Reflections on the New Zealand Model

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The views expressed in this paper are those of the author and do not necessarily reflect the views of the Treasury.
The Spirit of Reform, my assessment of the New Zealand model, was suffused with ambivalence. Although I accumulated palpable evidence of significant improvement in the machinery of government and in the performance of the state sector, key elements which mimicked but did not truly replicate markets made little sense to me. I perceived that the improvements were not those of a Hawthorne effect; they were not merely the ephemeral side-benefits that occur when procedures are changed or people pay attention to what staff are doing. Departments had a clearer idea than previously of what was expected of them, their output was specified and fully costed, chief executives had broad discretion to manage resources and operations, and ministers had choice in obtaining outputs, including policy advice.

But this was not the whole picture. The new system brought accountability at the expense of responsibility, contestability was more ideal than reality, strategic capacity was under-developed, managers had a narrow view of their work, transactions costs were high, and most contracts lacked means of enforcement. The model worked, but to what end?

In the five years since The Spirit of Reform was published, I have become more critical and less ambivalent, more admiring of the remarkable managerial edifice erected in this country, but less convinced that it is the right way to go. My concern has been whetted by the plain fact that few countries, and none of the most developed ones, have modeled their public sector along the lines of the New Zealand version. Some countries that have embraced the “new public management” have taken alternative routes to get the same results that New Zealand claims for its efforts. As an outlier, New Zealand has generated more fascination than emulation. A few national and subnational governments have copied the New Zealand reforms, but the main market has been in some of the least developed countries in the world who hope to leapfrog national development by embracing avant-garde innovations.

If other “new public management” countries have not emulated New Zealand, it would be hard for New Zealand to pick and choose the elements of new public management that fit its needs. In contrast to other countries in which reform meant adding peripheral elements to
the pre-existing managerial system, in New Zealand, the reforms are the system. There is no other managerial system. This means that dismantling the reforms would require the government to divest itself of the ways in which it prepares and administers the budget, runs departments, links ministers and managers, and decides what to do. In other countries, an unsuccessful reform can be stripped away, leaving the core system intact. This would be more challenging in New Zealand but, as the Review of the Centre project suggests, can be done. It remains to be seen, however, what will be left if critical elements are stripped away.

To make matters even more difficult, the remarkable coherence of the New Zealand system complicates the task of picking and choosing elements to suit one's tastes. There is a conceptual coherence to the New Zealand model that is unrivalled elsewhere. Unlike most countries which assemble reforms as if they were putting together lego blocks, in New Zealand, taking away a critical element, such as the output orientation, would strip the system of its magnificent conceptual architecture. In New Zealand, the buy-in has to be almost total, which probably is why few countries have modeled their public management along its lines.

These characteristics leave me uncertain about the course that New Zealand should take in adjusting its model to the experiences of the past decade. I see little prospect for abandoning the model but need for improvement. To deal with my quandary, I propose to assess New Zealand's fiscal management in the light of standards and practices that have been applied by the World Bank and other international institutions. These practices evaluate public expenditure management in terms of three core functions:

-- the maintenance of fiscal discipline;
-- the capacity of government to allocate resources on the basis of its strategic priorities and objectives; and
-- the ability of government to operate in an efficient manner.

Fiscal discipline, allocative efficiency, and operational efficiency are common to all expenditure management systems; they have become the metrics by which country systems are compared and reforms are proposed. In most countries, and in the international
community, it is accepted that fiscal discipline is the most urgent task, for without a realistic, sustainable budget, government cannot accomplish other fiscal objectives. Most observers would accord improvements in allocation higher priority than operational efficiency. That is, they believe it more vital to do the right things than to merely do things right. Nevertheless, developments in New Zealand moved in the reverse order. The Public Finance Act 1989 emphasized operational aspects of budgeting, then in the early 1990s the government introduced strategic and key result areas (SRAs and KRAs) to sharpen capacity in defining objectives and allocating resources. The final complement was fiscal discipline, as manifested in the rules and procedures prescribed by the Fiscal Responsibility Act 1994.

