

SENATE COMMITTEE ON FINANCE AND PUBLIC ADMINISTRATION

INQUIRY INTO THE TRANSPARENCY AND ACCOUNTABILITY TO THE  
PARLIAMENT OF COMMONWEALTH PUBLIC FUNDING AND  
EXPENDITURE

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*Summary*

*Australia has a strong international reputation for the quality of its budget documentation. Over the past 25 years budget documentation has improved dramatically. The Financial Management Improvement Program, publication of forward estimates and the introduction of program budgeting, were all important steps.*

*The transition to outcomes/outputs accrual based budgeting in 1999-2000 was accompanied by further significant changes in budget reporting. Some of these added to transparency and accountability: in particular, information is now available on assets and liabilities, changes in the net worth of government can be monitored, and there is now consistency between the reporting structure in the budget papers and departments'/agencies' Annual Reports.*

*Other changes at that time, however, diminished transparency. These include a reduction in the amount of functional reporting, lack of program information, and duplication of financial statements under both GFS and AAS (the relevant statistical and accounting standards).*

*The challenge now is to improve budget reporting to deliver the same high standards of transparency that applied under a cash budgeting environment, while preserving the benefits of the additional accrual information now available.*

*The necessary steps include:*

- *Publish a more comprehensive range of key indicators:*
  - *program information (currently collected but not disclosed). The ideal means to do this would be to align outcome and output structures with program reporting structures: this would reduce duplication of effort and be a more transparent option than parallel reporting on both outcomes/outputs and programs*

- *trends in net worth (sufficient information is now available to allow a useful time series to be presented) together with explanatory material on the driving forces behind these trends*
- *a reconciliation table broken up by function*
- *a historical time series of expenses by function*
- *Pending the outcome of 'harmonisation' of AAS and GFS reporting standards, report against only one of these*
- *Provision of detailed tax expenditure information with the budget*

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This submission is structured around the committee's terms of reference as follows:

1. introduction and background
2. the impact of outcome budget appropriations and reporting
3. multiple sources of funding including special appropriations, advances to the Minister for Finance, annual departmental carry-over surpluses, revenue retained under section 31 of the Financial Management and Accountability Act 1997, special accounts and goods and services tax appropriations;
4. the use of ordinary annual services to fund activities including non-annual services
5. options for improving the transparency and specificity of budget papers and related documents
6. other measures to improve the Parliament's oversight of proposed and actual Commonwealth funding and expenditure.

## **1. Introduction and background**

Transparency - that is, the extent to which an organisation opens its activities to external scrutiny and examination, through the publication of information on its structure, performance and finances - is one of the fundamental building blocks of good governance. Transparency is not just an abstract concept: government openness to external scrutiny (in relation to performance overall but particularly its financial performance) builds confidence in a country, makes it a more attractive destination for investment, and reduces the premium on its borrowings. In this way, transparency in government helps a country help create employment and keep interest rates low<sup>1</sup>.

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<sup>1</sup> other things being equal. Transparency is only one of many factors contributing to risk premiums applicable to a country's borrowings. Other governance factors that have been important in Australia include (longer term) political stability, strong adherence to the rule of law, separation of political and military interests; and (more immediately) effective fiscal policy settings, and the independence of the Reserve Bank.

Among nation states there is a strong correlation between having a system of governance that is highly transparent and economic performance. It is not a coincidence that the countries that rate highest in the annual surveys of organisations like Transparency International also have among the highest levels of GDP per capita in the world.

Transparency is also a powerful driver of confidence in government. It acts as a disincentive to mismanagement or unethical behaviour, allows groups or individuals in a country with an interest in particular activities of government to monitor those, and leads to better informed decision making by both the executive and the legislative branches of government.

Australia has a strong international reputation for transparency. We were among the first countries in the world to publish comprehensive forward estimates of spending and revenue, to include performance information in annual reports of government departments, and to require evaluations of government programs to be conducted regularly and published. More recently, although not at the leading edge, we are still amongst the top ranked countries in making government information available online.

While Australia has a strong legacy of transparent and high quality budget reporting to draw on, standards can slip over time – especially in relative terms as other countries improve the quality of their reporting and transparency. This diminishes, albeit slowly, our international standing and the economic advantages that entails.

Even aside from any economic concerns, there are public policy reasons for transparency in government reporting that make it inherently desirable. Open and reliable reporting means performance can be monitored, and that the Parliament (particularly the Senate with its traditional ‘house of review’ role) can be more effective in holding the government to account for its actions.

Australia has a long history of changes aimed at improving the budgetary and financial reporting framework. Attachment A provides background to the introduction of the new accruals based outcomes/outputs budgeting framework in 1999-2000. All of these initiatives have had the intention of improving transparency. Some have not entirely met this objective. The 1999-2000 budgeting changes are a case in point<sup>2</sup>.

## **2. The impact of outcome budget appropriations and reporting on the Parliament's ability to scrutinise, approve and monitor proposed and actual expenditure**

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<sup>2</sup> The reasons these changes were less than successful are many, and covered in more detail in the Attachment. But at the risk of over-simplifying, it could be said in summary that the mistake made by the Finance department was to give control of design of the system to a separate taskforce (the Accrual Budgeting Taskforce) that never properly got to grips with the issues. Instead of simply implementing the approach suggested in a Management Advisory Committee report *Beyond Bean Counting* this taskforce developed a system that took little account of advice from budgeting experts and was over influenced by recondite accounting theory. Indeed, this committee could do worse than refer to *Beyond Bean Counting* for an outline of possible alternatives to the current system.

