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Next Steps for Public
Spending in New Zealand:
The Pursuit of Effectiveness

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ABSTRACT/RÉSUMÉ

NEXT STEPS FOR PUBLIC SPENDING IN NEW ZEALAND: THE PURSUIT OF EFFECTIVENESS

This paper reviews public expenditure in New Zealand and the scope for further progress. Since the mid-1980s, New Zealand has been a world leader in public management reforms. Government agencies have been transformed by delegating managerial responsibility to them and replacing input controls with an output-based budgeting and management approach. The adoption of a medium-term top-down fiscal management framework contributed to a large reduction in public debt. But while the system is good at producing outputs cheaply and often in innovative, responsive, and customer-driven ways, it is not as good at choosing what to produce in the first place (*i.e.* technical versus allocative efficiency). This reflects insufficient evaluation of programmes, not enough focus on managing for outcomes, and a budget that is excessively fragmented. The quality of spending could also be improved by a greater willingness to extend the use of market-based mechanisms, including user-charges, competition and choice, in social policy areas such as health and education. There is also scope to get better value for money from social welfare expenditure, which is a relatively “passive” income support system that for some beneficiaries is fairly generous by OECD standards and in some cases is administered in a relatively lenient way.

JEL classification: H0, H1, H4, H5, H6, I28, I38

Keywords: Government expenditure, public management, fiscal transparency, welfare programmes.

* * *

PROCHAINES ÉTAPES POUR LES DÉPENSES PUBLIQUES EN NOUVELLE-ZÉLANDE : A LA RECHERCHE DE L'EFFICACITÉ

Le présent article examine les dépenses publiques en Nouvelle-Zélande et la possibilité de les améliorer. Depuis le milieu des années 80, la Nouvelle-Zélande a été un chef de file mondial en matière de réformes de la gestion publique. Les organismes publics ont été transformés en leur attribuant des responsabilités de gestion et en remplaçant les contrôles des ressources par une approche de planification et de gestion des résultats. L'adoption d'un cadre de gestion budgétaire à moyen-terme de conception descendante a contribué à réduire fortement l'endettement public. Mais si le système est satisfaisant pour produire moins cher et souvent de façon innovante, réactive et tournée vers le client, il n'est pas aussi performant pour choisir ce qu'il faut produire d'abord (ex. efficacité technique ou allocative). Cela reflète une insuffisance au niveau de l'évaluation des programmes qui n'est pas assez ciblée sur la gestion des résultats et un budget qui est trop fragmenté. La qualité des dépenses pourrait aussi être améliorée en utilisant davantage les mécanismes fondés sur le jeu des marchés, dont les redevances d'utilisation, la concurrence et le choix dans des domaines de la politique sociale comme la santé et l'éducation. Il est aussi possible d'optimiser les ressources consacrées à la protection sociale qui est un système de garantie plutôt passif, assez généreux selon les normes de l'OCDE et relativement laxiste dans l'application des critères d'éligibilité.

Classification JEL : H0, H1, H4, H5, H6, I28, I38

Mots clés : dépenses publiques, gestion publique, transparence budgétaire, programmes de garantie de ressources.

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**NEXT STEPS FOR PUBLIC SPENDING IN NEW ZEALAND:
THE PURSUIT OF EFFECTIVENESS**

by David Rae¹

Overview and main themes

New Zealand began an ambitious fiscal reform in the late 1980s, trying to boost the quality and reduce the level of public spending. This involved a change in the role of the state, re-engineering the public sector and, a few years later, creating a transparency-based framework in an attempt to impose better top-down expenditure control. On the whole, these moves have been successful. Reforms began with one of the OECD's most aggressive corporatisation and privatisation programmes, and this, combined with an efficiency drive, reduced general government outlays from more than 50 per cent of GDP in 1986 to less than 40 per cent at present. The central government's operating accounts moved into surplus in 1994 and, since then, have seen nine structural surpluses in a row, an uninterrupted run that only two other OECD economies have achieved since 1970. Overall, fiscal policy has remained prudent, albeit with some slippage around the edges, and has withstood a constitutional shift from single-party to coalition governments. The innovative "fiscal provisions" framework can take some of the credit for this. New Zealand has also moved further than many countries in reforming public management, by removing most input controls and giving managers broad freedoms to run their agencies, but at the same time making them accountable for the results. Consequently, its best public agencies are world class.

After these initial reforms, however, New Zealand has made little further progress while other countries have caught up. As a result, one (admittedly uncertain) indicator of government efficiency ranked New Zealand best in the OECD in 1999, but it has since slipped to thirteenth place (IMD, 2001). Strong growth in nominal GDP, partly driven by unexpectedly high terms of trade, has taken some of the pressure off fiscal policy. The economic recovery, combined with favourable demographic trends, opened a window of opportunity to lock in large surpluses and make room for looming age-related spending pressures. That opportunity was not squandered, with undoubted progress in paying down debt, but by the same token it was not fully seized. At least some of the "windfall" was spent, which may reflect society's choices about spending today versus spending in the future, or may indicate that the fiscal framework was unable to avoid the OECD-wide difficulty of running *large* fiscal surpluses for any length of time. In any case, it increases the pressure on other areas of spending, implying a need for greater attention to ensuring that

1 . The author is an economist at the OECD. This paper was originally produced for the *OECD Economic Survey of New Zealand* published in May 2002 under the authority of the Economic and Development Review Committee. Thanks for their comments go to many colleagues, especially Peter Jarrett, Mike Feiner, Jørgen Elmeskov, Alex Matheson, and Derek Gill; special thanks go to Françoise Correia, Mee-Lan Frank, and Lillie Kee for their technical assistance.

scarce resources are channelled to the highest priority areas and to how greater value for money and better outcomes can be delivered.

This paper reviews the strengths and weaknesses of the public management framework and discusses an agenda for further reform. There are several broad themes. The *first* is that the current public management machinery is good at producing outputs cheaply and often in innovative, responsive and market-driven ways. It is less good, however, at choosing what to produce in the first place (in the jargon, technical versus allocative efficiency). This is partly because there has been more focus on outputs than outcomes, and not enough evaluation of whether programmes are achieving their objectives. Decisions that are made on the basis of political and economic judgement, but with little supporting evidence, crop up in several places. *Second*, after being opened up to some extent in the 1990s, competition and choice in the provision of social services are being discouraged for various reasons. Examples include schools, tertiary and early childhood education, accident insurance and health. *Third*, while market-based mechanisms such as user charges, contracting out and implicit vouchers have become commonplace in several areas, there is a reluctance to extend them further into social policy areas such as education and health, but also into areas such as road transport. Instead of economic of economic incentives, there is a preference for co-operation and partnership in achieving desired social outcomes. This is most clearly seen in the social assistance area. *Finally*, there is a move back towards more universal provision of social services and for public providers to be favoured over private ones. Universal provision is expensive, but it has the advantage of reducing problems associated with high marginal effective tax rates (METRs). It is difficult to get the trade-off right but there are some areas where the extra expense probably outweighs the potential benefits, so outcomes are not being achieved in the most cost-effective way.

Long-term expenditure trends: rise, fall, stabilisation

Government spending has grown substantially since the 1960s, with most of the growth being in merit goods and transfers rather than public goods (Table 1 and Figure 1). A distinctive feature of New Zealand's history is its very large public investment programme in the 1970s and 1980s, averaging around 7½ per cent of GDP. It began after the second oil shock and was concentrated in major energy projects, such as hydro-electric dams and synthetic petrol plants, in order to reduce the reliance on imported oil. But expenditure growth was not confined to investment. Income transfers have increased from 6 per cent of GDP in the early 1960s to 12½ per cent today, driven by a rise in the unemployment rate and the introduction of a universal pension in 1972. They are now higher than in other English-speaking countries, but much less than in continental Europe.² Expenditure growth from all sources led to a blow-out in the structural deficit in the mid-1970s and again in the mid-1980s to as much as 8 per cent of GDP. A reformist government then sought to control spending, but the unemployment that flowed from economic restructuring stymied their plans. Spending continued to rise, and the fiscal gap was plugged by a faster increase in taxation. The net effect was that the general government spending ratio remained around 50 per cent of GDP until serious expenditure control began in the early 1990s. Welfare cutbacks played an important part, with benefit rates being reduced, eligibility criteria tightened, and the pension-eligibility age being raised from 60 to 65.

2. The difference between countries is exaggerated in the chart because it is calculated on a pre-tax basis, and European countries claw back more than other countries through their higher tax rates (Adema, 2001).

Table 1. **General government spending¹**
Per cent of GDP

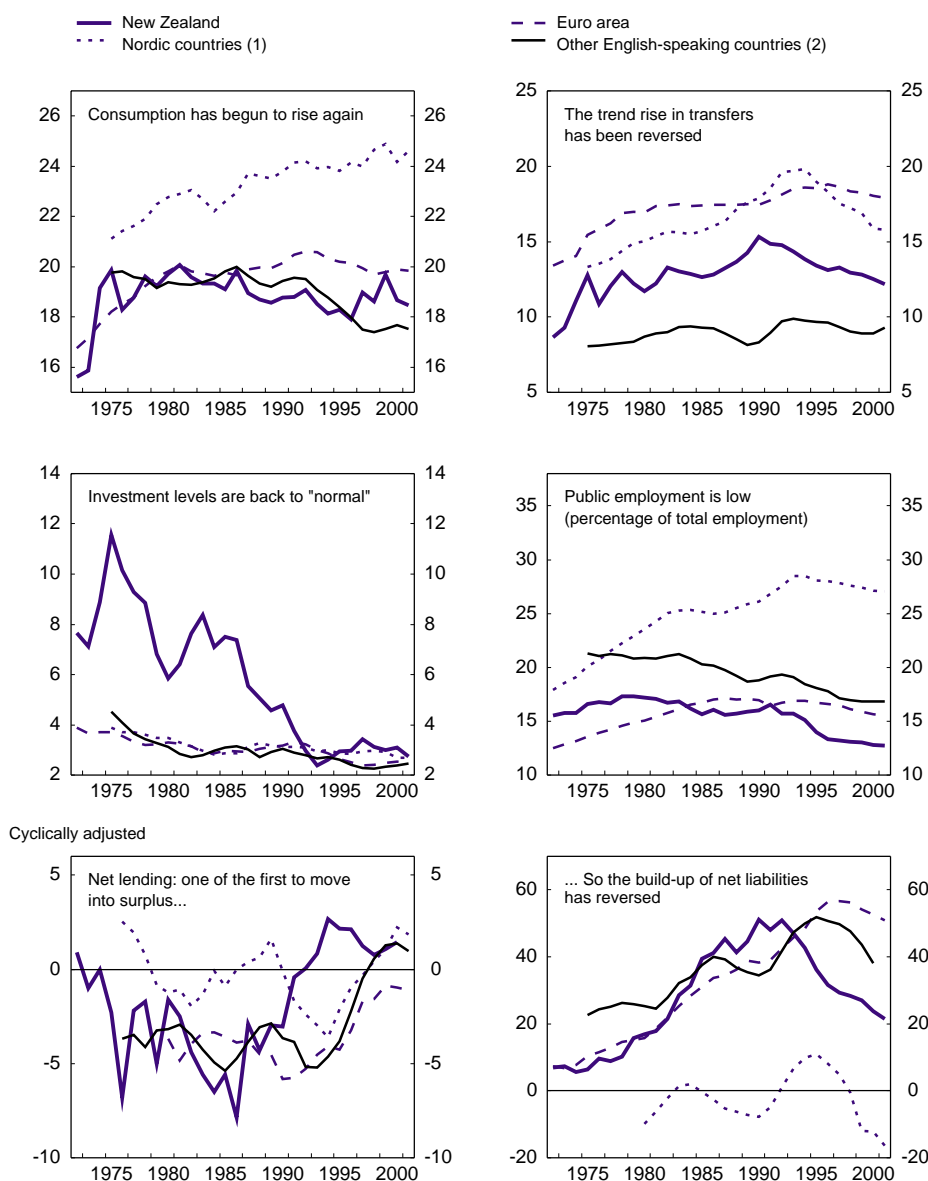
	Total excluding interest	Merit goods				Income transfers					
		Total	Educa-tion	Health	Other social services	Total	Pensions	Disability and sickness benefit	Family cash benefits	Unemploy-ment	Housing and other benefits
New Zealand											
1999	36.1	12.3	6.0	6.1	0.1	13.8	5.4	2.9	2.4	2.2	0.9
1986	41.8	9.9	4.1	5.8	0.0	13.6	7.1	1.7	2.6	1.7	0.5
1972 ²	28.3	8.4	4.5	3.9	..	8.1	..	..	..	..	..
Australia	30.5	10.9	4.3	5.4	1.2	10.2	4.2	2.1	2.2	1.5	0.2
Austria	46.0	13.8	6.0	5.8	2.0	19.0	12.8	2.5	1.9	1.4	0.4
Belgium	40.4	11.4	5.0	6.1	0.3	18.1	9.8	2.0	2.0	3.8	0.3
Canada	31.0	12.1	5.5	6.6	..	11.2	5.5	1.0	0.8	1.4	2.6
Czech Republic	42.7	11.1	4.1	6.5	0.5	12.7	7.6	2.7	1.6	0.5	0.3
Denmark	47.8	18.8	6.8	6.8	5.2	17.8	6.8	2.6	1.5	5.0	1.8
Finland	44.0	14.0	5.7	5.3	3.0	18.3	8.0	3.5	1.9	3.9	1.0
France	48.4	15.0	5.9	7.3	1.9	19.7	12.2	1.6	1.5	3.1	1.3
Germany	42.7	13.7	4.4	7.8	1.6	18.0	11.0	1.7	1.9	2.6	0.8
Greece	43.3	9.1	3.4	4.7	1.0	16.9	12.2	1.9	1.2	0.7	1.0
Iceland	35.7	16.8	6.5	7.0	3.2	8.2	4.3	1.6	1.2	0.5	0.5
Ireland	29.5	9.5	4.3	4.6	0.5	10.6	3.5	1.5	1.6	2.9	1.2
Italy	39.8	10.8	4.8	5.5	0.5	19.1	15.4	1.7	0.6	1.4	0.0
Japan	32.7	9.8	3.6	5.6	0.6	8.4	6.7	0.6	0.2	0.7	0.2
Korea	22.5	6.7	4.1	2.4	0.3	3.3	2.1	0.4	0.0	0.6	0.2
Luxembourg	39.8	11.3	5.0	5.4	0.9	15.2	8.7	3.1	2.3	0.8	0.3
Netherlands	38.8	12.1	4.5	5.9	1.7	16.1	7.0	3.4	0.8	3.9	1.0
Norway	43.9	18.6	6.8	7.1	4.7	15.2	6.3	4.3	2.2	1.4	0.9
Poland	43.4	10.2	5.3	4.6	0.2	18.4	10.2	5.9	0.9	1.0	0.4
Portugal	37.3	11.3	5.6	5.1	0.6	12.5	7.7	2.3	0.6	1.6	0.3
Slovak Republic	50.7	0.5	..	..	0.5	13.3	6.3	3.1	1.8	0.8	1.2
Spain	36.1	10.2	4.4	5.3	0.4	13.9	8.9	2.3	0.3	2.2	0.2
Sweden	49.9	18.6	6.6	6.6	5.4	18.9	8.2	3.5	1.6	3.9	1.7
Switzerland	32.0	13.9	5.4	7.7	0.8	19.9	12.5	3.4	1.2	1.8	0.9
Turkey	36.2	8.2	2.9	5.0	0.2	9.1	6.3	0.3	1.0	1.0	0.5
United Kingdom	34.3	11.6	4.6	5.6	1.3	17.8	10.8	2.8	1.7	0.6	1.8
United States	26.4	11.0	4.8	5.8	0.3	8.2	5.9	1.1	0.2	0.4	0.5
OECD average	38.6	11.9	5.1	5.8	1.4	14.4	8.1	2.4	1.3	1.8	0.8