In considering these three components, it is not merely that the sequence has been reversed, the emphasis also has been somewhat reversed. What distinguish the New Zealand model from public management developments in most other countries are the creative innovations in operational management through performance contracts, accrual accounting and budgeting, the capital charge, output-based appropriations, and other novel techniques. New Zealand has also made contributions in fiscal management, but can learn from innovations in other countries, such as higher-level sector allocations in Australia. Strategic allocation has been the weakest link in the New Zealand reforms, and compensatory innovations, such as the SRAs and KRAs have been only marginally successful.

The difficulty in moving ahead on strategy and policy explains, I believe, some of the current government's unease with the system it inherited. Although I am not writing from direct knowledge, discussions with a few politicians and senior officials lead me to conclude that ministers are frustrated because the system focuses on operations while the dialogue they seek deals with allocation. One way of making this point is that chief executives and ministers have different perspectives and interests. Although chief executives may be interested in outcomes and results, the system impels them to focus on the outputs for which they are accountable; and although ministers have an interest in inputs and outputs, their political goals impel them to focus on outcomes and objectives. The operational machinery
demands that ministers function as purchasers while they see their role as changing society. The problem goes beyond communication and role definition to the use of the power and resources of government to promote change. The problem is not one of measurement, but of focus. The State Sector and Public Finance Acts make chief executives responsible for the details of operation; this legislative framework does not bar them from considering outcomes and policy linkages, but it nevertheless gives them an operational role that weakens their connection to ministers. While managers focus on the minutiae of internal operations, ministers are interested in how to use their authority and resources to shape New Zealand's future. The connection between the political and managerial world is impaired if each side remains absorbed in its own narrow concerns and the two do not share enough in common to make for a satisfying relationship. In reality, most minister/chief executive relationships are much richer than this but nevertheless many ministers have compensated for what they see as a frustrating relationship by placing their own policy advisers in the Beehive. These political operatives have no bureaucratic base of their own, but the have the advantage of proximity to power holders. Whatever the short-term benefits of this arrangement, it further distances ministers from managers and complicates the job to meld the two realms into an effective government.

The success, pervasiveness and demands of New Zealand's operations-oriented management regime leave inadequate opportunity for the government to use the budget to promote better allocation or to pursue its strategic visions. The SRA/KRA system sought to fill this vacuum, but it was corrupted by some managers who adroitly used the strategic and key result measures to campaign for additional resources. It was not hard for them to make the case that one or another ongoing activity would contribute to this or that strategic measure, nor difficult for them to argue that they were meeting KRA milestones. In fact, once they were embedded in performance agreements, the KRAs became the checklists by which managers ran their operations to show they were producing the expected results. The
The government had good cause for abolishing the SRA/KRA system, but doing so left it without a systematic means for deploying budget allocations in the service of its strategic priorities.

The foregoing comments seek to explain the government’s frustration with the arrangements it inherited. The remainder of this paper compares New Zealand’s approach with developments in other countries that have sought to strengthen fiscal management. The discussion is organized around the three critical aims identified earlier – fiscal discipline, allocative efficiency, and operational efficiency. In each of these areas, the paper assesses New Zealand practice in the light of recent innovations in other countries.

**Fiscal Discipline**

**From balance to sustainability.** As recently as a decade ago, fiscal discipline was defined in almost all countries in terms of the annual balance between revenues and expenditures. Nowadays, a growing number of countries define it in terms of the sustainability of the government's fiscal position over the medium term. In contrast to balance, which looks at each year’s fiscal performance independently, sustainability considers the government's capacity to maintain its fiscal position over a period of years. Some countries now prepare their budgets within a medium-term expenditure framework that enables them to project the multi-year implications of proposed or adopted revenue and spending policies.

New Zealand is in the vanguard of this movement. The 1994 Fiscal Responsibility Act (FRA) requires the government to publish long-term budget assumptions and forecasts and to explain changes in its fiscal position. The FRA's timeframe stretches 20 years ahead, far beyond the 3-5 years normally covered by a medium-term expenditure framework. It is highly likely that future governments will regard the medium term as too brief and that many will adopt the longer-term perspective promoted by the FRA.