## 2.1 Unintended consequences of the new budgeting framework: reduction in the number of reporting points

A legacy of the introduction of the outputs and outcomes structure has been a dramatic reduction in the number of reporting points in the budget papers. Although in theory *outcomes* and *programs* should have been much the same – both simply bring together reporting on spending that contributes to a common objective or purpose – in practice most departments took the opportunity of the change to the new framework to reduce their reporting points. Under pre-1999 program structures, departments typically had around 8-10 programs; these were reported in Budget Paper 6. With the introduction of outcomes/outputs budgeting, a majority of departments reduced these to only a handful of outcomes (some to as few as one, many to only two or three)<sup>3</sup>.

This could be considered an unintended consequence of delegation of authority to individual Ministers and their Departments (Australia has a highly devolved system, with little central control or oversight). It is often not in the interests of an individual Minister or Department to have a detailed and transparent breakdown of their activities. Ultimately, though, the interests of the government as a whole, and of the Parliament, should take precedence. Traditionally these interests have been safeguarded by the Prime Minister, Treasurer and Minister for Finance, together with their departments.

The problem with a lack of program information has been recognised by the government already, but only for its internal purposes. Departments and agencies prepare expenditure information, and provide it to the Department of Finance and Administration and the Expenditure Review Committee of Cabinet, on a program basis. This program information has not been made public.

In corporate governance it would be considered highly undesirable for management of a listed company to use one set of information for decision making purposes while releasing a different set to the shareholders, regulators and public. Even if it did not amount to fraud, it would at the very least contribute to poor scrutiny of firm performance.

The current situation, where government takes decisions on a program basis but reports to the Parliament on an agency and function basis has similar drawbacks. The problem is that program information is not simply a more detailed breakdown of the information in the budget papers – it is a presentation against a very different cut of the data, and one that would appear from anecdotal feedback from Ministers to be manifestly more useful and easier to understand.

Transparency would be greatly enhanced if the program information were to be made public. Given it is already collected, the cost to government of reporting the information would be minimal, and the gains in terms of accountability and transparency considerable.

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<sup>3</sup> There were notable exceptions, such as the Health portfolio

An associated issue is the high level abstraction of outcomes descriptions. Not only parliamentarians but also external observers such as John Uhrig AC (in his report on *The Governance of Statutory Authorities and Office Holders*, June 2003) have noted that some outcomes are expressed at such a high level of generality as to be virtually meaningless.

There is a role for more guidance to be provided to agencies by the Department of Finance and Administration, and where mere guidance is insufficient, intervention by the Minister for Finance and Administration may be required to persuade colleagues of the value of more meaningful outcomes.

A suggested solution is set out in section 5 below.

The committee should note that reporting program and outcome information is inherently prone to dispute, and there is no complete solution. There were numerous disagreements over what constituted a “program” even under the previous system of ‘program budgeting’. What a Minister called a “program” in a press release to an affected interest group would frequently be only one of many activities that fell within the one official program under the reported program structure. Almost certainly the current information on programs provided to Ministers has similar features – not everything described in the media or in a ministerial statement as a program will be separately reported. This would make the level of detail in the Budget papers impossibly large, and lead to problems of inconsistency, with considerable overlap between the classifications of different activities to programs.

There is also the perennial problem of departments and agencies changing their program structure year by year, which makes it difficult for the Parliament to monitor performance over time. This was the case prior to the outcomes/outputs budgeting system, and has been a longstanding bugbear for Senators and Senate Committees. This is a problem that possibly could be addressed through better central agency coordination, but whether or not that occurs is entirely dependent on the approach endorsed by the government of the day. It is not a problem related to the question of whether the budget is reported against inputs or on an outcomes/outputs basis.

Despite these inherent possibilities for dispute, there would still be considerable value in both better outcome definition and the release of program information.

## **2.2 Unnecessary parallel accounting and reporting**

A further legacy of the introduction of accruals has been an unnecessary duplication of reporting in the budget papers against two standards: Government Finance Statistics (GFS) and Australian Accounting Standards (AAS). This parallel reporting confuses readers of budget papers, and adds unnecessary bulk. It also increases the scope for governments to report information selectively: where information is reported differently

in GFS than AAS, or vice versa, (not often, but it does happen) then the government can ensure it is reported against the standard that best supports its case<sup>4</sup>.

The duplication of budget accounting standards arises because the *Charter of Budget Honesty Act 1998* requires budget reporting to be “based on external reporting standards” (s.12(3)(a)) – and both GFS and AAS are applicable standards for the purposes of this legislation. I understand that the Department of Finance and Administration has had legal advice to this effect.

There is no inherent merit in one standard over the other.

The AAS approach has advantages:

- It is based on well developed accounting principles
- There are specific accounting standards for the public sector (especially AAS 28 and 31) that are designed to take account of its specialized requirements
- There is a mechanism for arms length technical review of the standards via the Australian Accounting Standards Board and Financial Reporting Council.
- Many State governments use AAS to prepare their budget documents.

GFS has advantages:

- GFS accruals is an international standard, supported by an expert panel
- Presentation of Australian budget information on a GFS basis allows comparison with other countries (and has to be prepared in any case for reports to international forums such as the IMF, OECD and United Nations)
- Australian Bureau of Statistics data are prepared on a GFS basis: there are considerable advantages in the budget papers and the national accounts being presented on a consistent basis

Both standards have disadvantages including:

- AAS can be overly technical, and encourage nitpicking debates on fine points of accounting detail; and it draws heavily on private sector approaches that do not always translate well to the public sector (see Professor Alan Barton’s critique of the adoption of AAS in his 2004 annual accounting research lecture)
- GFS is not finely detailed – it is a broad brush standard which reflects the limitations of international standard making; some elements of GFS (such as the treatment of military equipment) distort the true asset position of government.