1. Data is for 1999, or 1998 when not available. Education data always concern 1998. Data is from different sources, so public goods cannot be calculated as total government outlays minus merit goods and transfers.

2. OECD estimate based on several sources, so this figure is only approximate.

Source: OECD.

Figure 1. Trends in general government spending
Per cent of potential output

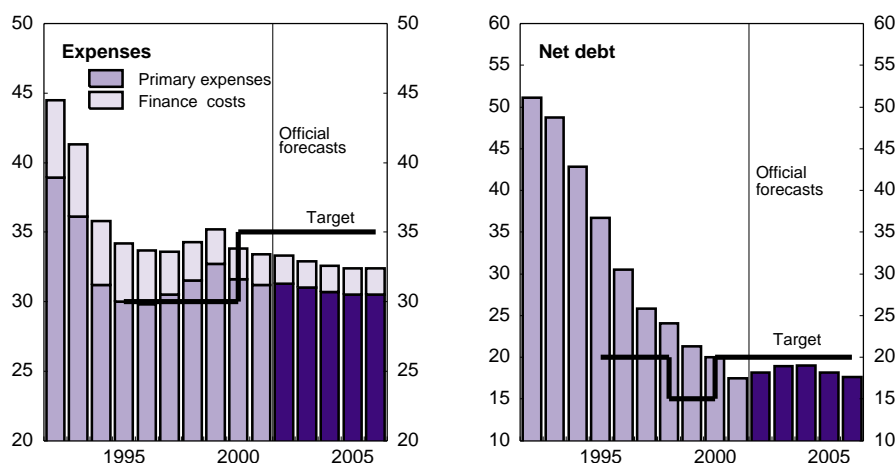


1. Denmark, Finland, Norway, Iceland, Sweden.
 2. Australia, Canada, United Kingdom, United States.
- Source: OECD.

The Fiscal Responsibility Act (FRA) has played a part in expenditure restraint, but in a limited way. It came into effect in 1994, just as the Crown accounts were moving into surplus, and a key objective was to maintain those surpluses in order to reduce debt. That has been achieved, so that net debt as a proportion of GDP has halved since the Act came into force (Figure 2). On the other hand, it requires the government to set long-term objectives for operating expenses.³ Progress towards the expense objective

3. Clarifying some terminology would be useful. Since 1992, Crown accounts have been presented on an accruals basis, so operating and capital expenditures are treated separately. In this paper, the term

Figure 2. Progress towards objectives has been mixed
Per cent of GDP, June years



Source: New Zealand Treasury.

has been less impressive. The original goal was to reduce expenses below 30 per cent of GDP, and while they fell considerably in the early 1990s, little headway has been made since. The current government altered the target in 2000 to mirror current expense levels rather than driving them down further in any material way.

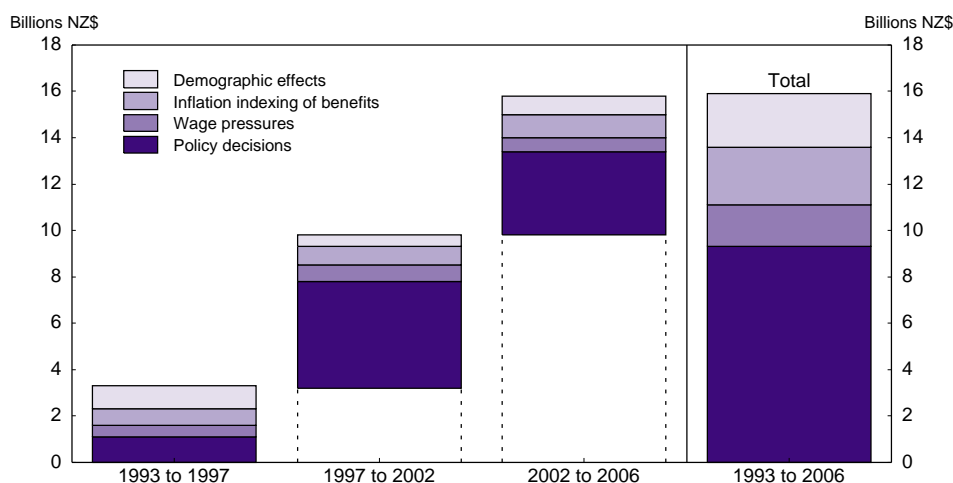
A partly-seized opportunity?

With favourable demographics, the 1990s gave a window of opportunity to lock in surpluses and make room for future age-related spending pressures. That opportunity was partially seized: debt was reduced significantly; taxes fell; and spending was maintained as a proportion of GDP. However, if policies had remained unchanged then spending could have fallen much further. For example, nominal operating expenses increased by around NZ\$ 10 billion in the nine fiscal years to June 2002. A small amount of this was caused by population growth, some by benefits being indexed to inflation, and some by wage pressures, but more than half has been the result of explicit policy decisions (Figure 3). Without those policy decisions, the operating surplus could have been as much as 5 per cent of GDP in 2001/02 rather than the actual 2 per cent.⁴

“expenses” refers to *Crown operating expenditure measured on an accruals basis*. As for a private firm, it includes an allowance for depreciation. However, new investment (expanding the balance sheet) is treated as capital expenditure. At present, the Crown refers to central government agencies but excludes some quasi-independent government agencies (Crown entities) and state-owned commercial enterprises. There are also accounts for the *general government* (which includes local government and Crown entities) presented on a national accounts or SNA-consistent basis, and are therefore cash-based. However, these are out-of-date: the latest estimates end in March 1998. Figures for general government after that date are OECD estimates based on whatever sources are available. In any case, general government is not referred to from this point forward.

4. There is no clear-cut way to split the spending increase into policy vs. other effects, although rough estimates can be made. Treasury (1997) analyses the increase in spending from 1992/93 to 1996/97 and splits it into non-discretionary effects (demand and demographics, plus the impact of indexing benefits to

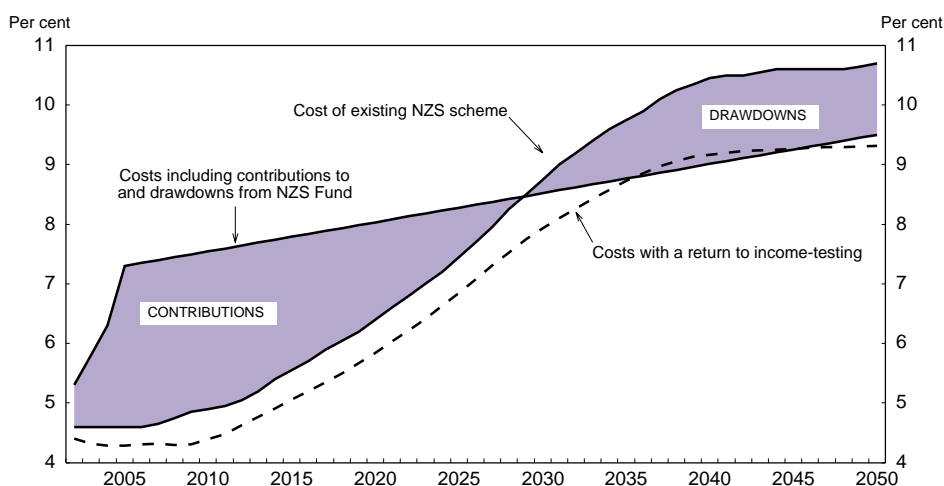
Figure 3. Reasons for the increase in spending
NZ\$ billion, June years



Source: Crown Financial Statements and OECD calculations.

While New Zealand’s future pension problem will not be as difficult as in many other OECD countries, the costs will still be significant (Figure 4). By far the biggest step towards controlling future costs has been raising the pension eligibility age from 60 to 65. In addition, the pension was income-tested between 1986 and 1998. The government has now begun to set aside surpluses in a Superannuation (NZS) fund, which is being managed at arms-length by government-appointed trustees. While this is a useful

Figure 4. The rising cost of superannuation
Per cent of GDP



Source: OECD estimates based on NZ Treasury model.

inflation) and policy effects (all other). A similar breakdown is available from the financial accounts for subsequent years. In the Treasury analysis any other increase above the fixed nominal baseline, including wage increases for public employees, is regarded as a policy decision. The estimate of 5 per cent of GDP in this paragraph, however, treats wage increases as an unavoidable cost pressure.

additional step, it will not reduce the fiscal cost of an ageing population, but only spread it more evenly through time (unless it increases national saving and investment, which is highly uncertain). By doing so, superannuation costs are projected to peak at around the same level as if pensions had continued to be targeted (Figure 4). In any event, only partly taking up the fiscal opportunity will make further parametric reforms to pensions more likely.

Budget strategy: making sure the budget mirrors the government's goals

New Zealand launched a thorough overhaul of public management in the late 1980s, reforming more deeply and more broadly than most other OECD governments. The most important aspects of the reform (Box 1) involved clarifying what agencies were supposed to be doing (controlling them by telling them what outputs they were required to produce, not what inputs they were permitted to use), giving managers a free rein over how they went about their business (managerial freedom plus accountability) and providing better management information (accrual accounting). Conglomerate departments were re-organised into smaller, more focussed units, using the principle of "one purpose, one organisation." Most of the other reforms, such as separating policy advice from the delivery of outputs, were to support this basic framework by giving managers more options over how they delivered outputs and by removing conflicts among objectives.

Box 1. Public management reforms

Clarifying the objectives. New Zealand's system is often described as a "contractual" model in which ministers write contracts with department heads (chief executives), which specify what outputs they are buying and at what price. Appropriations are made to ministers who can buy from government agencies or from outside suppliers (in reality, most purchase from their "own" department). Appropriations are made for output classes, which are bundles of related outputs. While it can be helpful to think of the system as being like private-sector contracting with an arms-length relationship between the purchaser and provider of services, this exaggerates the similarities with formal contracts and overplays the distance between ministers and their departments. In practice, the detailed purchase agreements are just a formal way to create a dialogue so that both parties know what is expected of them. Consequently, the quasi-contracts, and the accountability paperwork that supports them, can (and are) being simplified without losing the essential element of clarity about objectives.

Freedom to manage. Permanent heads of departments were replaced by chief executives on fixed-term contracts (of up to five years), with the possibility but no expectation of renewal. They have been given considerable freedom over how they manage their departments. Although there are some exceptions, chief executives are free to choose the most efficient mix of inputs to produce each output. They employ staff and negotiate terms of employment directly (although centralised wage bargaining remains in some areas such as teachers and nurses).

A consequence of this devolved management approach is that decisions on whether to produce in-house or to contract out are largely left to managers. Information on the extent of contracting out is therefore difficult to come by, although a 1997 study (which was itself contracted out; see DTT, 1997) estimated the figure to be around ten per cent of spending. This is most prevalent for back office functions (inputs) such as IT services and banking, although some outputs are provided by third parties, including some social services.

Better information for managers. The Public Finance Act 1989 introduced accrual accounting at the departmental level, although not at the total government level. This came later in the Fiscal Responsibility Act 1994. The government is now required to follow Generally Accepted Accounting Practices (GAAP) and has improved financial information by accounting for depreciation and charging for the cost of capital tied up in an agencies' balance sheets.

