a system similar to where New Zealand is today.

Part 5

Conclusion

In the past ten years, the New Zealand government's financial-management systems have been completely reengineered. Cash accounting has been jettisoned in favor of accrual accounting. Output-based budgeting has replaced outdated program-based budgeting. Public-sector managers now have significantly greater discretion than elsewhere—matched by increased accountability and robust performance-appraisal systems. The New Zealand public sector is widely recognized as more efficient and effective than it was a decade ago.

The New Zealand reforms were rapid and dramatic, and they have survived a change of government. Accrual accounting and appropriations, along with output-oriented accrual budgets, are particularly seen as successful changes.

The reforms are in part responsible for the turnaround in New Zealand's formerly weak fiscal position. And government agencies have increased efficiency and their standards of client service. Assets are now better managed than they were a decade ago.

New Zealand is a microcosm of the reorganization of the public sector that is taking place globally. To varying degrees, governments in the United States and in other nations such as South Africa, the United Kingdom, Australia, and Iceland, are implementing aspects of the reforms pioneered in New Zealand.

In none of these governments are reforms modeled exactly on New Zealand, nor would one expect that. However, they all increasingly recognize the desirability of accrual accounting, of devolving responsibility and accountability, and of basing budgets and departmental success on price-oriented outputs.

Some governments in America have already begun to fundamentally overhaul their financial-management systems. Many will tie these reforms to far-reaching budget and management changes. Cities and states that have not begun to change will soon be required to do so in order to remain in compliance with the Government Accounting Standards Board (GASB). They will be confronted with the difficult task of calculating and clearly reporting the future costs of decisions made today. Adding to the possible complexity, state and local governments will still have to issue a few of the financial statements on the older basis and more on the new basis, almost like keeping two sets of books.

However, viewed in a positive light, the proposed GASB reporting model includes much of what private businesses report. Businesses must collect enough revenue to meet the costs of today's decisions, shouldn't government? Don't reinvent the wheel. One way to ease the burden is to use most of the standards business has developed, as other governments have.

New Zealand offers powerful lessons for how to create a 21st century financial-management system. There is no doubt that the ideas behind its reforms could help address the performance problems existing in many U.S. governments.

About The Authors

Ian Ball and **Tony Dale** are Principals at Public Sector Performance (NZ), Ltd. They were previously Central Financial Controller and Budget Director, respectively, at the New Zealand Treasury.

Dr. John Sacco is an Associate Professor in the Department of Public Affairs at George Mason University in Virginia. He is the author of *Financial Reporting in Government*, 1996 (<http://www.pwc.edu/gmu/course/govt490>).

William D. Eggers is Special Assistant to the Texas State Comptroller, and co-author of *Revolution at the Roots: Making Our Government Smaller, Better and Closer to Home*.

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Other Related RPPI Studies

How to Compare Costs Between In-house and Contracted Services, by Lawrence Martin, How-to Guide No. 4, March 1993.

Performance-Based Contracting: Designing State-of-the-Art Contract Administration and Monitoring Systems, by William D. Eggers, How-to Guide No. 17, May 1997.

Appendix 1

Implementing the Financial-Management Reforms

New Zealand's financial-management reforms were implemented over a relatively short period of time. A number of features of the reform design simplified implementation. These features included:

- Fully integrating financial management into the overall management system. For instance, tying accrual accounting into the appropriations process was key to the new accounting standard's quick acceptance and effectiveness.
- Delegating decisionmaking. Chief executives had the power to determine how their departments would implement the reforms and use resources to implement the process.
- Creating the incentive structures implicit in the new system. Chief executive performance rewards were linked in part to the successful implementation of the reforms.

Together these features meant that the chief executives of departments were motivated to implement the reforms and had the authority to carry them out. This enabled the Treasury, the central agency driving the reforms, to focus its efforts on developing policy rather than implementing it.