There can be unproductive debates over the details contained within reporting standards that make not the slightest difference to decision making, accountability or transparency.

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<sup>4</sup>Well informed and very patient readers can find their way through the budget papers to locate information on most subjects against both AAS and GFS standards – but it is time consuming, and few readers have the necessary range of expertise (the task requires an understanding of both budgeting/economic concepts and of how to read financial statements)

For example, with the introduction of accruals, public sector assets were for the first time reported on comprehensively: an important advance in transparency.

At the time however there were some fruitless debates within official circles at both Commonwealth and State level on valuation of assets unlikely ever to be sold (eg War Memorials, Parliament Houses, or national parks). This is unproductive and unnecessary. The main thing for the purposes of decision making and accountability is not the one-off issue of how such assets are valued when first brought in to the accounts, but how the government's management over time changes their value. In this way, we can see if the government is managing them well or badly. For this to be measured, all that matters is that the accounting standard is applied consistently year on year. This allows observers to see if the value increases or decreases, and to make judgments about the government's stewardship of the asset accordingly.

Similarly, with the AAS/GFS debate, what matters is not the standard per se, but that it is applied in a consistent fashion year on year so reliable estimates of trends can be reported. Settling on one standard only will be a major step forward. If amendment of the *Charter of Budget Honesty Act 1998* is required to allow this, that amendment should receive bipartisan support.

There is currently an exercise underway to harmonise the AAS and GFS standards. This would be a highly desirable outcome, allowing budget reporting against just the one comprehensive reporting standard. In the meantime, however, the best approach would be to adopt just one of the two. Adoption of either one or the other as the primary reporting standard would be vast improvement over the current practice of using both.

A more radical approach to simplifying reporting, but one which the government has shown no interest in to date<sup>5</sup>, would be to report only departmental expenses on a full accruals basis, and not require departments/agencies to have a full accruals chart of account for their administered items. These could still be included in the overall budget figuring on an accruals basis, but for the purposes of Portfolio budget statements (PBS), only the departmental set of accounts would be presented with the full set of financial statements, and the PBS would include a much simpler table on administered items showing only the proposed annual expenditure in each forward year. This would simplify the reporting in PBSs considerably. The rationale for such a change would be:

- Accruals information is important mainly to enable better informed decisions on use of resources; departmental items are ones on which departments and Ministers can make resource decisions, administered items are ones which by definition are outside their control
- For most administered items – and certainly the largest category, those that fall under the Social Security Act – there is negligible difference between a cash and an accrual appropriation.

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<sup>5</sup> in terms of the official record at least – there may have been consideration of the issue that has not seen the light of day

### 2.3 Positive features of the budgeting arrangements that should be retained

There have also been significant gains from the move to accrual accounting and outcomes-outputs reporting. These should not be discarded. They include:

- Reporting in the budget on assets and liabilities – which in turn has forced departments and agencies to manage these better
- A measure of public sector net worth in the budget papers (although desirably trends in net worth could be more comprehensively graphed and reported)
- Consistency between portfolio budget statements and annual reports – that is, promised performance and actual performance are now reported on the same basis.
- A performance focus (at least in theory) in the appropriation bills approved by the parliament.

### 3. multiple sources of funding including special appropriations, advances to the Minister for Finance, annual departmental carry-over surpluses, revenue retained under section 31 of the Financial Management and Accountability Act 1997, special accounts and goods and services tax appropriations

One of the notable features of budgeting in Australia is our increasing reliance on special appropriations. They have grown to almost 80% of budget spending; which means that Parliamentary scrutiny of Appropriation Bills has become a relatively minor aspect of overall budgetary transparency and accountability. This is probably not what the framers of the Australian Constitution intended, but is now well entrenched in the Australian system (for a more detailed discussion of this issue see *Public Sector Governance Australia*, CCH, 2004).

The implications of this are that there should be correspondingly greater attention paid to the performance of government programs funded via special appropriations: in particular, in the areas of social security and health spending.

One option for this would be a separate reporting vehicle on these areas of spending; the obvious possibility is a budget-related paper that provides the Parliament with information on spending through special appropriations. The creation of the Department of Human Services, which brings under its umbrella many of the largest special appropriations, is possibly an opportunity to assign responsibility for production of such a budget-related paper.

On the other concerns of this term of reference (Advance to the Finance Minister, carryovers, s.31 and special accounts), the key concern is that there be accurate and reliable reporting in the interests of transparency. The mechanisms themselves are highly desirable in allowing the executive branch to carry out its functions.

There are however grounds for concern that reporting is not currently reliable or comprehensive – the lack of accurate reporting in other key areas such as government



contracts (revealed by recent ANAO reports) highlights the fact that it is not the mechanism so much as the willingness of departments and agencies to collect and report on information that matters in terms of transparency and accountability.

#### **4. The use of ordinary annual services to fund activities including non-annual services**

The importance of the term “ordinary annual services” for budget transparency and accountability is well known to this committee (the footnote is provided as background for other readers of this submission).<sup>6</sup> The diminution of the importance of annual appropriations (see previous section) has also been accompanied by a diminution in the number of appropriation items for non-annual services. This historical trend has been underway for many years. One of the problems for the scrutiny of the budget by the Senate is that adherence by the executive to the 1965 Compact is difficult to monitor. It depends on a number of factors including:

- knowledge by departments/agencies of the significance of the distinction between ordinary annual services and non-annual services
- willingness of the executive to ensure that they comply (including through promulgation of regulations or Finance department orders)
- Senate committees themselves being aware of the significance of the issue and raising it in their estimates hearings at budget time.