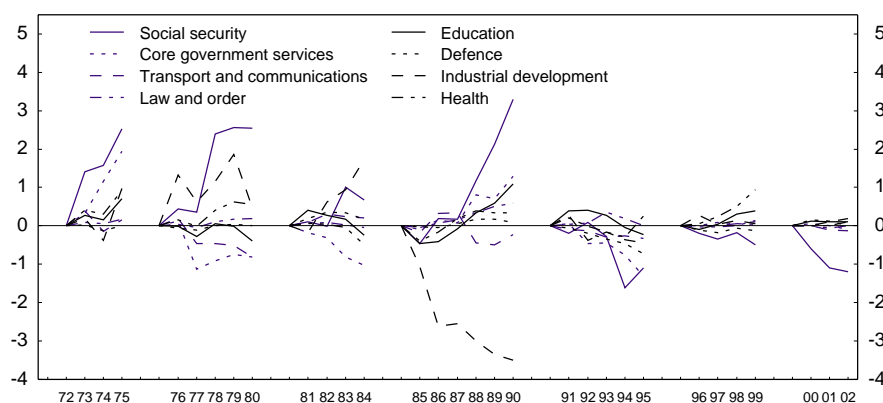
The framework has several strengths. First, there is convincing evidence that these reforms have raised efficiency.⁵ No single study is definitive, but the evidence is broadly consistent across several approaches: econometric studies of unit costs; surveys of public managers and the public themselves; and output price reviews, which are line-by-line reviews of departmental spending, undertaken by the Treasury and initiated by agencies who feel they have reached the limits of productivity gains within existing baselines. There is also considerable anecdotal and survey evidence that the public sector is now providing better-quality services and is more innovative and responsive to the needs of the public. However, there have been occasional failures, such as difficulty getting through the tax department's labyrinthine computerised telephone system and delays in the disbursement of student loans. Yet it is notable that service delivery problems of this sort have resulted in public outcry rather than being regarded as typical of government agencies, as they may have been in the past.

There are also some areas requiring further focus. The biggest challenge for the public management system is to improve the alignment between the allocation of resources and the government's overall goals. The Secretary to the Treasury commented that "it was interesting in the 2000 budget round that out of 500 budget proposals from spending ministers, only a handful offered up savings, particularly given that there was a new government in office, which may have wished to discontinue or reprioritise some existing programmes" (Bollard *et al.*, 2001). The State Services Commission (SSC), which oversees the public service, has also noted a weak connection between strategy and spending, with budget allocations having a strong historical bias. Occasional large-scale strategic choices have been made, such as abolishing the Air Force's air combat wing, but these have been the exception rather than the rule. Such problems are common place⁶ but, even so, there are examples of countries that do appear to have been more successful. The World Bank in 1995 compared the public management frameworks of New Zealand and Australia and concluded that Australia was stronger in the area of allocative efficiency while New Zealand's system was more geared towards technical efficiency (Campos and Pradhan, 1996). While the difference between the systems has shrunk since then, and the World Bank study probably exaggerated the difference in the first place, the basic point appears valid. Australia's regular expenditure review process has, between 1985-86 and 1995-96, generated savings of AUS\$27 billion, offset by spending on new policy of AUS\$20 billion. Total policy changes stemming from expenditure reviews over this decade has amounted to about 45 per cent of the average annual budget outlays (Keating, 2001). A direct comparison with New Zealand is difficult, but the provisions framework encourages savings to be identified so they can be reallocated to new initiatives; however, identified savings have been small since 1997. In addition, and bearing in mind the obvious difficulties of making such comparisons, there is some tentative evidence that New Zealand's budget allocations in the 1990s were stable by historical standards across relatively broad categories (Figure 5).

The apparent difficulty in reallocating expenditure is surprising. Fixed nominal baselines have put departments under significant fiscal pressure and should have forced them rethink priorities and to offer up suggestions to ministers. To the extent that stability of budget allocations reflects rigidities in the system, there would seem to be three primary causes, each of which is developed further in the following sections:

-
5. A broad range of evidence from 40 studies is surveyed in Petrie and Webber (2001). International benchmarking, however, is not common. One exception is the Department of Corrections, which runs prisons and seems to be quite efficient by international standards (Department of Corrections, 2001).
 6. It is striking that of the five international case studies of reallocation in OECD (2001a) all discussed a major one-off reallocation process that occurred at a time of fiscal crisis rather than an ongoing process.

Figure 5. Spending patterns have become more stable over time
 Cumulative increase in spending relative to a balanced growth path¹
 Per cent of GDP



1. The balanced growth path assumes that all spending categories grow at the same rate as nominal GDP. Data before 1994 is on a cash basis; data afterwards represents expenses on an accrual basis.
 Source: Crown Financial Statements and OECD calculations.

- *Not enough evaluation.* Although the budget process forces a detailed examination of new spending proposals, this represents only 5 per cent of total expenditure. There is no centrally driven, systematic or regular review of the remaining 95 per cent.
- *Insufficient focus on outcomes.* Outcome management has been underdone, partly because managers have had insufficient incentives to develop an information base and analytical capability, and partly because of insufficient push from the centre. The balance between efficiency and effectiveness could be improved by focussing more on outcomes.
- *Not enough central stewardship.* As in an army, literally hundreds of agencies have been sent into the field, each with their specific “orders.” This fragmentation and delegation have been the main reasons why the machinery has been good at increasing efficiency. However, it makes re-allocation difficult, unless supplemented with strong “generalship” or strategic management from the centre to ensure that agencies and resources are redirected when government priorities change. This is not done as well as it could be, for several reasons, one of which is that, in general, the pools of money are too small and scattered too widely. In addition, the government’s strategic priorities are too vague to allow agencies to “redirect themselves”. However, the government’s recent *Review of the Centre* is addressing some of these concerns.

Regular and comprehensive programme review is needed

Fiscal pressures in the 2000 budget round led the government to undertake a partial review of baseline expenditure in its *Value for Money* exercise. The effort, however, generated savings of only around NZ\$ 65 million per year (just 0.2 per cent of spending). Part of the problem may have been that it was driven from the top down, with insufficient support from agencies or spending ministers. A possibly more important reason is that it was relatively unstructured. There was, and still is, no systematic

Box 2. Questions to evaluate value for money

1. Does the programme still serve a clearly defined public purpose that matters?
2. Is this an appropriate role for government?
3. Would we establish the programme today if it did not already exist?
4. Is it desirable to maintain it at its current level?
5. Can it be delivered more effectively or efficiently? Have there been changes (in the service environment, infrastructure, technology, etc.) since the programme's inception that would now permit an alternative means of achieving its objective with greater economy, efficiency, or effectiveness?

Sources: Canadian Office of the Auditor General and Finance Canada.

framework for assessing value for money. A regular programme review process needs to be put in place, with an emphasis not on whether a particular output is being delivered efficiently, but on whether it is high priority for public expenditure in the first place. The suggestions of Canada's Auditor General would be a useful starting point (Box 2). Evaluation on its own is not enough. Government must clearly support the process, and ministers must be willing to cut programmes that are not performing. The process could benefit from oversight by an independent agency.

A greater focus on outcomes

The government is taking some initial steps towards public management's Holy Grail — linking budget decisions to desired outcomes. A deliberate decision was taken early on to make managers accountable for outputs rather than outcomes, mainly because outcomes are too ephemeral to tie performance to, and therefore cannot provide management incentives that are sharp enough. The Public Finance Act requires departments to link outputs with outcomes, although this has typically been done in a cursory manner by baldly asserting that Output *a* contributes to Goal *b*.⁷ Neither departments nor central agencies extensively measure or evaluate outcomes, and New Zealand is one of the few OECD countries that does not present to parliament its performance against outcome targets (OECD, 2002). However, several useful steps have been taken to overcome these weaknesses, including: *i) Evaluation criteria*. All bids for new expenditure must include criteria on how that programme could be evaluated in the future. This should be extended to all baseline expenditure. The government could boost the credibility of this new requirement by, for example, committing itself to assessing a certain proportion of new expenditure against their nominated criteria; *ii) Improved information on "the state of the nation"*, such as the *Social Report*, which contains snapshot information on a range of social indicators; and *iii) Improved performance documents*. New planning and reporting expectations have been set for all departments, and aim to ensure that more emphasis is given to co-ordination, outcomes, human resources and risk management, rather than just outputs. One of the main required documents is a Statement of Intent (SOI), tabled in parliament, which sets out a picture of what the agency is trying to achieve and how it plans to do so over the next three years. The first SOIs are of variable quality, but as they improve they should be of more use to ministers and parliament than the previous annually-focussed Departmental Forecast Reports.

An increased emphasis on outcomes will lift the quality of public spending to the extent that it improves the dialogue between ministers and managers about the ultimate objectives of each policy or programme. But improving incentives for managers to undertake this work will also be necessary. The proposal to link chief executives' performance evaluations to their progress in outcome measurement and

7. See Ussher and Kibblewhite (2001) for a more detailed discussion.

evaluation should help, if done well. However, care will need to be taken to ensure that the recent discouragement of one-off bonuses does not unduly restrict performance-related pay since it could reduce performance incentives at all levels of the public service, including those facing managers to deliver their outputs.

While there can be a tension between managing for effectiveness and for efficiency, outcomes and outputs can be used side by side in the public sector. Outputs are a better management tool where their characteristics can be specified centrally, such as passports or border control, with control then being delegated to line managers. Outcomes are more appropriate at the other end of the spectrum, such as in the areas of social and labour market policy, where the ultimate goals are clear (for example, reduce teen suicides) but solutions are best determined at the front line.⁸ But even in the latter areas it would be a mistake to back away from a clear specification of outputs as the main basis for accountability. If done well, outcome management can lead to a government that is more focussed on its ultimate objectives and less on process, ownership or control, and by doing so is more effective. For example, the government has legitimate social and cultural objectives in the area of public television. But it is not immediately obvious that owning a TV network is a necessary, or even the most efficient, way to achieve them. They might also be achieved by retaining only the non-commercial part of the company, or by buying airtime in the open market. Similar re-thinking can be done throughout the public sector. To what extent does the government need to control the running of schools in order to achieve its desired education outcomes? Can health outcomes be achieved better, or cheaper, by encouraging other providers? Does the government need to own and run an insurance company if it wants to ensure efficient and adequate accident coverage (Box 3)? Some of these questions are taken up in the next section.

Strengthening the centre by reducing fragmentation...

The fragmentation of the system gets in the way of re-allocation and the pursuit of effectiveness. In 2000, there were around 800 separate appropriations for outputs spread across 78 Votes. In contrast, Australia has the equivalent of 27 Votes administered by 17 portfolio ministers, while Sweden also splits spending into 27 broad categories. These appropriations vary enormously in size, ranging from NZ \$20 000 to NZ \$1.4 billion. If the District Health Boards are treated as a single output class, then the eight largest appropriations account for half of current expenditure; the 200 smallest account for only 2 per cent. Parliament must approve non-trivial re-allocations between appropriations, so most occur at budget time and tend to be within rather than between Votes. There is an understandable tendency for agencies and ministers to protect their patch or to regard their programmes as important, and there is little incentive for agencies to volunteer savings or to give up programmes if those savings may be reallocated to another Vote Minister.⁹ The bigger the portfolio, the greater the opportunity for a minister to move funding around to meet priorities. Allocating bigger pools of money has the potential to substantially improve the top-down focus of the system.

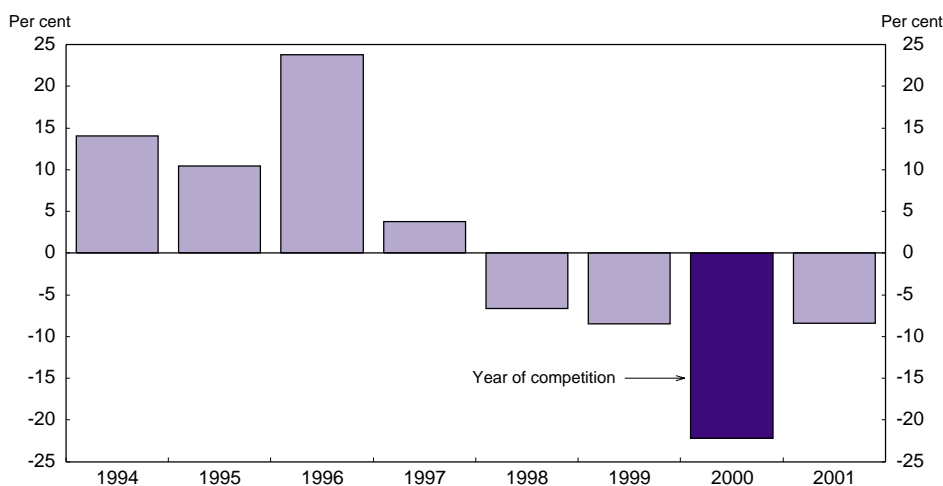
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8. In any case, the distinction between outputs and outcomes is greater in theory than in practice. The textbook case of outcome targeting in New Zealand is the Reserve Bank's inflation target. Even here, however, accountability is not based entirely on outcomes. Under the law, the primary function of the Bank is "to formulate and implement monetary policy" (an output) "with the economic objective of ... maintaining price stability" (an outcome). The Governor is not automatically dismissed for failing to achieve the outcome, but may be if he fails to produce the output (by not setting policy appropriately, given the information he had available at the time).
 9. Canada's experience provides salutary lessons. It tried putting funding in common pools and attempted to relocate within them. This failed. No savings were offered up, even by a Minister to fund another project under his or her control, because those savings could be hijacked by someone else.

Box 3. The benefits of competition and choice: the accident insurance monopoly

Accident insurance is the only significant non-wage labour cost. The government spent NZ\$ 1.7 billion on accident rehabilitation and compensation in 2001 *via* its accident insurance monopoly, the Accident Compensation Corporation (ACC). The workplace accident scheme is fully funded and is financed by a payroll tax averaging 0.9 per cent of wages, with a portion of the levy being used to cover the ongoing costs of accidents that occurred before the scheme became fully funded in 1999. Other accidents are covered from general taxation or other specific levies.