In New Zealand, as in other countries, a multi-year framework coexists with annual budgeting. The annual budget survives as an instrument of short-term financial control.
Appropriations still are voted one year at a time, departments and other entities publish annual financial reports, and spending units are limited in the amount they may spend during the fiscal year. The coexistence of annual budgets and long-term frameworks has led some countries to deregulate certain short-term controls. A few countries permit spending units to carry over unused operating funds from one year to the next and to pre-spend a portion of the next year's operating budget. Because of its emphasis on operational matters, New Zealand has reinforced certain annual controls. It has annual purchase and performance agreements, annual departmental forecast reports, annual audited financial statements, and other instruments of within-year control. It does not automatically permit the carry-over of savings from one year to the next, though it is relatively straightforward for departments to transfer funds in this way. Each year requires its own specification of outputs and resource envelope. In my view, these elements of annual budgeting have fostered a short-term outlook that coexists with, but is not subordinate to, the FRA's long-term perspectives. New Zealand is currently piloting longer-term appropriations and examining ways of easing the boundary problems that exist at year-end.

**Fiscal norms and rules.** As they have focused on sustainability, some governments have adopted fixed fiscal targets, such as the Maastricht criteria to guide annual budget decisions. Fiscal targets are central to the Maastricht criteria and to IMF-imposed conditionalities. The fixed targets replace the dynamic fiscal policies embraced by most developed countries during the heyday of Keynesian demand management. Targets mean that the government must stay on a preset fiscal course regardless of cyclical swings in the economy. The case for fiscal targets rests on the argument that dynamic fiscal policy generates cyclical imbalances which then become structural imbalances, and leads to a progressive expansion in the relative size of the public sector.

Fixed targets are a recent development and their viability cannot be tested until affected countries have gone through at least one economic downturn. Targets pose no problem in good economic times, but if they are applied during periods of weakness they
inhibit counter-cyclical responses. The targets do real damage if they preclude operation of automatic stabilizers, but they can also retard economic recovery if they restrict discretionary responses to economic difficulty. The current situation in the United States offers an unfolding case study of the new world of public finance. Despite strong evidence of a looming recession, politicians are committed to a fiscal stance that compels them to run a budget surplus equal to the current surplus in the social security fund. In practical terms, this means that in the face of economic deterioration, the United States government is expected to incur an aggregate budget surplus of at least US$150 billion. This sizeable sum can no longer be used, as it was in the past, to counter the adverse effects of recession. New Zealand is one of the few OECD countries that has eschewed fixed targets. The FRA does not dictate any particular fiscal outcome. In lieu of targets, it opts for transparency in fiscal conditions. The government must announce its preferred fiscal course in a budget policy statement, which may be revised as circumstances dictate. In this regard, New Zealand may have taken the more responsible course, though there is reason to suspect the existence of de facto targets. For example, if New Zealand were to topple into deficit, there would be no legal breach, but the government would likely be held to account for its failure to meet its stated fiscal target. Nevertheless, relying on transparent targets rather than on fixed fiscal norms gives New Zealand greater flexibility in managing its finances during periods of economic weakness.

**From cash budgeting to the accrual basis.** Efforts to strengthen fiscal discipline are often undermined by evasive tactics which hide the government's true financial condition. When they budget on a cash basis, as most countries still do, governments can satisfy fiscal norms by deferring payments or accelerating tax collections, by deferring maintenance and selling assets, and by a variety of bookkeeping tricks. To counter budgetary legerdemain, a growing number of countries are shifting financial reporting from the cash to the accrual basis, and a few have put the budget on an accrual basis. New Zealand has led the way, with the 1989 Public Finance Act which prescribed accrual accounting and budgeting, depreciation and audited financial statements. Although it inhibits certain scams, the accrual basis
introduces new complexity into financial management. For one thing, most governments still maintain some cash controls; for another, the accrual basis relies on assumptions about income, assets and liabilities. Whatever the limitations of the cash basis, its overriding virtue is that it is grounded on actual rather than assumed transactions. One should not be surprised if accrual budgeting leads to new types of evasions, and with an enlarged role for auditors to police the system.