The high rate of staff turnover, especially in budgeting/finance areas of government agencies, gives rise to the possibility that awareness is low, but there is no empirical evidence on the question. A survey of departments/agencies could establish the extent to which they are aware of the importance of this issue. The second question, Department of Finance and Administration monitoring and enforcement of the split, is an area the committee should probably explore with that department in due course.

Audit coverage of the budget documents would be one way to strengthen monitoring of not only this but many other aspects of the accuracy and reliability of budget reporting,

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<sup>6</sup> extract from Bartos, S. *Public Sector Governance Australia*, CCH, Sydney, 2004: “Under s 53 of the Constitution “The Senate may not amend proposed laws imposing taxation, or proposed laws appropriating revenue or moneys for the ordinary annual services of the Government”. This provision applies most crucially to the Appropriation Bills presented at the time of the Budget. Under the Constitution the government is entitled to have its budget passed by the Senate without amendment. Although it cannot amend an appropriation bill the Senate can decline to pass it, as happened most famously in October-November 1975. But just what are ordinary annual services? What sorts of proposed spending can the Senate amend, and what does it have to leave alone? This was the subject of much debate and disagreement for the first half of the twentieth century. The matter was finally resolved in what is known as the “Compact of 1965”, an agreement between the Senate and the Executive that saw some items such as new buildings, grants to the States and new policies put into their own appropriation bill (Bill 2) that the Senate had power to amend. An amendment to the Compact was agreed with the introduction of accrual budgeting in 1999, whereby appropriations for depreciation (to allow replacement of capital equipment) were classed as “ordinary annual services”.

but it would have huge resource implications for the ANAO and in any case is unlikely to be adopted by the executive government.

## **5. options for improving the transparency and specificity of budget papers and related documents**

Arising from the discussion above, the following options are suggested to the committee:

- either a) seek reporting on the program information currently used for budget decision making by the executive government or b) a preferable option, break the current outcomes/outputs structure down to a level that corresponds to what the public and ministers commonly understand as programs
- recommend to the executive that the Minister for Finance and Administration be delegated a power to require outcomes descriptions to be expressed in clear, simple and measurable terms. In practice, this power would be exercised by his department in negotiations with other departments, and could be expected to result in considerable improvement in budget transparency, especially if combined with the first suggested option above
- adopt only one external reporting standard as the primary reporting standard, pending harmonization of AAS and GFS
- report in a budget related paper on spending under special appropriations
- as well as reporting on net worth for the budget and forward years, provide a time series and graph on trends in net worth, together with an explanation for these trends.

## **6. Other measures to improve the Parliament's oversight of proposed and actual Commonwealth funding and expenditure**

### **6.1 Tax expenditures**

Tax expenditures are the various reductions in tax collected arising from rebates, allowable deductions and other government measures. The OECD *Best Practices for Budget Transparency* (May 2001) recommends that the estimated cost of key tax expenditures should be disclosed as supplementary information to the budget. Australia does not do this. The Tax Expenditures Report prepared annually by the Treasury appears in or around December each year, and is not related directly to the Budget papers. The Budget provides only a bare summary of tax expenditures.

This is a major defect in our budgeting framework. Tax expenditures are a large and growing component of the budget, amounting to a total of some \$30b (and this only includes those that can be estimated reliably – the real total is much higher), or around 15% of the total amount spent directly by government. At present it is not possible to assess the relative merits of tax expenditures and direct spending side by side in the budget papers.

They are among the least transparent elements of our financial management framework. At present, it is virtually impossible for the parliament to quiz officials about the performance of tax expenditures in the same way those officials are questioned about direct expenditure programs. The information is not provided in a form that allows or encourages scrutiny.

Inclusion of detailed tax expenditure data in the budget papers, preferably broken down by function in the same way as other expenditure, would be a highly desirable step forward in transparency.

## **6.2 Functional information**

Functions provide consistent information over time, in accordance with international government finance statistics classifications, of government activity. The functional sections of the budget papers are a highly useful tool in allowing parliamentarians, commentators, interest groups and others to understand government spending.

The current functional sections of Budget Paper 1 are useful – certainly better than having no functional information at all – but by comparison with best practice budget papers, relatively brief and lacking in analysis. They could make use of charts and graphs to show trends, identify the key drivers of expenditure in each function (eg demographic, social or environmental), and the relative importance of new measures in each. This sort of information has been provided to Australian parliamentarians in past budgets. Better functional information would be highly desirable.

## **6.3 Other matters**

Some other issues that could be addressed are:

- Reconciliation table. The reconciliation table is one of the most useful tables in the whole of the budget papers. It is produced for both the Budget and the Mid Year Economic and Fiscal Outlook (MYEFO). It shows, for both revenue and expenses, the reasons for changes in the budget figures since the last update (ie MYEFO to Budget, or Budget to MYEFO). It sets out what movement is due to government policy decisions, what to parameter variations (ie changes in the economic assumptions underpinning the budget) and what to “other”. Prior to the introduction of the new framework, the estimates reconciliation table was also provided on a functional basis – we could see for each function the reason for changes in the estimates. This was a valuable part of the budget papers which has been dropped – it should be reinstated.
- longer term time series data. The budget papers used to show expenses by function over a 10 year period prior to the current year, together with the forward estimates. This was valuable information to assess longer term trends, and again, should be reinstated. If there is a problem with a break in the series from the introduction of accrual budgeting in 1999-00, then the obvious approach is to produce a time series starting in this year – it will be a 10 year series soon.