The portion of the scheme that covers workplace accidents was privatised in July 1999. Five private insurers entered the market during 1999/2000 and ACC was not permitted to compete. It is difficult to draw definitive conclusions about the effects of the private market because it existed for only one year and was not fully competitive: many overseas insurers were reluctant to enter the market because the then-opposition had already signalled its intention to reverse that decision. Nevertheless, the initial results were impressive. Prices dropped by an average of 22 per cent, the largest fall in the scheme's history (Figure 6). According to the Chief Executive of ACC (Wilson, 2001), large and medium-sized firms faced the biggest declines, although prices rose for some small companies, while large firms tended to initiate injury prevention programmes in order to negotiate lower premiums. There is also some anecdotal evidence that rehabilitation rates increased, but evaluation is hampered by a lack of hard data. Perhaps, as a consequence, rehabilitation costs fell significantly but have since risen. The major negative effect was some deterioration in relationships, especially between doctors and insurers, and delays in settling some claims. Despite these promising initial results, the incoming government re-instituted its monopoly over the scheme in 2000, arguing that marketing costs in the competitive environment were too high and private companies may have been setting premiums at unsustainably low levels in order to attract business. However, no formal evaluation was done to justify the decision (although work is in progress), and it seems unlikely that premiums were too low given that premium rates have continued to fall under the new structure. This is an area that has successfully been left to the private sector in many countries, and the brief experience with privatisation was overwhelmingly positive. Opening up all areas of accident insurance to competition could potentially boost the efficiency of public spending.

Figure 6. Competition reduced ACC insurance premiums sharply
Employers' levy, annual percentage change, June years



Source: Statistics New Zealand.

A second problem is that the large number of agencies may stop savings initiatives bubbling up from below. Few managers would volunteer to give up a large chunk of their resources for the "common good". When Crown entities are included, there are more than 200 substantive government agencies, although they vary considerably in size: the two largest departments account for a third of state-sector

employment. Fragmentation may have led to “tunnel vision”, reducing co-ordination across agencies and making it more difficult to re-allocate spending.¹⁰ However, it is not evident that amalgamation of agencies is the best solution. The benefits of having a highly focussed organisation may be lost, the costs of restructuring are significant, and organisational walls can be just as impenetrable between divisions of a single conglomerate organisation. Dealing with cross-cutting or horizontal projects is more about project management than industrial organisation. As part of its *Review of the Centre*, the government is considering encouraging networks of agencies to deal with inter-sectoral issues. This is welcome and could be supplemented with more use of formal networks at the ministerial level, such as in the Biosecurity project. Further consideration should also be given to alternative arrangements, such as UK-style executive agencies operating semi-autonomously within departments.

The approach of separating delivery from policy units has added to the number of departments, and there has been a concern in some quarters that theory has become too far removed from front-line delivery issues. This was part of the reason why the Ministry of Social Policy was reunited with the agency that pays benefits, WINZ (Hunn, 2000).¹¹ However, amalgamations like this may not be the answer. There is merit in the original intention of separating delivery from policy, especially in avoiding policy capture and in reducing the risk that policy analysis gets crowded out by operationally urgent requirements (SSC, 2000a). The problem may not be the separation *per se*, but that some of the policy shops are too small to attain critical mass and therefore have difficulty attracting or retaining the highest-quality analysts (Boston, 1999; Scott, 2001). A more effective solution may be to amalgamate policy organisations into two or three large policy Chancelleries that can provide high-quality competing policy advice, as was mooted at the time of the 1988 reforms.

... ensuring that broad priorities are clear and specific...

Successive governments have made several attempts to articulate their strategic priorities in the hope that ideas for improving delivery and re-allocating funds would filter up from below. Many OECD governments are also struggling with the issue of strategic alignment, and some measure of success has been achieved (such as in the United Kingdom and Australia). There are currently six Key Government Goals, but they are too vague and long-term to guide allocation decisions at the departmental level. Most, if not all, of today’s expenditure could be slotted into one or more of the Key Goals. The recently announced *Growth and Innovation Framework* is an attempt to provide more specific goals and to pick three generic sectors that the government would like its agencies to focus most attention on. The goals are still too broad, however, but that may improve as more flesh is put onto the bones of the framework. An initiative that had some success in the 1990s was the system of Key Results Areas (KRAs), which attempted to bridge the gap between broad goals and current expenditure decisions. These were specific, three-year objectives that were clearly measurable and had specific timetables or milestones. The system worked well overall, even if some KRAs lacked a focus on results or set unchallenging milestones (SSC, 1997) although that was partly because they had a high level of ministerial support. The strong points of this system could usefully be resurrected. Another useful measure would be to ensure that one central agency has the primary responsibility for strategic oversight and ensuring that resources are in fact being channelled into the high-priority areas.

10. Senior managers themselves see this as a problem according to a survey undertaken in 1995 (Norman, 1995).

11. Other examples include: the amalgamation of the Specialist Education Service with the Ministry of Education following a review that found the SES was “increasingly ineffectual, fragmented and distanced from schools and parents” (Chen, 2002); and a dysfunctional relationship among agencies in the defence arena. The government has signalled that it may also look at re-attaching the Ministry of Justice (where policy is made) to the delivery agencies (the Department for Courts and the Department of Corrections).

... and giving better direction to semi-independent agencies

Crown entities (CEs) are semi-independent entities with a diverse range of activities,¹² some of which have unclear or conflicting goals. The key difference between a CE and a department is an extra layer of separation (usually a governing board) between the minister and the agency, in order to create an arms-length relationship (or the appearance of one) from government. Despite their important role in delivering services, the CE regime has inadequate governance arrangements, patchy accountability and significant legislative gaps and inconsistencies.¹³ Some reforms began in 1999, but the full package was put on hold in 2001 pending a more general review of public-sector agencies (the *Review of the Centre*). The proposed reforms had an administrative and legislative focus, tackling some of the main weaknesses. However, they were less focussed on the central issues of clarifying each entity's role (and whether it is needed at all), evaluating its effectiveness and efficiency and reconsidering whether it needs arms-length separation from government. In cases where ministers want greater control, the CE would be better off under the wings of a department, thereby benefiting from the elaborate machinery and culture of public management. Otherwise, its autonomy should be preserved.

Some further challenges*Achieving better outcomes from social expenditure*

Social assistance is probably the area that has the most to gain from a greater emphasis on managing for outcomes. Although there are no internationally comparable data, and so it is unclear whether benefit dependency is more or less acute than in other OECD countries, steps can certainly be taken to reduce it further. Not only will this raise the quality and effectiveness of public spending, it will boost potential output, improve health and education outcomes and lead to a more inclusive economy. While New Zealand has made some significant progress in this area, a substantial problem remains. In 2001, one in six people of working age relied on a benefit as their main source of income, while ten per cent of the working-age population had been continuously on a benefit for more than two years (MOSD, 2001a).

The causes are complex and depend on more than just the design of the benefit system. The problem is most acute for Maori and Pacific Island men, who lost less-skilled jobs in manufacturing during the economic restructuring in the 1980s and whose employment rates are only now recovering to those earlier levels. Even so, the progress that has been made in the 1990s suggests that social, economic and fiscal outcomes can be improved by boosting incentives to move from welfare to work. The Minister of Social Development has set this as a priority, and some steps have been taken, but some major work remains to be done. New Zealand's approach to social security is unusual in several respects. *First*, it is fairly generous for some groups such as couples and the long-term unemployed. *Second*, the benefit system is relatively passive by OECD standards, with more emphasis given to income support than to active

12. Examples include agencies that administer regulations (such as the Commerce Commission), distribute grants (Lottery Grants Board), undertake scientific research (the various Crown Research Institutes), distribute social services (Housing New Zealand), or that have primarily cultural functions (such as the Symphony Orchestra).

13. See SSC (2000b) for more information. A review by SSC in 1999 found that many of their Statements of Intent (SOIs) did not comply with legal requirements and failed to provide sufficient information to assess performance. Governance and accountability arrangements can be either incomplete or inconsistent, the roles and responsibilities of the main actors — boards, chief executives, and ministers — can be unclear, inappropriate payments have been made to board members, and monitoring by departments on behalf of ministers has been patchy.

policies designed to help people into jobs. *Third*, benefit administration is quite lenient in some areas. *Fourth*, while the government has made good headway in producing a benefit-tax interface in which METRs are usually not excessive, some further improvement is still possible, with greater emphasis being given to in-work benefits. These points are expanded on below.

The benefit system is on the generous side, especially for the long-term unemployed

Most OECD countries have an unemployment *insurance* scheme available for a limited time, after which people fall onto a less generous but time-unlimited social assistance safety net. In contrast, New Zealand has only the safety net. As shown in Table 2, benefits are not particularly generous for single

Table 2. **Unemployment benefits are on the generous side**
Net replacement rates¹

	In the first month of benefit receipt				For long-term benefit recipients			
	Single	Married couple	Couple-2 children	Lone-parent 2 children	Single	Married	Couple-2 children	Lone-parent 2 children
New Zealand	57	79	87	79	57	79	87	79
Australia	45	39	80	66	45	39	80	66
Austria ²	61	64	82	78	58	59	78	74
Belgium ²	85	80	79	81	60	80	84	86
Canada	62	64	97	97	35	57	81	80
Czech Republic	66	69	70	72	54	84	100	96
Denmark	89	89	95	96	85	96	102	97
Finland	79	83	88	92	73	92	100	69
France ²	78	76	82	83	43	41	59	60
Germany ²	67	65	75	76	63	61	71	71
Greece ²	48	48	46	50	8	8	11	12
Hungary	65	65	75	76	28	28	39	41
Iceland	74	66	79	85	68	97	104	80
Ireland ³	42	59	67	59	41	59	66	64
Italy ⁴	39	40	49	47	0	5	21	17
Japan	82	79	77	82	49	69	87	84
Korea	54	54	54	54	9	16	27	23
Luxembourg	82	80	88	88	70	92	93	82
Netherlands	88	84	85	80	74	83	85	76
Norway	65	67	82	90	53	73	83	69
Poland	53	62	58	67	48	72	93	81
Portugal ²	88	86	87	87	70	86	87	87
Slovakia	77	75	77	79	54	90	100	100
Spain	76	72	76	77	32	40	57	51
Sweden ⁵	82	82	90	93	79	102	110	70
Switzerland	91	90	92	92	78	99	100	96
United Kingdom	66	64	54	55	66	80	88	81
United States	59	59	49	49	10	17	59	48
OECD Average	69	69	76	76	50	64	77	69

1. For family types on 2/3 of the average wage, including family and housing benefits (after tax).
2. Replacement rates are based on unemployment assistance.
3. Excludes housing benefits.
4. Social assistance (Reddito Minimo di Inserimento) is not included due to its experimental character (on trial in 39 municipalities). Replacement rates are based on family benefits.
5. People in work are not entitled to social assistance.

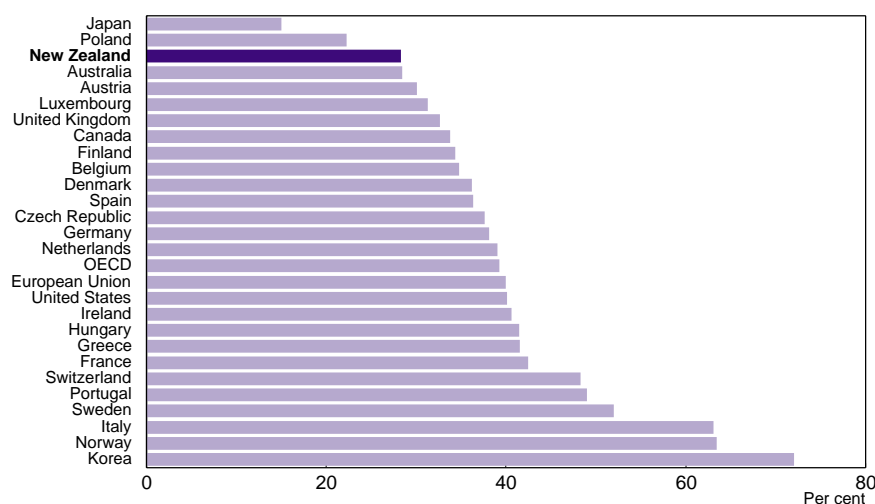
Source: OECD, *Benefit Systems and Work Incentives* 2002.

people who have only recently become unemployed, but they are above average for all long-term unemployed, and especially for couples. International evidence shows a relatively robust link between benefit duration and the rate of long-term unemployment (Layard *et al.*, 1991; OECD, 1991 and 1994). More specifically, unemployment tends to be higher in countries where benefits are available for long periods before someone drops onto the social assistance safety net, or where the social assistance level is generous. While New Zealand has successfully reduced the number of long-term unemployed, further progress may require reducing the level of assistance the longer someone remains unemployed, combined with tighter compliance requirements after a certain duration.

Active labour market policies can boost value for money

Active labour market policies (ALMPs) are programmes that try to get people into jobs by helping them search, improve their skills or assist them to move to where jobs can be found. Using that definition, spending is strongly skewed towards passive rather than active support (Figure 7). While the government is now placing greater emphasis on a case-management approach, the overall imbalance between active and passive measures should be remedied in view of the evidence that social spending in general can be a drag on growth but that active social spending can promote growth (Arjona *et al.*, 2001). In addition, the *types* of active intervention should also be reassessed. Spending on the public employment service is low, and the government intends to shift the emphasis of active programmes towards training. This contrasts with international evidence on the effectiveness of ALMPs, surveyed in Martin (2000), which led to five broad recommendations for maximising the effectiveness of such spending (Box 4). An important finding is that broad-based public training programmes have a poor track record in terms of value for money. While they can be relatively successful for some disadvantaged groups (*e.g.* adult women), they are much less so for others (men, and youths in general). Hence, unless the government's training programmes are carefully designed and targeted directly at groups for which they have been shown to work in the past, they are unlikely to be cost-effective. They can in fact be counterproductive, because beneficiaries often regard these placements as being at work and therefore stop looking for paid

Figure 7. Labour market expenditure is more passive than active
Spending on active labour market policy as proportion of all labour market spending, 1999¹



1. 2000-01 for New Zealand.