New Zealand has also pioneered in using financial statements in addition to the budget to measure the government’s fiscal condition. In the early 1990s, two IMF economists argued that the balance sheet provides a truer statement of the government’s fiscal position than the budget. Their article was ahead of the time in just about every country except New Zealand. The Public Finance Act envisions use of the balance sheet to measure the financial position of departments and the state sector. But although departments now routinely prepare financial statements, it appears that most see this as a technical exercise, not as a means of managing their finances.

It should be noted that in addition to contributing to fiscal discipline, the accrual basis aims to make managers accountable for the full cost of operations. In the New Zealand model, they are charged for the use of capital, and allocate depreciation and the indirect or overhead costs of operations. But New Zealand recognizes that charging full costs may be counter-productive if managers are denied discretion in using resources. For example, charging rent for accommodation in government-owned buildings contributes to efficiency only if managers have the option of relocating elsewhere. New Zealand gives managers operating discretion; some countries that have adopted the accrual basis do not.

From the base to the baseline. In stretching the time perspective of budgeting, it has been necessary to devise new tools that measure the financial impact of authorized policy or proposed changes on future budgets. This has entailed a shift in budgeting from the base – the current level of revenue and spending – to the baseline – projected future levels. In the past, the base was the starting point for budget work in almost all questions, and key
decisions revolved over the amount that it should be adjusted for the next year. Nowadays, by contrast, the baseline is the starting point in many countries, and key decisions focus on proposed revenue and spending changes. In contemporary budgeting, a policy change is measured as the difference between the original and the new baseline.

Baseline budgeting not only extends the time horizon, it also enables budget-makers to adjust spending trends for changes in prices and workloads. New Zealand is an outlier, however, because it does not routinely adjust the baseline for price changes; it does, however, permit departments to request a review of output prices and consider funding increases to address cost pressures for current services as part of the budget initiatives round. The review sometimes leads to an upward adjustment in the baseline, but this is not always the outcome. Failure to automatically adjust for price increases may lead to hidden cuts in services, especially in small departments which have little room to maneuver. Output pricing reviews are rare, but tend to aggravate relations between the Treasury and spending departments.

**Fiscal risk.** As they strive to bolster fiscal discipline, governments have become cognizant that these efforts may be undermined by contingent liabilities such as loan guarantees, deposit insurance and exchange rate guarantees. As many emerging market and transitional countries have discovered, hidden fiscal risks can destabilize government finances. In most countries, fiscal risks are not covered by accounting and budget rules. As a consequence, governments often take no action with respect to contingent liabilities until a default (or similar event) occurs. By then, however, it is too late to mitigate the impact on the budget.

New Zealand has pioneered efforts to regulate fiscal risks. It appends statements of quantifiable and non-quantifiable contingent liabilities to the budget and financial statements. These disclosures ensure transparency of known issues that are generally under active management by the appropriate ministers and departments. Others countries now follow this practice, and some have gone significantly further in imposing budgetary discipline on fiscal
risks. Canada has procedures for vetting guarantees through the budget process, the Netherlands treats guarantees as if they were direct expenditures, and the United States has devised a credit budget system to cover the projected subsidy cost of direct and guaranteed loans. One can expect further developments in the years ahead, as contingent liabilities are subjected to more rigorous budget control. New Zealand once led the way in this area; now there is much it can learn from other countries.

**Allocative Efficiency**

This is the most challenging task for public expenditure reform, for it relates to "who gets what" from government. Even when conditions are favorable and when political leaders support the effort, it is hard to reallocate resources from lower to higher priorities or from less to more effective programs. But other countries, such as Australia, have tried harder than New Zealand. In concentrating on operational concerns, the State Sector and Public Finance Acts allowed allocation to fall between the cracks. Even though the Public Finance Act made ministers responsible for outcomes, their major new role as purchasers of outputs predominated. The fact that it was necessary to improvise SRAs and KRAs in the early 1990s indicates that there was a perceived gap in the machinery that the Public Finance Act had established. Compared to other countries, New Zealand has under-invested in evaluation and it has had little success in defining outcomes, though it now is more actively tackling this problem.