- Treatment of depreciation There appears from the budget papers to be a strong possibility that there has been double dipping by agencies – being funded for depreciation while still receiving additional funding for new assets. Depreciation funding is not well understood. It provides for replacement of assets when they reach the end of their useful life. It is not for repairs or maintenance – that was already part of departmental running costs, and was transferred into departmental expenses (roughly equivalent to running costs) under the new system. Depreciation funding should have made all calls for new capital spending – except on new programs - unnecessary. It now appears from the budget papers that many agencies are not making provision for replacement of assets, and are still seeking supplementation when they need to undertake asset and systems replacement or upgrades (a prominent recent example being the Customs replacement IT system). This depreciation problem was recognised by the government in relation to large long-lived assets like the National Gallery – the problem emerged when the Gallery proposed using its depreciation funds for purposes other than asset replacement – and it has been addressed for these. It does now seem the problem is broader. It would be desirable for the Auditor-General to be asked to report on whether agencies have misused depreciation funding, and if there is supporting evidence that they have, for this component of departmental funding to be withdrawn.
- Reporting on budget, financial and public sector reform. There is virtually no information in the public domain on what (if any) financial management improvement projects are underway inside government at present. We know from the estimates hearings of this committee that there was a Budget Estimates and Framework review, but its full report has not been made public. In early 2002 the Management Advisory Committee commissioned a review of budgeting and financial management that involved among other things interviews with portfolio Secretaries and input from Commonwealth agencies' Chief Financial Officers – the findings of that have never been published. There may be other major review processes. Confidence in the budgeting systems of the government, and its commitment (or not) to transparency and accountability can be measured in part by the extent of disclosure on financial management reform processes. The current approach contrasts strongly not only with that of the previous government<sup>7</sup>, but also with that of the first half of the current government's decade in office. Greater disclosure, through papers, publications, Ministerial statements and the like, would be an improvement in transparency.

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<sup>7</sup> Probably the high point in disclosure of this sort was in the period when Dr. Michael Keating was Finance department Secretary and Mr. Pat Barrett Deputy Secretary. These two officials produced a substantial body of innovative, insightful, well considered contributions to budget and financial management thinking.

## ATTACHMENT A – HOW WE GOT HERE

Our current systems for financial disclosure and accountability have a long history. The publication of forward estimates, for example, was recommended in the Coombs *Royal Commission into Australian Government Administration* report in 1976. Significant milestones since that time have included:

- The White Paper *Budget Reform* (February 1984) which announced a comprehensive series of changes to improve the scope and reliability of budget reporting
- Introduction of portfolio budget statements to accompany the budget papers
- Publication of forward estimates of expenses progressively over the 1980s (there were some estimates published earlier, but a comprehensive and reliable set of forward estimates of outlays in something like the present form of estimates was published from 1986-87, and of revenue somewhat later that decade)
- Introduction of program “budgeting” (actually program reporting – budgeting was still done on the basis of inputs) in the late 1980s. Program budgeting divided government activity into segments that had a common identifiable objective and attempted to develop performance indicators on how well departments and agencies were meeting those objectives, and report against those
- The Financial Management Improvement Program, which helped improve the quality of agencies’ financial reporting and internal management
- Publication by the Finance department of advisory materials on topics such as the cost-benefit analysis, cost recovery, the performance improvement cycle; and a series of papers from the former Management Advisory Board on topics in the field of public sector management more generally
- Publication of the Management Advisory Committee *Beyond Bean Counting* report on improving financial management in 1998
- Introduction of outcomes/outputs based accrual budgeting from the 1999-2000 budget
- Publication by the Secretaries of the Finance and Treasury departments of the review of the introduction of the new budgeting system by Dr. Michael Vertigan.
- Reintroduction of functional reporting<sup>8</sup> to the budget papers from 2000-01 after a brief hiatus in 1999-00.<sup>9</sup>

In the past 5 years there has been little further discernable improvement in budgeting, financial management or performance information – although there have reportedly been

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<sup>8</sup> “functions” are a way of classifying government activity under Government Finance Statistics rules. The categories are broad (eg Defence, Social Security and Welfare) but there are also more detailed sub-function breakdowns. The advantage of functional reporting is that it remains largely consistent year on year; whereas reporting based on the division of responsibilities among government agencies is prone to change every time the government reallocates those responsibilities. However, agency by agency reporting is important for accountability reasons – it shows which agency is responsible for the activities concerned. Good budget reporting includes both functional and agency classifications, and also economic type (eg capital vs. current spending) information.

<sup>9</sup> From an accounting perspective, the “reporting entity” is key to presentation of financial information; one of the reasons why initially agencies were preferred over functions.

developments within government that have not yet had any appreciable effect on the quality of budget papers. In light of experience in recent years, there are obvious opportunities for the Commonwealth Government to improve its performance in budgeting and financial reporting.

*The move to accruals, outcomes and outputs*

This was the most comprehensive change to Commonwealth budgeting since the post-WWII taxation agreement with the States. The change affected mainly agencies in the general government sector – other parts of the broader public sector such as Commonwealth owned companies have been budgeting on an accruals basis for decades.

It was introduced extraordinarily quickly. Although accrual budgeting had been Coalition policy since the 1995 election, and was recommended in the 1996 National Commission of Audit (NCOA), there had been no formal government commitment to its introduction. There was an “in principle” decision to move towards accruals following the NCOA report, and an accrual budgeting team in the Department of Finance and Administration had been working on systems, training and policies over 1997 and 1998. But many government agencies, including the Treasury, were convinced it would never be adopted in reality, and consequently the state of preparedness was low.