Source: OECD, *Society at a glance*, 2001.

Box 4. What works among active labour market policies?¹

- A. Rely as much as possible on in-depth counselling, job-finding incentives (*e.g.* re-employment bonuses) and job-search assistance programmes. But it is vital to ensure that such measures are combined with increased monitoring of the job-search activity of the unemployed and enforcement of the work test.
- B. Keep public training programmes small in scale and well targeted to the specific needs of both job seekers and local employers.
- C. Early interventions, reaching back to pre-school, can pay dividends for disadvantaged youths, but they must be sustained. This should include steps to reduce early school-leaving targeted on at-risk students combined with policies to ensure that they leave the schooling system equipped with basic skills and competencies that are recognised and valued by employers.
- D. As the duration of unemployment spells lengthens, various forms of employment subsidies may serve to maintain workers' attachment to the labour force. However, employment subsidies should be of short duration, targeted and closely monitored.
- E. Use subsidised business start-ups for the minority among the unemployed who have entrepreneurial skills and the motivation to survive in a competitive environment.

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- 1. See also the range of studies produced by Sweden's Office of Labour Market Policy Evaluation.

Source: Martin (2000).

employment (MOSD, 2000). Active case management must ensure that beneficiaries continue to look for work while undertaking training.

Outcome management comes hand-in-hand with evaluation. The government has recently placed increased emphasis on the evaluation of labour market interventions but improving the scope and rigour of this work requires better information about individual programmes. Specifically, it is difficult to get reliable information on the cost per intervention, so that few assessments of value for money have been completed so far. Instead, evaluations to date have tended to be qualitative in nature, many finding that programmes "improve self esteem" but few having been able to compare outcomes with a control group. The diversity of training, job-search and work confidence programmes reflects a good degree of policy experimentation, which can be a creative and useful expenditure management tool. But without rigorous evaluation, promising initiatives risk joining the country's overcrowded pantheon of discarded training and make-work schemes.

Better enforcement of work requirements

There is a requirement to be actively seeking work in order to get social assistance. However, its application is relatively gentle by OECD standards (OECD, 2000*a*), although there is wide variation across both regions and different beneficiary categories. Between 1997 and 1999, notional work test requirements were extended to cover some other beneficiaries, such as sole parents. A formal evaluation of extending the work test to Domestic Purposes Benefit (DPB) recipients found that it was ineffective,¹⁴ largely because case managers said they rarely, if ever, enforced the work test sanctions because of the impact they

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- 14. The number of beneficiaries did decline after the tightening of requirements, but the decline was almost as large amongst those who were not subject to a work test as amongst those who were. The study also found that the probability of no longer receiving the benefit after 12 months rose only marginally (from 22 to 25 per cent) — see MOSD (2001*b*).

thought that might have on the families in question (MOSD, 2001*b*). The extensions to the work test were partially reversed in 2000 by a range of measures designed to make it easier to maintain receipt of some benefits, and were loosened again in 2001 with the introduction of legislation to abolish the test for sole parents and widows. They have been replaced with an enhanced case management system, designed to provide more individual attention, greater assistance for shifting into work, more education and training opportunities and greater assistance with childcare. It is not clear whether loosening the work test will have a substantially negative impact for these groups because the test had been ineffective in practice. But international evidence suggests, first of all, that stricter application of eligibility requirements tends to lower unemployment: for example, the European countries in which unemployment fell most sharply in the 1990s have considerably tightened eligibility criteria and their implementation (Grubb, 2000). Second, stronger enforcement can offset the disincentive effects which otherwise exist in the system. In sum, loosening the system risks lowering employment amongst these groups, which has implications both for the level and effectiveness of government spending and for social outcomes.

There is virtually no formal work test for those aged 55 and over, so some benefits can be used as early-retirement schemes. This policy was put in place in the early 1990s, partly to ease the burden on those close to retirement as the pension eligibility age was raised from 60 to 65. While prospects can be harsh for those who lose a job near retirement age, allowing an easy work test regime for a quarter of the average person's working life is excessive. This should be phased out, especially given that a large demographic bulge of unemployment and sickness beneficiaries is approaching the 55-year threshold.

Incentives to move into work: making work pay and the benefit-tax interface

Policies that "make work pay" are those that reduce the disincentive to move off a benefit, especially where jobs may be low paying. If well designed, they can be effective ways to boost employment at the same time as maintaining income levels. Experience with policies such as the Earned Income Tax Credit in the United States and the Working Families Tax Credit in the United Kingdom suggests that in-work benefits can have favourable effects on employment and, to a lesser extent, hours worked. To be effective, these policies must be well designed (the details can have a significant effect on performance and cost). They work best when combined with other measures to overcome employment barriers, such as finding affordable childcare. They also need to be carefully targeted if they are not to be prohibitively expensive, which means that across-the-board tax rebates are an expensive way to go about it. While New Zealand has a tax credit for all low-income families, it does not have a significant targeted in-work benefit system. Outcomes may be improved at little cost if some income support were transformed into such benefits.

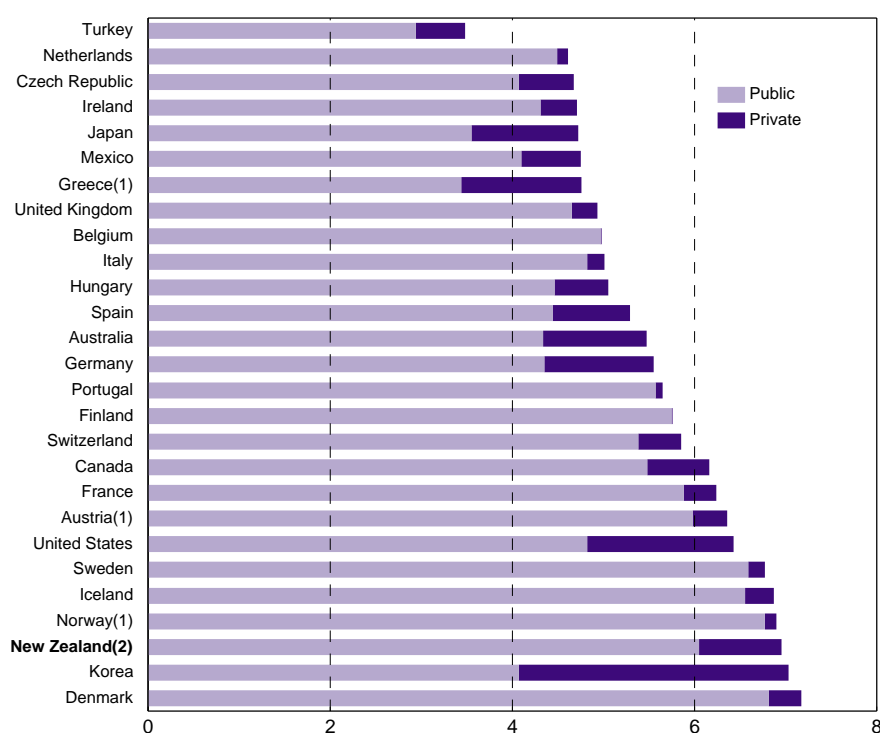
The major problem with policies to make work pay is they can increase METRs. However, with the exception of the sole-parent benefit (DPB), METRs are generally not high (OECD, 2000*b*). This suggests New Zealand may have some room to move before the trade-off between greater targeting and high METRs becomes a problem. Regarding the DPB, METRs of 80 to 100 per cent are common across a large range of incomes, both for marginal and for substantial (NZ\$ 10 000) increases in income. The government has introduced a dual abatement regime for the DPB, in which the benefit is abated at a lower rate for part-time than full-time earnings, and has extended to 37 the maximum number of hours per week for which childcare subsidies can be claimed. It is currently reviewing abatement, childcare costs and in-work benefits in order to reduce the problem of high METRs. This review needs to be completed and implemented with urgency, given that only a third of sole parents currently work, half the OECD average. The review also needs to look at other anomalies in the system. For example, the accommodation supplement, in contrast to most other benefits, begins to abate from the first dollar of earnings. Also, supplementary benefits, which have grown significantly since the early 1990s, can confuse what otherwise would be a relatively clean tax-benefit system. These benefits, which include a range of emergency

payments for specific factors including disability assistance, buying food and attending funerals, are relatively poorly integrated with the rest of the system and can lead to lumpy METR profiles. They can also overlap with other benefits (for example, the invalids benefit is higher than the sickness benefit because of the extra costs of long-term incapacity, but a supplementary disability allowance is also available). While special assistance is necessary, the system is rule-bound instead of giving more discretion to case managers. Alternatives, such as the United Kingdom's capped fund or Australia's channelling of special assistance through community agencies, could be considered.

Taking advantage of market mechanisms in education

Total expenditure on education is amongst the highest in the OECD (Figure 8), partly because of high enrolment rates at the tertiary level. Outcomes are more difficult to assess but seem to be good on average, although they are particularly poor for some groups (OECD, 2001*b*). The causes of educational failure, particularly amongst Maori and Pacific Island children, are complex, and a full analysis is beyond the scope of this paper, but there still seems to be room to get better value for the education dollar. Several issues stand out. *First*, schools are still more subject to central control than the rest of the public sector. *Second*, there is scope to increase competition and choice in order to improve outcomes, although the negative effects of competition need to be carefully managed. *Third*, shifting resources to earlier education levels may improve distributional effects and deliver better outcomes per dollar.

Figure 8. Education spending is high
1998, per cent of GDP



1. Public subsidies included in private funds.
2. Private expenditure is an OECD estimate.

Source: OECD, Education at a glance, 2001.

Freedom to manage can lift quality and innovation

As noted above, removing central input control and granting managers the freedom to manage have led to enormous gains in efficiency, innovation and responsiveness throughout the public sector. Education has not taken these steps to nearly the same extent. Major improvements were made in the early 1990s by making school principals accountable to locally-elected Boards of Trustees and by giving them autonomy over one-quarter of their budgets, but they have virtually no discretion over the remaining three-quarters. Most staffing number decisions are made centrally; wage bargaining is also centralised, and teachers of the same grade are paid the same regardless of whether there are shortages in particular regions or subjects, such as maths or Maori language (although “top-ups” can be made).

The previous government tested a bulk funding initiative that gave participating schools control of their whole budget (with the exception of major capital decisions). A definitive evaluation of this policy is difficult because bulk-funded schools received a slight increase in resources and were a self-selected (but broadly representative) sample. Even so, the great majority of schools reported positive outcomes: almost all channelled extra resources into staffing, especially for special-needs students; three-quarters felt that the extra flexibility had enabled them to improve the curriculum; and 81 per cent felt that learning opportunities for students had increased (Ministry of Education, 1999a). The current government abolished the bulk funding system but retained several of its elements of flexibility. These include the ability to use their budgets to employ more teachers than their core staffing entitlement, to top up teachers’ salaries with one-off payments, and to spread its staffing entitlement over the year. What has been lost is the freedom to reduce staffing levels in order to free up resources for other educational priorities such as IT. With this in mind, the government should look for more opportunities to extend the current flexibilities so that more emphasis is given to underachievers, the area where it is needed most. These include opportunities to provide for greater differentiation of teacher pay on the basis of demand and performance, and greater opportunities for schools to manage their property resources. In addition, to the extent that staffing costs increase faster than other input costs over time, the proportion of a school’s budget that is centrally-set (currently three-quarters) is likely to rise and crowd out the portion over which managers have discretion.

Greater choice could yield further benefits...

Although no precise figures are available, contracting out the production of government services has become common throughout the public sector. Education is one of several areas, however, where the government prefers services to be provided directly (almost all schools are state-owned or integrated within the state system).¹⁵ Provision of choice is a useful supplement to the voice parents currently exercise through their role on Boards of Trustees. Parents were given increased choice in the 1990s with the abolition of geographically based school zoning. However, the potential benefits were not fully unlocked because resource constraints in the most popular schools meant that they had to introduce queuing mechanisms of their own, so entry was never entirely unrestricted (see Box 5). Policy was changed again in 2000: families are now given priority access to their local schools, and any remaining places for out-of-zone students are allocated by lottery. This change impacts most on poorer families who are less able to buy themselves into the catchment area of a good school. In addition, a limited voucher programme

15. To be fair, some state funding is provided to private schools (although these educate just 3 per cent of students). In 1999, they received a government subsidy for each student equal to 30 to 40 per cent of the average per pupil (operating) cost of a state school, up from 14 per cent ten years earlier. Integrated schools, attended by around 12 per cent of students, have private owners but in most respects are run as if they were state schools. They maintain the right to keep their own special character (which is mostly religious) and the right to restrict entry to faith adherents, in return for which they teach the national curriculum, keep opening times more or less the same as state schools, and have parents elected onto their managing Boards.

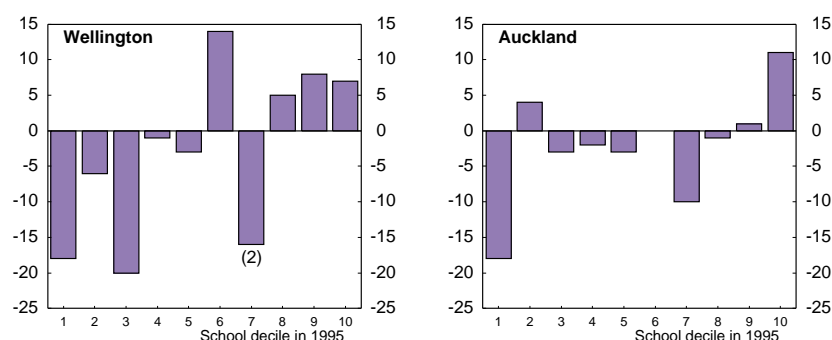
Box 5. The benefits of competition and choice: schools

The *Tomorrow's Schools* reforms, which took effect in 1990, replaced the old central-control system with increased autonomy for individual schools. Principals make management decisions and are answerable to locally elected Boards of Trustees. Each school is now free to spend its operating grant, which covers around a quarter of costs, but staffing and capital costs continue to be largely controlled centrally. The amount of funding per pupil varies, with the lowest-decile¹ secondary schools receiving around 30 per cent more per pupil than the most advantaged schools (although half of this is offset by the greater fund-raising abilities of schools in wealthier neighbourhoods). This extra management flexibility was combined with greater parental choice from 1992 to 2000, with the abolition of geographically based zoning. Parents were able to vote with their feet by sending their children to any state-funded school, with schools competing for the best students and deciding whom to admit.