A. Central Responsibilities

The Treasury's responsibilities during the reform process included:

- Ensuring that there was widespread understanding of the nature of the new and radical changes. With limited resources for educating government officials, the substance of the changes was conveyed mainly with three principal tools: 1) a video which captured the key ideas (in 14 minutes!), 2) a plain language booklet which described the elements of the reforms and the nature of the new legislation, and 3) briefings for senior managers within departments.
- Developing a set of accounting policy parameters, within which departmental accounting policies were constrained. As the existing private-sector accounting standards were adopted as default standards for government, only certain situations required specific Treasury instructions (for instance the appropriate recognition point for tax revenues). Adopting private-sector GAAP facilitated the flow of expertise from the private sector to the public sector, both through the consulting work required to develop new systems and in the recruitment of staff for ongoing financial roles within departments, and had the effect of reducing the need for Treasury's technical support.

- Setting up the central cash-management system and contracting for the government’s banking services. This tender was won by Westpac Banking Corporation—a major trading bank in New Zealand that was able to provide state-of-the-art banking services with low transaction costs, as well as centralized cash and debt management for the Treasury.
- Exercising quality control over the reform process and approving the readiness of departments to move on to the new system.

The Treasury provided little in the way of advisory or training resources. To do so might have hindered the “culture change” message—chief executives of departments were now responsible for effecting the changes.

B. Implementation in Agencies

For individual departments all the key structural elements of the new system were changed at the same time, including both the accrual budgeting and appropriation process as well as the reporting process. This required each department to:⁴³

- Prepare an opening balance sheet. Here the auditors were particularly helpful and constructive. A valuable side effect of the process was identifying surplus properties which were subsequently sold.
- Specify its outputs—in consultation with the Treasury—which then became the basis for accrual appropriations.
- Implement an accrual-based accounting system to provide the basis of monthly reporting to Ministers and the Treasury.
- Develop cost-allocation systems to allocate all departmental input costs to specific outputs—including overhead costs, depreciation, and the capital charge.
- Develop a system of cash management, and open departmental bank accounts.

In addition, departmental chief executives had to take on full responsibility for the financial management of their departments, including the integrity of the information provided to Ministers and the Treasury.

⁴³ See the International Federation of Accountants Occasional Paper #1, “Implementing Accrual Accounting in Government: The New Zealand Experience,” at <http://www.ifac.org/StandardsAndGuidance/PublicSector/OccasionalPaper1.html>.

Appendix 2

Changed Culture in Government: The Case of Income Support Services

The culture of the New Zealand public sector has changed dramatically in the past decade. A glimpse into the change is visible in the story of George Hickton, an executive from Honda Motors, who was the man largely responsible for overhauling the Income Support Services division of the Department of Social Welfare. The agency, which determines an applicant's eligibility for welfare payments, had a well-deserved reputation for incompetence and poor service.

Brookings Institution Professor Allen Schick, writing about the incredible change Hickton helped bring about, describes the new and improved Income Support Service office in Auckland:

The New Zealand Income Support Service in the Department of Social Welfare exemplifies the dramatic improvement possible when managers give priority to the impact of services on customers. Shortly after entering the . . . office, each client is greeted by a receptionist who inquires concerning the purpose of the visit and the services sought. The Service has a target that each client should be met within ten minutes after arrival To facilitate quick turnaround of cases, the number of persons and steps involved in each case have been reduced. In complicated claims, the case worker takes the problem to a nearby supervisor who is authorized to make on-the-spot determinations.

With Hickton at the helm, the agency's walls came down—both figuratively and literally. In every field office, the walls separating the case managers from the clients were torn down, giving way to open settings. Several layers of management were eliminated. Managers were placed on individual performance-based contracts. Drawing on models developed by the retail clothing industry, competition between district offices was encouraged through the daily ranking of offices on quality and efficiency. Soon the time to process an application had fallen from 24 days to overnight.

The Wellington district manager for Income Support Services is a young man named Nigel Bickle. He is 27. And he is an exceptional manager.

Prior to the reforms, it would have taken at least a decade for someone like Bickle to rise to district manager. Chances are, frustrated with the painfully slow uphill climb, he would have left for more rewarding—and greener—pastures in the private sector. “Initially there was quite a lot of talk along the lines of ‘whose butt have you been kissing?’ and ‘you haven’t been here for ten years,’” recalls Bickle. “But things were changing quickly. Structures were becoming flatter. There was an environment of recognizing people that did perform.”

Examples such as this are the norm rather than the exception and illustrate the culture shift in New Zealand of the past decade.

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