Then, shortly after the October 1998 election, the Treasurer announced that the 1999-2000 Budget (to be brought down in May 1999) would be on a full accruals basis. This left effectively less than 6 months for the Department of Finance and Administration to introduce the new system. The previously separate accrual budgeting taskforce was soon after amalgamated with the Budget Group in the Department of Finance and Administration; but by the end of 1998, the former head of this accrual budgeting group had moved to a position in a State jurisdiction and other staffing changes had taken place. By this time it was becoming obvious that the “in principle” development work by that group had left significant implementation issues to be addressed.

The changes involved were massive – not only was the financial reporting basis for the budget to change from cash to accruals, but its structure was changing from inputs to outcomes and outputs. There is no necessary relationship between the two changes: it would have been possible to have accrual budgeting based on inputs, or moved to outcomes/outputs reporting on a cash basis. Nevertheless, Australia opted to do both at once. At the same time, the responsibility for estimates was devolved to departments and agencies, rather than being kept within the Finance department. There were also systems problems: on its first exposure to real estimates updates in December 1998, the budget IT system, the Accrual Information Management System, proved unable to cope with the demands of the officers in agencies who were entering the data. In addition, there were only high level accounting policies in place – leaving an enormous amount of detailed policy work required to develop guidance for departments and agencies.

In the circumstances, the miracle was that the 1999-2000 budget was produced on a full accruals outcome/output basis at all. More details on the transition, the difficulties it

involved, and suggestions for overcoming those difficulties, can be found in the report by Dr. Michael Vertigan AC that was commissioned by the Secretaries of the two departments most involved in budgeting (Treasury and Finance) shortly after the 1999-2000 Budget.

It is important to note that there were sound policy reasons for the change:

- Annual reporting by departments and agencies had been on a program and an accruals basis since 1989 and the early 1990s respectively (changes introduced under the previous Labor government). As a result, there was a disconnect between promised performance outlined in the Portfolio Budget Statements produced at budget time and the actual performance reported in the Annual Reports. The new system overcame this problem.
- Program “budgeting” was never budgeting – it was reporting after the fact. Program estimates were in many cases a result of departments force-fitting numbers from the budget into the program structure, and not a basis for budgeting or planning.
- The Commonwealth had made commitments to the States to introduce the new system, in line with longstanding budget and financial reporting arrangements known as the Uniform Presentation Framework (a legacy of the Niemeyer reforms of the 1930s which sought to standardize financial reporting by governments in Australia)
- Our near neighbour, New Zealand, had introduced accruals and outputs based budgeting to considerable international acclaim
- Over the preceding decade the Parliament’s Joint Committee of Public Accounts and Audit had consistently, and unanimously, recommended changes along these lines. The Coalition, Labor and Democrat parties had all supported these recommendations.

Although some of the transitional problems associated with these budgeting changes have been addressed, others are still with us:

- Many departments took the opportunity of the move to radically reduce the number of reporting points. Many that had had 8-10 programs under the old reporting structure chose to have only 1-2 outcomes. An example cited at the time (since remedied) was the Department of Transport and Regional Services – which although it appeared even from the title of the department to have at least two outcomes to deliver, decided it only had one. At the time, the responsibility for the outcomes/outputs structure to be adopted rested with the Secretaries of departments and heads of agencies. This reflected the climate of devolution at the time: remember that the Parliament had only recently passed the *Financial Management and Accountability Act 1997* that devolved considerable powers from the Finance department to line agencies. In retrospect, however, this reduction in reporting points was to the considerable detriment of information available to the parliament and public, and more central guidance would have been desirable.
- There were inconsistencies in deciding which measure to use for the budget bottom line. Treasury had developed an accrual equivalent of the previous

underlying cash balance, called a fiscal balance. This was used as the reporting point at first, but in later years as the fiscal balance began to show a worse result than the cash balance, the former measure was reintroduced as the primary figure on which the budget bottom line would be reported

- The accounting details in the budget became voluminous. This was exacerbated by the budget reporting against two standards – Government Finance Statistics (GFS) and Australian Accounting Standards (AAS) – meaning parallel, and often significantly different, sets of accounts presented in the budget. This made it harder for the parliament, media and others to analyse the detail of the budget. This appears to have been an unintended consequence of the 1998 *Charter of Budget Honesty Act* that mandated budget reporting would be “based on external reporting standards” (s.12(3)(a)) – according to Finance department officials, legal advice had stated this meant both standards had to be used.

This is only a brief outline. For more detail see

- *Public Sector Governance – Australia* Bartos (2004), especially for some of the constitutional and legal underpinnings of current arrangements, or
- *Managing Public Expenditure in Australia* Wanna et.al. (2000), for a comprehensive, well researched survey of Australian Government public expenditure issues since Federation.

Also attached is a letter written by the author of this submission to Dr. Watt, Secretary of the Department of Finance and Administration, in August 2002. Many of the points made in that letter are still relevant to the present inquiry. The only changes made to this letter have been to remove names of other Commonwealth employees, to preserve their privacy.



Dr. I. Watt  
Secretary  
Department of Finance and Administration  
John Gorton Building  
PARKES ACT 2600

Dear Ian

Recently [ ] suggested I should write to you setting out my views on the current budgeting framework. While it is an overall step in the right direction, there are significant defects in that framework, and I have taken the liberty of suggesting remedies that might be applied to address those shortcomings.

I understand that there is a review going on at present, and it is likely that much of what I cover below will also have occurred to the reviewers, because these are issues which have been discussed among budget group people for some time. Nonetheless, if the points I raise cover similar ground it may help confirm the usefulness of any proposed changes.

You will recall that as part of the MAC commissioned review of the framework early this year I spoke with most CEOs of departments and large agencies – this letter draws in part on their observations, but for the most part reflects my own direct experience with the new arrangements.