A consequence of parental choice was, not surprisingly, a flight from low-decile schools (Figure 9). Not all these students ended up in the highest-decile schools, partly because many of the most popular schools quickly became full (and introduced selection mechanisms as a consequence). Despite some initial fears, this flight does not appear to have led to greater ethnic polarisation or cream-skimming at the expense of at-risk groups. It is striking that Maori families were the most aggressive at taking advantage of their freedom to choose.² Some of the poorest schools had their rolls decimated, although the government has closed only a small number of them. Many students have been able to escape from under-performing schools, and they are likely to be better off as a result. Whether this gain was offset by worse outcomes for those students who remained at the shrinking schools is uncertain. Falling rolls may simply have made an existing problem more visible (which, paradoxically, may help by enabling the government to channel resources in their direction or implement needed changes in personnel or structures). Even so, the government's concerns about students that got "left behind" in downwardly spiralling schools was part of its reason for reinstating zoning. But some conflicting evidence from the OECD's recent PISA study suggests this concern may have been over-played. It showed that even in 2000 an unusually high share of the spread in student performance occurred *within* schools rather than between them (Figure 10). In other words, educational failure is not so much about problem schools, though such schools exist, but more about problem children or about a problem with the system as a whole.

Possibly the major flaw in the reforms was that choice on the demand side was not matched by the required responsiveness on the supply side. The government was, and remains, reluctant to invest in expanding popular schools when there are spare places at other schools. Oversubscribed schools had almost total freedom to pick their students, although most gave at least some preference to local students. Even so, it held back the ability of the system as a whole to boost its performance. Consequently, perhaps the main lesson learned from the 1990s is that while competition and choice have the potential to raise performance, they are not sufficient. They need to be backed with an admittedly expensive commitment to allow successful and innovative schools to grow, at least in a one-off shakeout of the system. That clearly also applies to the current zoning arrangements.

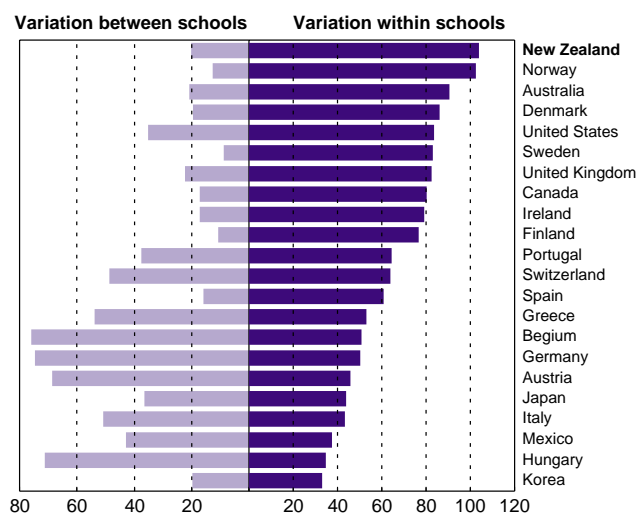
Figure 9. Growth has been faster in higher decile schools
Excess roll growth,¹ 1991-96, per cent



1. Excess roll growth is the difference between actual roll growth and growth expected based on the number of children in each school's area.
 2. The flight from decile 7 to other deciles is related to bad publicity following suicides at a school in this decile.
- Source: Fiske and Ladd (2000).

Box 5. The benefits of competition and choice: schools (*continued*)

Figure 10. Most variations in student performance is within schools
Variation in student performance between schools and within schools
on the combined reading literacy scale



Source: OECD PISA Study, 2001.

1. Each school is assigned a decile ranking that reflects the characteristics of its students, such as the proportions of Maori and low-income students.
2. The proportion of Maori students going somewhere other than their local schools increased from 18 per cent to 31 per cent in the three years after zoning was removed. The proportions for the non-Maori, non-Pacific population rose just 3 percentage points, to 28 per cent (Ministry of Education, 1999b). However, Fiske and Ladd (2000) find evidence of a (small) increase in ethnic polarisation between schools. The two results suggest that at least some of the polarisation may be attributable to the choices made by the ethnic minorities themselves (although capacity constraints in the best schools mean choice has been limited to some extent).

was tried from 1996 to 2000 but was abandoned by the new government. It initially involved funding for 160 students from low-income families to attend private schools, and by 1998 had expanded to 600 students. The scheme may not have been as effective as it could have been, partly because participating private schools insisted on being able to choose their students rather than have them assigned randomly, as was originally desired. While the evidence on the success of school choice is unclear, there were encouraging signs, particularly for Maori students, although concerns remained about the quality of education for the students who stayed behind.

... and in tertiary education

The level of choice and competition increased enormously in the 1990s in the tertiary system, with the government essentially operating a voucher system (Box 6). This has had very positive outcomes: access has increased such that participation rates are the highest in the OECD; Maori and Pacific Islanders have benefited more than any other group from the explosion in the number of private vocational training enterprises (PTEs); and access by adult students has increased significantly, aiding the government's goal of lifelong learning. Funding for PTEs jumped to NZ\$ 135 million in 2001, up from NZ\$ 7 million three years earlier (Table 3). A consequence has been that these small, innovative institutions have driven

Box 6. Current tertiary funding arrangements

The main form of funding for tertiary institutions is the Equivalent Full Time Student (EFTS) system. Providers are funded through an annual bulk grant based on their number of EFTS enrolments. Courses are divided into six broad categories, and the level of funding is notionally based on relative costs of providing each type of course. For example, an engineering or architecture degree receives around twice as much funding per EFTS as an arts or commerce degree. Medicine (including dentists and vets) is the only area where funding is capped. There is also a “research add-on” for each category, and a small number of supplementary grants (for public providers only) for Maori, Pacific Island and disabled students. The sector is “bulk funded” in the sense that institutions have almost complete freedom to choose how to spend their funds. All institutions charge fees directly to students, which can be paid using the student loan scheme. Around half of the funding received by public tertiary institutions comes from the EFTS system, with a quarter from student fees and the rest from other sources. Skill New Zealand, a Crown entity, purchases industry training on behalf of students directly from tertiary institutions (mainly PTEs).

several polytechnics to the point of bankruptcy.¹⁶ In July 2001, the government froze funding for new PTEs and for new courses in existing PTEs. It did this in order to “provide stability to the system” in the run-up to the Tertiary Education Advisory Commission’s (TEAC) review of tertiary funding, yet it did not impose the same restrictions on its own tertiary providers. The review recommended stopping funding to any private institution where there was “undesirable duplication” (*i.e.* competition) with a public institution in order to “protect the government’s ownership interest”. The government has yet to respond to the TEAC report. However, it would be a mistake to reduce competition in the sector, as it would lower participation by Maori and Pacific Island students, reduce the supply of skills to the labour market, lessen the likelihood that low achievers will move off welfare benefits and stifle innovation and diversity in the way that students are taught.

Tertiary students contribute around a quarter of the cost of their education, which is more than continental European students (11 per cent) but less than in other English-speaking countries (30 per cent). A large proportion of funding is directed to students rather than institutions (40 per cent, compared to an OECD-wide 17 per cent). Most of this is in the form of student loans, but a parental-income-tested living allowance is also available. The government has recently made this student-loan scheme more generous.

Table 3. **Private training enterprises are taking over from polytechnics**
Equivalent Full Time Student (EFTS) funding by sector, NZ\$ millions

	1991	1995	1996	1997	1998	1999	2000	2001	Annual growth rate (Per cent) 1995-2001	Share in 2001 (Per cent)
Universities	572	656	670	673	685	693	757	758	1.5	56
Polytechnics	368	402	399	400	404	405	344	353	-1.3	26
Private organisations	..	6	7	7	7	17	92	135	36.5	10
Other	54	57	51	54	57	66	81	96	5.4	7
Total	994	1 121	1 127	1 134	1 153	1 181	1 274	1 342	1.8	100

Source: Tertiary Education Advisory Commission (2001).

16. In 2001, the Auditor General was unwilling to sign off the accounts on a “going concern” basis of several polytechnics unless they had received a letter of support from the government. The government would not automatically provide such support unless the polytechnics first formulated an adequate business plan. Two polytechnics in deep financial difficulty were taken over in 2000/01.

Since 2000, full-time students (and some part-time students) no longer pay any interest on their government loans while studying. Repayments begin after graduation with a ten per cent tax surcharge, but only after earnings have risen a certain threshold. This and other changes will cost around NZ\$ 100 million a year, while the freezing of university fees from 2000 will cost another NZ\$ 25 million each year. The take-up rate of student loans increased from a half to two-thirds of those eligible after the policy was introduced, possibly because students can borrow and re-invest the money (TEAC, 2001). This is poor-quality spending. *First*, it is poorly targeted, benefiting all students regardless of their ability to pay. *Second*, most goes to those who would study anyway since it is unlikely to increase participation by much. The enrolment rate is already very high, and both international and local evidence shows that enrolment rates are not significantly affected by study costs, even for the most disadvantaged groups, provided that loans are available (OECD, 2001*b* and Ministry of Education, 1999*b*). *Third*, tertiary students tend to be from relatively affluent backgrounds and end up being relatively affluent. The policy was partly motivated by concerns that students were being saddled with overwhelming levels of debt at graduation. Yet the median level of student debt in 2000 was less than NZ\$ 10 000,¹⁷ while 90 per cent owe less than a typical graduate's starting salary of NZ\$ 30 000, so these concerns may be exaggerated.

Better social outcomes might be achieved if funding was shifted from later to earlier years

It is difficult to estimate precisely the efficient share of costs that students should pay. One New Zealand study finds that private and social returns to post-compulsory education are roughly equal, so there may still be room for students to pay a greater share before the costs outweigh the benefits.¹⁸ But more importantly, that study found that the returns from earlier education — such as shifting from no qualification to gaining School Certificate — were significantly higher than the returns at the tertiary level. Hence there may be a payoff from shifting resources to this area (or earlier, including early childhood), in order to lift school completion rates among minorities.

Controlling health-care spending

As in many countries, controlling the cost of health care is the most pressing fiscal challenge. Four institutional structures have been tried over the past decade with varying degrees of success (see Annex I), but the public remains unsatisfied.¹⁹ Costs have been contained fairly successfully over the past decade, but not all the progress has proved sustainable: the public hospital sector's deficit has surged again in the past two years (Table 4); and staff shortages have become acute in some fields, especially for specialist staff and in rural areas. Under-funding is not obviously a problem: health-care spending is around OECD norms given New Zealand's income (Figure 11). Nor is performance: most health outcomes are also about average. As with social policy, however, the averages conceal major differences between Maori and non-Maori. Life expectancy has been rising in the past decade, although less quickly than in most OECD countries, but the average Pakeha (person of European descent) will still live eight or nine years longer than the average Maori. The difference is not just due to Maori having lower

17. This includes students in their first year of study, so median debt at graduation will be higher.

18. See Maani (1999). However, this study assigns zero weight to the external (spillover) benefits of education.

19. As in most countries, there is clear public dissatisfaction with the health system. However, survey responses are a little inconsistent. In a recent survey of the elderly in five English-speaking countries, New Zealanders were the most likely of any country to rate as "excellent" their recent hospital experiences and overall health care (Commonwealth Fund, 1999). Yet New Zealand was the only country where more people felt the system needed to be completely rebuilt rather than thinking it was working well and required only minor changes.

Table 4. Public hospitals have moved back into substantial deficit
Financial performance of public hospitals and health services, \$NZ million, June years

	Four purchasers (Regional Health Authority)				Transition 1998	Single purchaser (Health Funding Authority)		Transition 2001	Distric Health Boards 2002 ¹
	1994	1995	1996	1997		1999	2000		
Revenue	2 482	2 596	2 773	2 901	3 004	3 355	3 539	3 745	3 792
<i>of which:</i>									
from Government	2 324	2 398	2 535	2 654	2 737	3 081	3 282	3 411	3 498
Expenses	2 665	2 794	2 943	3 124	3 200	3 411	3 552	3 807	3 979
Wages and salaries	1 751	1 818	1 904	1 970	1 991	2 023	2 101	2 270	2 428
Medical supplies and other	914	976	1 039	1 154	1 210	1 389	1 451	1 537	1 551
Surplus/Deficit	-183	-198	-171	-223	-196	-56	-13	-62	-188
Deficit as per cent of net assets (Per cent)		20	18	26	22	6	1	7	21
<i>Memorandum Item:</i>									
Government capital injection		160	105	181	163	45	46	37	

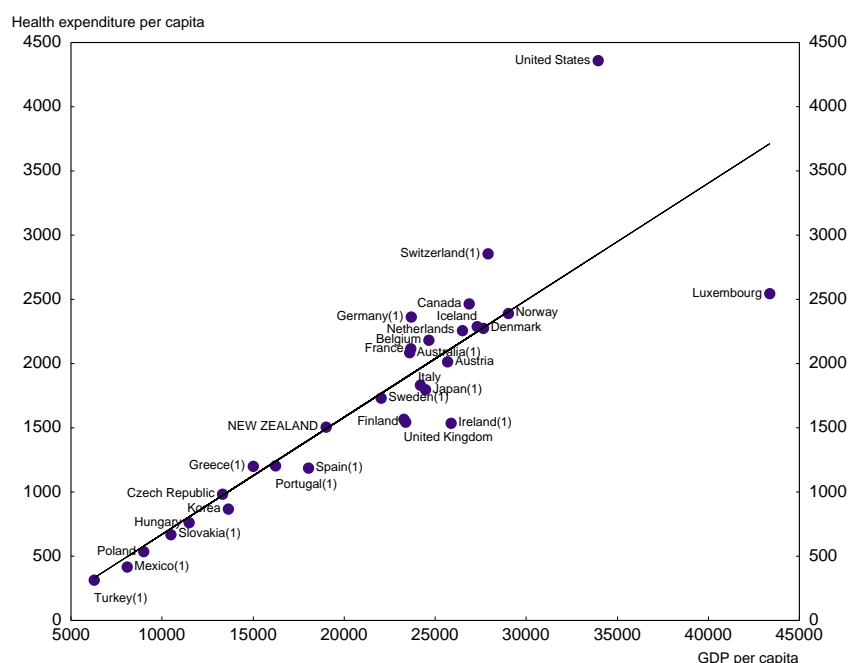
1. First half at an annual rate.