There is reason to believe that allocation is also the facet of budgeting that has proved most frustrating to the current government. It inherited arrangements which impede its ability to use the budget to shape the future New Zealand it wants. Ministers do not want to be purchasers of outputs; they want to be builders of society. They see their function as agents of change, but the budget seems grounded in past decisions and commitments. Ministers do not appreciate that everywhere budgeting is essentially an incremental process that retards the pace and scope of change. They seek a quick fix that would give them better advice from
bureaucrats and more scope for program development. But they do not have the tools to do the job.

How well are other countries – those that have tried – faring? As already mentioned, reallocation is inherently difficult. Politicians fight reallocation, even when they profess to want to do the job. Reallocation means taking from in order to give to. But a few other countries are making a stronger effort than New Zealand is.

**Medium-term frameworks.** In expanding the time horizon of budgeting, some countries have reoriented the process from costing the estimates to deciding on policy changes. In contrast to New Zealand, which has deployed the baseline as a sinking lid, others have used it as the metric for policy change, thereby organizing annual budget decisions around the question, "What policies do we wish to change, and what is the cost of these changes relative to the baseline?" New Zealand has moved in the same direction, less by design and more by **force majeure** of politics, with the arrival of MMP and coalition government. MMP governments have specified a fiscal envelope for policy initiatives over the three-year parliamentary term. Enforcing the coalition agreement entails a "fiscal provisions" process of estimating the budget impact of proposed or adopted policy initiatives to ensure they are within prescribed limits. By measuring fiscal provisions against the baseline and over the medium-term, New Zealand has moved toward the best practice of other countries.

**Evaluation.** The neglect of evaluation in the New Zealand model was not accidental; it derived from the notion that government can purchase all the information it needs in the marketplace of ideas. The failure to invest in evaluation thus arises out of the same mistaken assumptions as New Zealand's failure to invest in human resources.

Evaluation is tough work, for it depends on both relevance and objectivity; it has to be sufficiently proximate to the issue to influence policy, and sufficiently distant to be carried out without bias. It also is costly, for it requires governments to look beyond their own operations to assess the impacts on society. Only a few countries have had sustained success with evaluation. Canada failed in the 1970s and the 1980s. Australia had some success in the
late 1980s and early 1990s by building evaluation into the machinery of policy-making both within cabinet and sectoral ministries.

To build more evaluation into budget decisions, it is necessary for New Zealand to earmark resources for this purpose. Folding evaluation within broad "policy advice" output classes will not be enough.

Outcome measures. Measuring outcomes often is a frustrating, fruitless task. Governments invest considerable resources and years later have little to show for it. Managers and policy analysts fight over what is to be measured, over the causes and effects of change, over who should be accountable for what, and so on. They fight over whether a particular result is an intermediate or an end outcome, as if these terms had scriptural meaning. As noted earlier, New Zealand's fetish with outputs has made the task of defining outcomes even more problematic. The Public Finance Act's explicit distinction between ministerial accountability for outcomes and managerial accountability for outputs gets in the way of an effective relationship.

New Zealand has made some headway in recent years by thinking of outcomes in terms of the impact of government programs or expenditures. This more modest, workable, definition of outcomes may yield better results than one focused on social conditions broadly, and indeed some innovative piloting of outcome management is under way. It would be useful for New Zealand to study Britain’s use of public service agreements and to consider replacing the output-based purchase agreements with broader impact statements along the lines of those now negotiated in Britain.

Promoting reallocation. To pursue its ambitious social agenda, the New Zealand government must free up resources by vigorously reallocating money from lower- to higher-priority programs. While reallocation is difficult in all countries, it is even harder to do in New Zealand. One problem is the weakness of priority-setting mechanisms at the center of government; another is the sheer number of departments and other organizational units.
In discussing reallocation, it is useful to distinguish shifts between sectors from those within sectors. The former require strong capacity at the center; the latter may be facilitated by devolving responsibility to sectoral ministers and department heads. The key to active reallocation is to make potential adversaries (sectoral leaders) into allies by encouraging them to make trade-offs within their areas of responsibility. Broadening the jurisdiction of ministers by significantly reducing the number of departments would broaden the scope for reallocation. In this regard, the new Ministry of Social Development may be a move in the right direction, but one should not be surprised if this entity were to undergo further restructuring in the years ahead.