In summary:

- the move to an accrual based budget on an outcomes and outputs basis is fundamentally sound, and over time will prove to be a significant contributor to improving the management of the Australian public service
- nevertheless, for a complex set of reasons, the implementation of the changed budgeting arrangements left a number of areas of unfinished business behind, including:
  - ongoing slowness in preparation of estimates updates by comparison both with the previous cash updates timetables and with private sector best practice.
  - unnecessary complexity in applying accrual measurement to many areas of administered expenditure (eg transfer payments) which are of an essentially cash nature
  - lack of understanding of the system among many senior managers and indeed Ministers
  - the high level of specification of outcomes by comparison with the previous programme structure
- The question is why do we still have these problems after three years of experience with the new framework? Given that they have persisted, there are

likely to be systemic, rather than simply transitional, issues at the heart of the matter. What are these systemic weaknesses, and how are they to be addressed?

### **Slow estimates (incentive issues)**

One of the failings of the new arrangements in my view has been that accounting concerns have predominated, and traditional economic perspectives on the changes have been missed. In fact the way in which the reforms are called “accrual budgeting” when in fact many of their elements have nothing to do with accruals is a signal that the accounting perspective has dominated. The accounting perspective was highly valuable, arguably essential, in the early phases, but balance has been lost. The result of this has been a relative lack of focus on more traditional economic concerns such as the role of incentives. This is nowhere more apparent than in the devolution of estimates to agencies.

From an economic perspective, agencies have little incentive to complete estimates in a timely and accurate fashion – and in relation to their own departmental estimates many economists in the public choice theory tradition would suggest that in fact they have an incentive to pad those estimates to the extent they can get away with it. The accounting paradigm will tend to address these concerns through control and audit measures: These are needed, but will not address the fundamental incentive structure. To meet the government’s expectations, devolution of estimates could only work in a different incentive framework. There are conceivable options to do this, but not likely to be adopted in the current management environment. They might include:

- Making any Secretary/CEO performance bonus dependent on their agency getting estimates done on time
- Penalties in the form of reduced departmental budgets for agencies that prepare inaccurate estimates [problems with this include determining what constitutes inaccuracy, and perverse incentive effects]
- Formal reporting to Ministers on the ranking of agencies in terms of timeliness and accuracy of estimates [a role Finance has in the past sought to avoid because of the inevitable rancor this would provoke].

Given the likelihood of these or similar changes to the incentive structure is low, estimates updates will continue to be a problem.

In addition, devolution of estimates has had a profound impact on Finance’s own ability to advise Ministers. The preparation of forward estimates provided a window in to the operations of other agencies. Although much of the estimates work was mechanical, agencies could not deny that it was a legitimate interest of Finance, and in many cases it therefore was a jumping off point to other policy work of broader interest. With devolution that window was not just shut – the frames were removed and the wall bricked up! There were negative aspects to the Finance preparation of estimates – in particular, an obsession by some officers with minute details of agency running costs while ignoring large administered items. On balance though, devolution of estimates has damaged Finance’s overall policy advising function.

### *Suggested solution*

Make the estimates lines again a Finance responsibility. In order to make this a manageable task, Finance could be responsible only at the level at which funds are appropriated (ie administered items and total departmental expense items). The composition of estimates within the constraint of the total could still be left with agencies, particularly in relation to the details of how their estimates for departmental items are to be split.

### **Slow estimates (systems issues)**

In the corporate world, an achievable best practice target for an equivalent task to our estimates updates would be about 48 hours for a full update. In reaching this conclusion last year in Budget Group we undertook comparisons with a number of private sector benchmarks. Not all can achieve this standard by any means, and it is difficult to get a comparison on all fours with our own arrangements. However looking at a large multinational with semi-autonomous country management units seemed the right sort of order of comparison. The comparison is not exact, but a reasonable one given that the greater homogeneity of those business compared with government is offset by their geographical dispersion and having to manage within different countries' legal systems. Examination of such companies suggests that a 48 hour turnaround is possible and in fact at the low end of expectations. The ideal is real time, on line, information updated automatically, available on request whenever needed by decision makers. Some companies have this already.

In the Commonwealth this standard would be impossible. This sort of best practice relies on a single, integrated, centrally-managed financial management information system (FMIS). At present in the Commonwealth we have around five different competing FMISs, all managed at agency level, and our devolved framework does not provide for centralised management. AIMS is not a FMIS – it is a reporting tool which relies on the submission of data from other agencies. This was a deliberate strategy of the Accrual Budgeting Project team to take away Finance control over estimates. At agency level, the multiplicity of systems reflected input from the then OGIT which gave agencies a choice from an approved FMIS suite. (noting that five was at that time a considerable improvement from the scores of competing systems used by agencies).

Since that time scalability of systems has improved, promised open systems approaches to allowing a central system to interact with any other have not eventuated, and the original purpose for which AIMS was designed and which it could still perform pretty well has been shown not to meet the expectations of the government.

### *Suggested solution*

To my mind there are two options.

- 1) If devolution of FMIS remains important to Ministers, then their expectations of updates will need to be addressed. The asserted speed of updates in the past is largely a myth – Treasury and Finance could do quick updates but these were based on in house information, not agency data, and we corrected the inevitable mistakes later in the processes. Such corrections could at times be large, but were not significant in terms of the budget bottom line and frequently revenue and outlays estimates corrections offset each other. Now however the very tight tolerance around the surplus/deficit level has made Ministers unhappy about the prospect of corrections.
- 2) If Ministers do want a systems change, the Commonwealth can take advantage of the fact that in line with normal IT replacement schedules agencies will within the next two to five years all need to replace their existing FMIS. A move to a single FMIS for the government would enable estimates updates to be done much more quickly. Finance department control of the system may be resisted by agencies concerned that this runs counter to the emphasis of recent management reforms on devolution. A counter argument to this is that ownership of the data itself, and the use made of that data for management purposes (as opposed to estimates updates) would remain with the agencies.