Source: Statistics New Zealand, Auditor General.

socio-economic outcomes: the average Pakeha in the most deprived deciles will still live longer than Maori in the seven least deprived. Delivering better health outcomes for Maori is, therefore, a priority.

In structural terms, the most significant change to the health system has been to shift away from the purchaser-provider split (Annex I). Health spending is now divided among 21 District Health Boards (DHBs) which have responsibility for their local communities and which own and run public hospitals. In

Figure 11. Spending on health is average given New Zealand's income
Health-care expenditures, US\$ PPPs, 1999



1. 1998.

Source: OECD Health Data 2001.

some respects this change is unfortunate since the strengths of the previous structure included cost control, Maori health and a stronger focus on primary care, three of the government's priorities for the sector. But that decision has been taken and further major restructuring is not recommended. Cost control is difficult in any third-party-pays system, but fragmentation of this sort raises particular challenges.

First, central funding in combination with locally elected Boards creates a significant risk of over-spending, since local Boards will have strong incentives to extract extra funding from government, but will gain little from rigorous cost control, which perhaps partly explains why there has also been a recent blow-out in hospital deficits (Table 4). In response, the government has set a three-year funding path for the health sector. Expenditure baselines will rise by NZ\$ 400 million for each of the next three years (so total spending will end up NZ\$ 1.2 billion higher) over and above the roughly NZ\$ 100 million automatic increase due to demographic factors. This rate of increase is similar to the pace of recent years and may help avoid any acceleration in costs by signalling in advance how much the government is willing to fund, rather than the current approach of hospitals seeing what they can get away with each year in the knowledge that the government will be forced to pick up the tab. To be effective, however, the three-year path must be fixed for each individual DHB, as is proposed. If not, there is little incentive for any DHB to control costs because any overrun will be shared amongst the 20 others. An alternative would be to impose a hard central budget constraint, with DHBs being permitted to raise extra funds locally using local taxes. This would force communities to bear the full marginal cost of health spending.

The drive for efficiency may also be hampered by this fragmented structure. While DHBs can purchase from whomever they want, they are likely to favour their own hospitals over providers who may be able to deliver services more efficiently. This problem could be reduced if patients were permitted to transfer their health-care entitlements to non-governmental health-care plans, as is possible in Sweden. Having a large measure of public financing but private provision of health care has been successful in several other countries, including France and the Netherlands.

A further risk is expensive duplication of services. Duplication can be beneficial if it allows competition between service providers; otherwise it is wasteful. For this reason, it is important that competition is boosted by allowing patients to choose treatment at a DHB outside their area, otherwise the system risks having the worst of both worlds. DHBs have an average population catchment of only 180 000, seriously limiting the scope for exploiting economies of scale. Some service areas are already operating at the minimum volume to ensure clinical viability, which not only raises costs but further shrinkage would compromise patient health. To address these problems the government should reduce the number of DHBs, promote formal and informal collaboration between DHBs, and where possible make treatment more mobile by assisting patients (and their families) to move temporarily to existing facilities rather than setting up duplicate clinics throughout the country. Closing facilities that are on the borderline of viability, or as populations shrink, is always difficult but becomes more so under a fragmented system.

One way to contain costs is through greater emphasis on primary care. The government is planning to base primary care around primary health organisations (PHOs), which are non-profit institutions largely owned and run by group of clinicians. PHOs will be paid by DHBs to provide a set of primary services for their enrolled patients, with funding based on capitation rather than fee-for-service. The details of this model have yet to be worked out, but some are likely to be based on the Independent Practitioner Associations (IPAs) which spontaneously emerged under the previous health structure. By having control of their own budgets and a direct financial interest in the success of their associations, IPAs were successful at finding savings for re-investment in quality and services elsewhere. The lessons learned should be carried over to the new PHOs. In particular, to foster efficiency PHOs should keep substantial control over their budgets (in line with the broad public-sector reforms), have the ability to retain and re-invest surpluses, and be able to take patients from outside a DHB catchment area to ensure that the most efficient (and highest-quality) PHOs can grow.

Make more use of user charges as a way to manage demand in health and other sectors

Although hard data is not available, user charges are reasonably common in the public sector, more so for core public goods than for social services. Sales of goods and services, such as passports and drivers' licences, raised around NZ\$ 660 million (0.6 per cent of GDP) in 2001; another NZ\$ 500 million came from road user charges on heavy vehicles, and NZ\$ 180 million from motor vehicle licensing fees. Significant co-payments exist for tertiary education and pharmaceuticals. An overnight charge in public hospitals was trialled in the early 1990s but very quickly cancelled after public outcry. The government has a clear set of guidelines for where such charges are appropriate and how to set their level, although there is a bias towards over-charging that needs to be fixed.²⁰

As a general policy instrument, user charges have several strengths. *First*, they can curtail demand, and therefore public spending, in situations where demand is partly price-sensitive. *Second*, they raise revenue without redistributing income or consumption possibilities between users and non-users. *Third*, the allocation of funds can be driven to some extent by demand, rather than by central dicta. *Fourth*, consumers are likely to pay more attention to the quality of service if there is an out-of-pocket payment, creating demand-side pressure for better outcomes. The government's policy has previously been open to user charges, unless it is setting prices to zero in a deliberate attempt to increase access or encourage the use of services. This is the motivation, for example, behind its policy of free doctors' visits for children under six. The government is also considering removing general practitioner charges across the board in order to encourage greater use of primary care services, although this would be an expensive policy. But one area that cries out for user charges is road passenger transport, where the government clearly wishes to *discourage* rather than encourage road use.

Strengthening top-down expenditure control

The *Fiscal Responsibility Act* has been a key innovation of the New Zealand reforms, and has served as the model for several other countries. It is useful, therefore, to review how it has performed and how the framework has evolved over time. The approach reflects a compromise between hard-and-fast fiscal targets, and total discretion. One of its more useful features is the obligation to publish a *Budget Policy Statement* several months before the budget itself; this ensures that overall expenditure and debt objectives are decided before the detailed budget horse-trading begins. The government sets its own targets, and can alter them as circumstances change. The key question is whether this imposes any effective restraint at all. The experience of the 1990s suggests that, on its own, it has been only partially successful. In particular, there has been substantial movement toward debt objectives, but there was much less progress toward the previous government's expenditure target of 30 per cent of GDP (Figure 12).

The framework itself may have contributed to this outcome. The *Act* requires long-term objectives to be set for expenses, revenues, the operating balance, debt and net worth (Box 7) but does not require the government to specify which one is the binding constraint. Thus, for example, if revenues turn out unexpectedly high, at least one of the remaining objectives could be breached (or over-achieved). Fiscal discipline may be reduced since governments can pick and choose among the goals *after the event*. Overseas evidence warns that revenue shortfalls are more likely to be absorbed by debt, but excess revenue is more likely to be spent, thereby ratcheting up spending over time. In addition, there is no obligation to set an explicit time path for achieving long-term objectives, so shocks can push fiscal outcomes off track

20. Fees must be set at a level that covers long-term costs. A shortfall in revenue in any year requires an extra appropriation from parliament to cover the deficit, so there is a tendency to forecast conservatively and set fees too high. Multi-year appropriations would reduce this bias, as would more innovative appropriations such as one that covers overheads and a per unit "price" that covers variable costs.

Box 7. The Fiscal Responsibility Act

The Fiscal Responsibility Act took effect on 1 July 1994. Its aim was to improve fiscal management. Its two main features are principles of responsible fiscal management and stringent reporting requirements in order to encourage transparency.

The five principles of responsible fiscal management are:

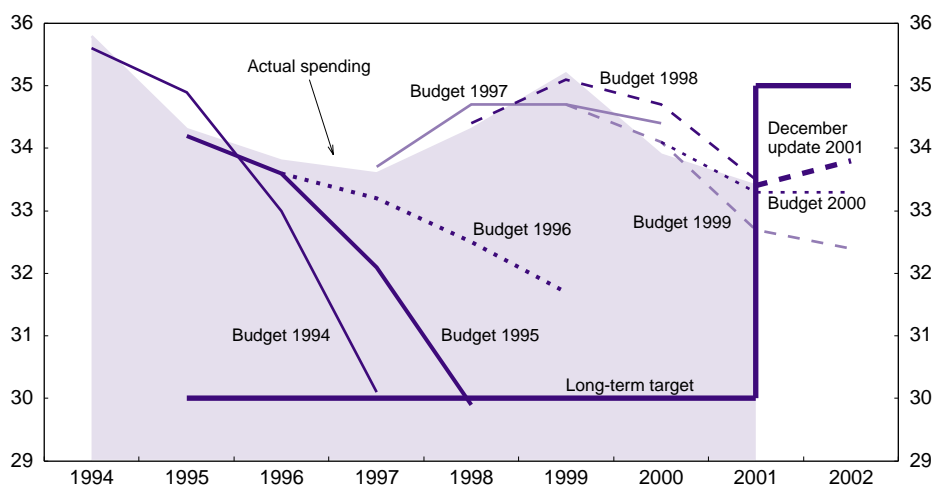
- Reduce total Crown debt to prudent levels by running an operating surplus each year.
- When that has been achieved, maintain that debt level by running operating surpluses on average over a “reasonable period of time” (which has been interpreted as meaning over a business cycle).
- Achieve and maintain a prudent level of Crown net worth.
- Manage prudently the fiscal risks facing the Crown.
- Ensure that tax rates are reasonably stable and predictable.

The Act does not define “prudent” or “reasonable.” These are left to the Government of the day to interpret.

The reporting requirements aim to ensure that the short term and long term fiscal objectives are clear, and that some degree of “top-down” fiscal control is placed on the budgeting process. The key reports required are:

- The *Budget Policy Statement*, which must be published by the end of March. This is the “top-down” document that sets out: *a)* long-term goals for operating expenses, revenues, balance, debt and net worth; *b)* short-term intentions for these variables for the next three years; and *c)* broad strategic priorities for the coming Budget.
- The *Fiscal Strategy Report*, which is tabled with the Budget. It must: *a)* compare the fiscal forecasts with those contained in the earlier Budget Policy Statement, and explain any differences between them; *b)* contain Progress Outlook projections of the main fiscal variables over at least the next ten years; and *c)* assess whether that outlook is consistent with the long-term objectives, and explain any inconsistencies.
- Several fiscal updates throughout the year. These include an Economic and Fiscal Update at the time of the Budget and each December, and a pre-election Fiscal Update to be published before each general election. They must include macroeconomic and projections of Crown financial statements.

Figure 12. Inconsistent progress on spending targets
Expenses of the core Crown plus contributions to NZS fund, per cent of GDP



Source: Government financial statements.

for prolonged periods. A clearer articulation of when long-term objectives are intended to be reached could help reduce this problem.

Ironically, expenditure control may have been hampered by the assumption that spending baselines would not increase. The budgetary approach indexes some spending (including most social welfare benefits) but holds the rest fixed in nominal terms. However, this meant that the fiscal forecasts always showed policy to be well on track to achieving the long-term goals, so slippage was hard to resist. That led in the mid-1990s to the development of the fiscal provisions framework, in which future spending increases were explicitly allowed for in the forecasts. More than that, they were an announced commitment to keep new discretionary spending within a certain limit over a government's term of office (Box 8). There are separate provisions for new operating and capital expenditure. These are calculated in net terms (so new spending can be financed by a tax increase without breaching the limit; in that sense, the operating provision is used more to control the operating balance than the level of expenditure *per se*), and they are treated as future expenses in the accounts, even if they have not been allocated to specific programmes.

The fiscal provisions framework has helped

On the whole, this *short-term* commitment to limit discretionary (or *controllable*) spending has been successful. *First*, it has improved top-down fiscal control by providing a simple link between short-term decisions and long-term objectives. Reaching agreement within coalition governments on aggregate fiscal objectives before making low-level budget decisions, then calculating the maximum amount of spending that would be consistent with those objectives, has helped impose some discipline. *Second*, the provisions for discretionary spending “float on top of” baseline expenditure, so automatic stabilisers are allowed to work fully. An unexpected recession will result in an increase in spending on unemployment benefits, although that will not count against the provisions and, therefore, not require an offsetting cut in discretionary spending. By doing so, the tendency for governments to spend “windfall” tax revenues during cyclical upswings, but to be unable to cut spending during cyclical downturns, is reduced in this system. This is a significant advantage of the provisions framework over a simple operating balance or expenditure target. *Third*, it is a simple communication device that raises the political costs of expenditure slippage. Even so, the constraint is not entirely binding as it has shifted several times, most recently in 2001 (by ¼ per cent of GDP) in the face of spending pressures. *Finally*, a three-year provision gives more of a medium-term focus to fiscal management and allows more scope for policies to be phased in over time. The framework should remain a key part of the government's top-down budgeting strategy and potentially be enshrined in legislation. It could also be improved by having separate provisions for expenses, revenues and capital,²¹ and by putting more emphasis on the capital provision, which has not been as prominent or effective.