**Operational Efficiency**

For more than a decade, New Zealand has been the pioneer in inventing new instruments for improving the efficiency with which outputs are provided. But being a pioneer is not always a virtue, for there is little that can be learned from the experiences of other countries. As a pioneer, New Zealand has added greatly to the stockpile of ideas on public management. As noted earlier, it has been studied, but rarely emulated.

New Zealand's operational innovations fall within the rubric of "new public management", an approach whose twin tenets are that managers should be given freedom to manage and should be held accountable for results. But the New Zealand version of “new public management” differs in some critical features from the model introduced in other countries.

Running costs versus output classes. Other countries draw a sharp distribution between running and program costs. The two types of cost are budgeted separately, and each has its own rules. Typically, running costs are voted in a lump sum, with managers given substantial discretion in deciding on how to run their operations. Program costs, by contrast are allocated by law to specified activities. Different rules are applied to each type of cost in computing baselines, allocating resources, and managing the organization. New
Zealand combines program and operating funds in output classes on the grounds that doing so provides a full accounting of the cost of producing outputs. I favor the approach taken in other countries, for it clarifies both the discretion given managers and the performance expected of them. Moreover, full costs can be measured through managerial accounting systems without affecting the structure of votes and appropriations.

**Performance targets versus output specification.** Most countries target performance; New Zealand specifies outputs. Targets are selective; specification aims to be comprehensive. Performance focuses on the most important results or those warranting most attention; outputs cover all the goods and services produced by an organization.

By targeting performance, Britain and other countries communicate a strong message: these are the measures by which you will be judged. Selective measures influence behavior; if the right measures are selected, performance will improve, but there is always a risk that the measures will not be sufficiently challenging or that they will be the wrong ones. In this case, fulfilling the targets may have an adverse effect on overall performance.

New Zealand's output specification arises from the premise that the government should know exactly what it is purchasing when it spends public funds. In the same way that a firm specifies what it is purchasing from suppliers, the government should also behave as a purchaser. In practice, however, this specificity is spurious, for the New Zealand government is buying an indefinite volume of output. In the case of policy advice, which is an output class that appears in the budgets of virtually all departments, the government is purchasing the judgement, expertise and professionalism of the chief executive and other senior managers, so that they should be prepared to render advice on demand. The output specification and the payment would be the same if the minister were to meet with the chief executive once a day or only once a year.

**Contracts versus relationships.** The New Zealand model is sometimes described as government by contract. Formal agreements specify the money to be paid by ministers
for the outputs produced by departments, as well as the performance expected of chief executives (and subordinate managers) and their terms of employment. Other "new public management" countries tend to rely more on informal arrangements, such as Sweden's reliance on dialogue as the basis for the relationship between ministries and agencies. Even when formal agreements are written, as in Britain where performance agreements describe what is expected of Next Steps agencies, there is no pretense that these are genuine contracts.

In fact, New Zealand's contracts are not real contracts either. The parties to the agreement are not really at arm's length from one another, nor do they normally have effective remedies for failure to perform. In conducting research for The Spirit of Reform, I asked ministers and chief executives to describe the benefits of the agreements they negotiated. Almost all of them replied that the process of reaching agreement helped to forge relationships that carry through the year and enable both sides to discuss the results they hope to achieve. This side-benefit can be attained, I believe, without all the baggage of contracting.

The formal agreements are part of New Zealand's extensive accountability framework. So too are the specification of outputs, the accrual-basis annual reports, and other rules and procedures. In New Zealand, the accountability system entails enormous costs because more than any other country, New Zealand takes accountability seriously. It is not an afterthought or a byproduct, but the central thread of the New Zealand model. The accountability system is as demanding today as it was a decade ago, perhaps even more so. Why has it survived: because it is useful or because it is required by law? The answer to this question will go a long way in charting the future course of public sector reform in New Zealand.