### **Complexity of applying accruals to administered estimates**

This has been one of the major complaints from agencies. In effect the vast majority of administered payments are of a cash nature – transfer payments to individuals or organisations, payments to the States etc. However, there is a full chart of accounts in the accrual format for all of the administered items. Many of the departmental managers I spoke with could not see the value of these. There are important exceptions (eg superannuation and HECS) but for many of the complaints are valid.

Accrual measurement is primarily a management tool; thus, for items over which agencies have no real control – by definition, administered items – the value of accruals is limited.

For government as a whole, management of the administered items by both accrual and cash is consistent with the objectives of the overall reforms.

### *Suggested solution*

Recognise that administered items are a whole of government management responsibility and construct accrual statements for them only at that level. For each agency administering them, the workload would be considerably reduced. In accounting terms I understand that the sensible approach is to create a “crown” agency which is notionally responsible for these administered items. Note - I don't claim credit for this solution, it is something [ ] suggested a while ago and was working on before he was moved out of Budget Group. Examination of this year's portfolio budget statements suggests this has already happened to some extent, although I was unable to find a separate reporting entity for the administered items.

### **Lack of understanding**

One fundamental mistake of the move to the new arrangements was that most of the training and education effort happened under the Accrual Budgeting Project, prior to a final decision being made to implement the new arrangements. As a consequence, many of the people who most need to understand the system either did not attend or did not take the information seriously.

#### *Suggested solution*

A training effort of the same scale as occurred in 1997, but of a different nature, looking much more at the practical aspects of managing under the new environment and with a reduced promotional/rhetorical content. This would not be a cheap exercise – an additional allocation of departmental funds of the order of \$5m would be around the level needed to repeat that exercise.

### **High level specification of outcomes**

One of the persistent complaints about the new budgeting arrangements by outside observers (particularly parliamentarians and journalists) has been about a loss of information. The complaint about loss of functional data was quickly addressed in the second accrual budget; the complaint that there has been a loss of programme information persists.

In theory there should have been no loss of information in the transition from program budgeting to outcomes/outputs – in fact the reverse should have happened. A program under the former government was simply a collection of activities designed to achieve a common objective – very much the same as an outcome. Addition of outputs information would be a bonus.

In reality, in the transition to the new arrangements many agencies took the opportunity to rationalise their previous program structures into a much smaller number of outcomes. In many cases they are specified at such a high level that it is virtually impossible to either measure them or report on performance to achieving them.

The former Minister for Finance did have a role in approving outcomes and outputs statements, but in practice all proposals were approved.

#### *Suggested solution*

I suggest that the Minister ask his colleagues to agree to a review of all outcomes and outputs structures with his involvement, with the aim of increasing the number of reporting levels to no lower than it was prior to the introduction of the new arrangements. This would not be an easy task, given the need to balance whole of government and

individual agency needs, and has some political risks associated with it – but I would argue that taking no action involves greater risk.

**Other aspects of the new budgeting arrangements, which could be addressed.**

I am aware of a range of other issues which have been drawn to the attention of your review team, and see no need to repeat the points, although I can confirm that there remain a number of details of the estimates and accounting policies which could be amended to improve the system. Two broader whole of government issues of concern to me are what should be the main fiscal target under the new framework, and the application of the capital use charge.

*Fiscal target.* There is confusion in commentary about the fiscal targets used by the government. Some observers see fiscal balance as the “accrual” measure and underlying cash as the “cash” measure. This is a misunderstanding. Both measures are derived from the accrual statements. Initially fiscal balance was a measure devised by the Treasury to track public sector net lending; I would argue that underlying cash is equally useful for this purpose. The one reason for retaining fiscal balance is that it appears to have been somewhat more stable over time and to provide a better correlation between forward estimates and actual outcomes. I will however be interested to see if this trend is continued this year.

As you know, there is no such thing as an objective and technically correct measure of the budget balance, all measures used by governments anywhere are constructed according to particular judgements and assumptions. The academic literature around the choice of fiscal measure establishes no clear preference for any one – although there is a general consensus that “headline” cash can be easily manipulated.

In my view there are two (potentially three) important measures:

- Underlying cash, as noted above, is significant for macroeconomic management – for fiscal policy purposes it remains the important benchmark.
- Net assets or net worth is important in measuring how well the government is exercising stewardship obligations for Australia; the key issue here is not the absolute number but how it changes over time. One of the great advances of the accrual measurement of budgets is that net worth can now be reported on in budget papers.
- The operating result can be a useful measure of the national “management” function of government considered as a business; it will be more or less important to the extent to which the government of the day seeks to apply private sector models to its own management of the economy. Because government is not a business in many important respects, the usefulness of this measure is limited.

*Capital Use charge:* The CUC’s sole useful purpose is to ensure that outputs are priced at a rate equivalent to that of any potential private provider, reflecting the fact that the private provider needs to earn a return on capital. It was initially promoted by the

Accrual Budgeting Project as an incentive for better asset management; it is clear that the CUC is not useful for this purpose (see previous MAC draft report). If the government were still pursuing a strong market testing agenda and sought to expose all outputs to competition, the CUC or preferably a dividend regime needs to be in place; however my sense is that this is not a current priority, and I would therefore question the usefulness of the charge.

I hope you find these thoughts of interest.

Yours sincerely

Stephen Bartos  
29 August 2002