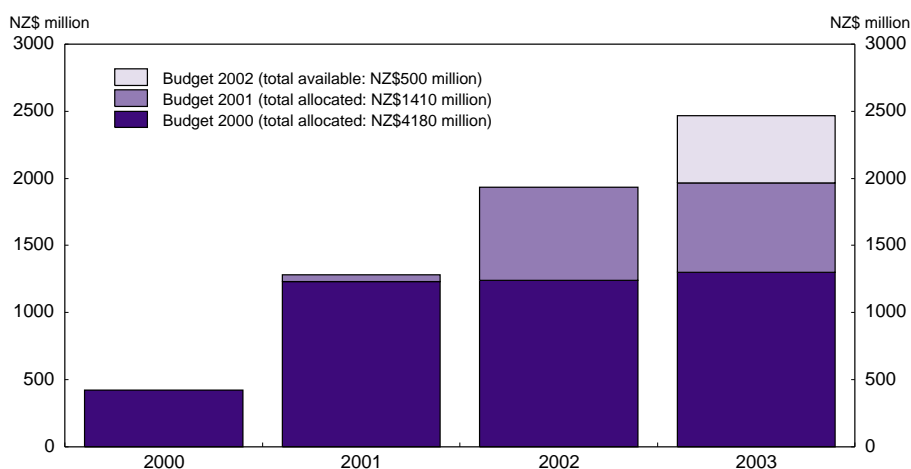
21. This would promote consistency with the expense, operating balance and net-debt objectives.

Box 8. The fiscal provisions

The operating provision is an attempt to split spending into its “controllable” and “uncontrollable” (or discretionary and automatic) components. The framework consists of a baseline level of spending, a pre-determined limit on “new” spending over a (three-year) parliamentary term, and a set of rules for what counts as new spending. The operating balance itself was seen as a poor indicator of the extent to which fiscal policy was making progress towards the government’s long-term objectives because it is strongly influenced by cyclical, valuation and timing effects. In this sense the framework gives the process of day-to-day fiscal management a clear and simple measure of whether current decisions are likely to be consistent with long-term goals. It also reduces the tendency for cyclical revenue windfalls to be spent, so it acts like a target for the cyclically adjusted balance.

Any policy decision that impacts on the operating balance will count against the operating provision. For example, any new policy decision or a change to existing policies (*e.g.* higher police salaries or a change to a benefit rate) will count; non-controllable factors, such as a change in the number of new entrants to primary school or an increase in the unemployment rate, will not. The fixed nominal baseline policy also means that wage and cost pressures do count against the provision. Provisions are cumulative and, therefore, implicitly assume that all changes are permanent. For example, a NZ\$ 100 million spending initiative in the first year of a three-year provision will count as NZ\$ 300 million against the provision. This is illustrated in Figure 13, which shows the allocation of the present NZ\$ 6.1 billion (GST inclusive) operating provision that covers the fiscal years 1999/00 to 2002/03 (it covers four fiscal years because the government took some steps early in its term). There is also a provision (cap) for capital expenditure, although this has been less useful.

Figure 13. Cumulative fiscal provision
Allocation of NZ\$6.1 billion limit, June years



Source: New Zealand Treasury.

Capital decision-making can be improved

Top-down control and transparency of capital decision-making has not been as good as for operating expenditure (Auditor General, 2001). Maintaining the asset base is not a major problem since the government gives a cash allowance to departments to cover depreciation (and, like all cash, departments

can spend it as they wish).²² The problem is with new capital spending, which is not well integrated with the budget process (capital bids have a habit of cropping up sporadically through the year), making it difficult to trade off competing bids, and to trade off capital against current expenditure. The information base has gaps (there is no central asset register), projects are sometimes poorly managed,²³ and the capital provision is not well anchored to the gross-debt target. The government has announced its intention to bind investment decisions more tightly to the budget process and to publish more detailed information on upcoming investment pressures, both of which will help.

Local government reforms need to be strengthened

Local government is currently small and largely self-funded.²⁴ However, its asset base is large; net assets in 2000 were around 40 per cent of GDP. Major reforms, currently before parliament, have the potential to greatly increase its scope over the next decade and more. Currently, local authorities can undertake only those activities specifically authorised by legislation, and so they are primarily involved in basic local services such as sewerage and water. Police, fire fighting and schooling remain primarily central responsibilities. The proposed changes would give them the power of general competence, in which they would be able to do anything not specifically prohibited by legislation, subject to public consultation. At the heart of the reforms is the “transparency” model used by central government: an assumption that providing information and consulting with the public will be sufficient to maintain spending discipline. The details have not yet been worked out, but the framework as it currently stands has several deficiencies that need to be remedied.

First, there are no guidelines over which activities are best undertaken by local government. While a local administration can be in better position to respond effectively to local problems, New Zealand’s population is both small and relatively concentrated,²⁵ so central government is not far removed from local issues. The *subsidiarity principle* suggests that central government should take over only those activities where there are efficiency reasons to do so. With local authorities’ median population base of just 39 000, economies of scale may often be an important factor. In any event, this or some other guiding principle should be enshrined in the legislation.

Second, a surprising omission is a top-down approach to budgeting and planning. At a minimum, local government should be subject to the key requirements of the FRA, especially its top-down approach. But that may not be sufficient. Low voter turnout, a perception that the consultation process is “a sham” (Auditor General, 1998), and the fact that the transparency model has been only partially successful at the

22. Departments were not funded for the accumulated depreciation that existed at their time their balance sheets were set up, and so require additional funding to cover the shortfall between the book value and replacement cost of assets.

23. For example, the Auditor General (2001) found serious defects in the tendering process for the NZ \$670 million purchase of 105 light armoured vehicles for the defence force, more than triple the original funding cap of NZ \$212 million. The report concluded that the project was poorly defined, had deficient market research, restricted competition, lacked strategic management and suffered from dysfunctional relationships amongst the various defence agencies. Other examples include the abandoned NZ \$82 million police computer system and a 70 per cent cost overrun on a motorway extension south of Auckland.

24. Local government revenues are around 3½ per cent of GDP, half of which comes from taxes (rates) on residential and commercial property. Less than a tenth of its funds come from central government, almost all of which is to fund road-building.

25. Half the population lives in the top of the North Island in an area the size of a large US county.

central level despite more favourable conditions for success, all favour serious consideration of more binding fiscal rules at the local level, such as legislated expenditure or debt ceilings.

Third, recent changes to funding mechanisms for local authorities mean that economically efficient methods such as user charges are no longer being encouraged. The previous legislation included guidelines for choosing funding mechanisms, such as a principle that services that generate mostly private (internal) benefits are more appropriately paid for by user charges. However, the government felt that the framework biased councils too far towards user charges, despite the evidence being to the contrary: general property taxation (“rates”) now makes up a larger proportion of council revenues than it did before the last reforms in the 1980s.²⁶ On the other hand, despite removing these guidelines, the new legislation gives councils more *options* for mechanisms such as being able to charge different taxes in different locations.

Box 9. Summary of recommendations

New Zealand’s public spending framework is in reasonably good shape. Even so, there is room for further changes in order to build on the gains that have already been made and to raise the quality of expenditure even higher.

Continue to improve the machinery of public management

- *Better evaluation.* Undertake comprehensive and regular evaluation of baseline expenditure.
- *A greater focus on outcomes*, but not at the expense of a clear specification of outputs. Combine this with more evaluation of effectiveness and value-for-money. Ensure that programme goals are specific, measurable, achievable, relevant, and timed (SMART), and make a central agency responsible for quality control in this area. Use sunset clauses on programmes. Push the Statements of Intent throughout the public sector.
- *Reduce fragmentation and boost strategic management:* Re-instate the more useful parts of the *Key Results Areas*. Ensure that there is flexibility for appropriations to become less fragmented. Institute a policy that, within limits, each minister can “keep” any savings if they are allocated to some other part of his or her portfolio, subject to approval from Cabinet. Push ahead with networks across agencies, and supplement with ministerial teams. Re-start the CE reforms, clarify the role of each, and bring under the wings of a department where there is no strong reason for the extra degree of separation. Resist combining policy shops with delivery arms, but consider creating larger policy Chancelleries.
- *Use multi-year appropriations where possible*, and use of other appropriation modes such as per-unit pricing.

Raise the effectiveness of social spending

- Focus on more active social support, with an emphasis on employment placement. Keep training programmes limited and focussed on those most likely to benefit. Reduce the level of unemployment assistance for long duration spells, combined with more active policies as they approach the cut-off point. Broaden, and enforce, work requirements, including for 55-65 year-olds. Consider more use of in-work benefits, address METR problems where they exist, and tidy up supplementary benefits. Consider more childcare resources for beneficiaries.

Make greater use of market mechanisms

- Encourage contracting out. Expand the range of user-charges as a way to manage demand. Introduce road-pricing mechanisms for all road users. Remove the incentive for user charges to be set at too high a level.
- Encourage competition in the education system, but carefully manage its side effects by giving greater management assistance to schools that need it. Increase management flexibility over schools’ budgets.

26. The Local Government Forum states that it has been “business as usual” since the financial management reforms were introduced in 1996, with “very few changes in the classes of services provided, privatisation of commercial activities, ... contracting out, or the method of funding” (LGF, 2001, page 69).

- Re-introduce full competition in tertiary education. Re-instate the level playing field between PTEs and public institutions. Push ahead with TEAC’s recommendations on separating funding for research and teaching, and take steps to steer enrolments into priority areas. Control costs by maintaining open access but with greater private co-payment if necessary, rather than restricting entry.
- Encourage choice and competition in the health sector by allowing patients to transfer their entitlements to private health plans, and by avoiding geographic restrictions on access care. Encourage DHBs to purchase from providers other than “their” hospital. Push ahead quickly with plans for primary care reform.
- Introduce competition to all forms of accident insurance.

Continue to strengthen top-down spending control

- Long-term objectives should have a specific timeframe and be ranked so that the binding restraint is clear. The objectives should cover core Crown and CEs.
- Retain the provisions framework.
- Bring capital decision-making more closely into the Budget process. Tie the capital provision explicitly to the debt target, use it as a spending cap rather than a forecast, and give it more public prominence. Use public-private partnerships wherever appropriate and possible. Fund new capital pressures by partial or full privatisations of non-core assets (SOEs and Crown entities).
- Maintain fixed departmental baselines as an incentive to search for efficiencies, at least until a comprehensive alternative mechanism is in place.

Fill the holes in the proposed local government reforms

- Legislate principles of appropriate activities for local government to undertake. Legislate a top-down spending framework, such as a local FRA, and consider more binding fiscal rules such as spending caps. Encourage economically efficient funding mechanisms such as user-charges and differential rates. Rethink whether the power of general competence is required for regional government.

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ANNEX I

AROUND THE WORLD IN 80 MONTHS: THE HEALTH SYSTEM IN THE 1990s

Around 80 per cent of health-care costs are paid for from the public purse; the rest is a combination of insurance and out-of-pocket payments. The health system operated under four different structures in the 1990s. Until 1993, 14 elected area health boards supplied hospital services with funding based on population. A purchaser-provider split was introduced as part of market reform in 1993. Purchasing was put in the hands of four ministerially-appointed regional health authorities, while providers were required to earn commercial rates of return and were encouraged to compete with one another and with private providers. In practice, little competition took place. This system failed to live up to expectations largely because of faults in implementation. Monopoly problems were not adequately addressed, and the system became loaded with controls that, in effect, partly reversed the split. The myriad of accountability documents were often in conflict. In 1996, a single Health Funding Authority (HFA) replaced the four regional purchasers, and the profit motive was removed. Documentation was simplified to a strategic plan and a Statement of Intent, and became the model for many other Crown Entities. A formal purchase agreement was signed between the Ministry of Health and the HFA although, as in the rest of the public sector, the formal “contract” was not key: it was just a mechanism to get the needed improvements in governance, clarity, transparency and long-term planning. Deficits reduced over time as contracting methods improved. In 1999, the incoming government abolished the purchaser-provider split and re-introduced 21 district health boards to act as both buyers and sellers of health care. The health system had come full circle in less than a decade, although it has retained some of the more useful baggage accumulated over its travels such as aspects of the largely successful planning and accountability documents.

The most interesting part of the experiment was separating purchase from provision. It had some positive outcomes:¹

- Improved information on the costs and use of services, enabling better allocative choices.
- Better mechanisms to manage fiscal pressures.
- More emphasis on primary and preventive care.
- Improved access by Maori² and more equal access and quality of care across the country.
- Emergence of new providers and innovations in service delivery, such as associations of primary-care providers and greater use of community organisations to deliver services. For example, the number of Maori service providers rose from 23 to 240 from 1993-98.
- Greater reliance on evidence of effectiveness in purchase decisions.
- Investment in public hospitals.

1. See Ministry of Health (1999) and *Report of the Health and Disability Steering Group* (1997).

2. Ministry of Health (1999).

The main drawbacks have been:

- While productivity has improved in some areas — for example, the average length of stay in acute care has fallen to one of the lowest levels in the OECD — productivity gains have overall been disappointing.
- Limited competition among service providers.
- Worsening relationships among health groups.
- High transaction costs, at least initially.
- Reduced public confidence.

Perhaps the major problem was the bilateral monopoly between hospitals and purchasers. Public hospitals have an effective monopoly on acute secondary and tertiary services, and contestability for provision of services existed only at the margin, even in the cities where geographical monopoly was less of a problem. This was compounded by the government “owning” both the buyer and the sellers, with its implicit guarantee affecting negotiating positions and the incentives to finalise contracts. Significant productivity gains remain difficult to extract unless the problem of monopoly provision is tackled, although clear goals and accountability arrangements were found to be helpful.

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