# Accountability – A poor substitute for responsibility

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## Introduction – a reminder from the north

A few years ago a delegation of Norwegian academics and public servants involved in economics and public administration came to Australia on a study tour. At a seminar in Canberra Australian academics and officials boasted about our progress in public sector accountability with measures such as the 1984 *Financial Management Improvement Program*, the 1997 *Financial Management and Improvement Act*, and the 1998 *Charter of Budget Honesty*.

Although their command of English was excellent, the Norwegians found the Australians' presentations hard to follow. When their turn came to respond, their spokesperson said "We have heard from you about *accountability,* but in Norway when talking about the role of government, we usually refer to *responsibility.*" "The two terms have different meanings in English, I believe", he added politely.

In this presentation I will briefly outline how Australian governments have retreated to a narrow perception of themselves as business enterprises and have therefore adopted the reporting practices of business, even though these are generally inappropriate for government. My focus will be on the Commonwealth, but this is not to exonerate the states, and it is not to draw particular attention to the present (Howard) administration, which has done no more than to build on the changes introduced by the Hawke-Keating Government.

Then, using the Commonwealth's *Intergenerational Report* as an example, I will illustrate what a different standard of reporting – one which goes beyond accountability into the realm of responsibility – may entail.

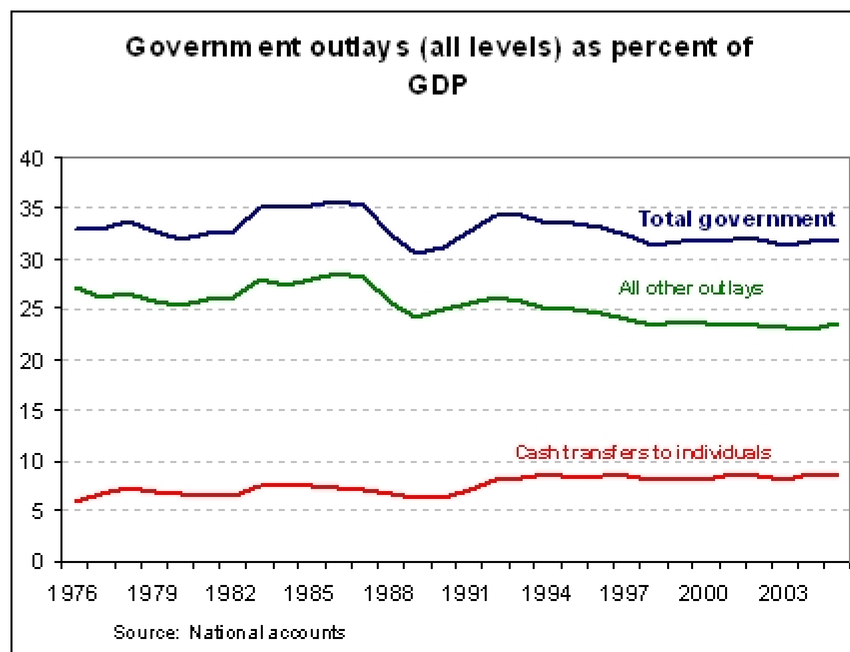
## The retreat of government – redefinition and the private sector model

*From services to transfers*

At first sight there does not appear to be a retreat of government. The Commonwealth, in particular, has intruded into our lives with preventative detention, control orders, book censorship, appointment of party apparatchiks to the ABC Board and a general muzzle on voices of dissent. It's not a 'small' government.

It is in the economic sphere where there has been a retreat of government, particularly in the provision of public goods and services to the community. Again, this is not evident at first sight. Over the past 30 years total government expenditure (recurrent and capital) as a

proportion of GDP has had no discernable trend, fluctuating between 31 and 35 percent of GDP.




But the *composition* of government outlays has been changing.

Government spending can be classified into two broad categories – 'own purpose spending' and 'transfers'. When a government builds a school and hires teachers, that outlay is classified as 'own purpose', because the government retains close control over the spending of that money. When a government pays a cash pension to an individual, however, that outlay is classified as a 'transfer'. For transfers, the government's only responsibility is to ensure that eligibility criteria are met; it has no control over how the recipient spends that money.

Personal transfers such as aged and disability pensions, unemployment benefits, and family allowances have been rising, from 3.6 percent of GDP in 1971 to 8.4 percent of GDP in 2005, and are projected to keep rising. Offsetting this rise governments, particularly the Commonwealth, have been paring 'own purpose' spending, being mainly spending on public goods in areas of infrastructure provision and service delivery, including education, transport and environmental protection.

At the Commonwealth level, personal transfers accounted for 23 percent of the 1975-76 Budget; they account for 44 percent of the 2006-07 Budget and forward estimates show continued strong growth. Government transfers now provide for almost half the income of low-income families; as recently as 1983 they accounted for only four percent of such a family's income.[1]

In short, governments are using public revenue to compensate for the economy's structural weakness; our economy is so uncompetitive globally that it is unable to provide well-paid jobs. Throughout the developed world there has been a similar trend; those governments which have gone down the neoliberal route of 'smaller' government have actually had to

increase their welfare payments, and have done so at the expense of capital expenditure and service delivery.[2]

While government rhetoric is often about condemning the welfare state, the reality is different, because transfer payments place responsibility for spending money in the hands of the recipients, rather than the hands of government. A family allowance is preferred to provision of public services, because it shifts responsibility for allocation from the government to the individual. Subsidies for private health insurance and private child minding are preferred to direct government provision of services, even though the effect of such open-ended subsidies results in some combination of waste and price inflation in the services. Transfer payments, when they replace direct service provision, allow governments to abdicate responsibility for service provision.

This shift in budgetary outlays from services to transfers, however, is only part of the story of the abandonment of responsibility. Over the last 20 years there has evolved a change in the way governments in Australia see themselves. These changes started with what may appear to be reasonably innocuous accounting reforms, but what has emerged is a fundamental redefinition of government.

### *The redefinition of government*

The initial priority of the Hawke-Keating Government, from 1983 to 1986, was to improve the efficiency of the public service – in itself a relatively uncontentious exercise. It had before it the unfinished business of Whitlam's *Royal Commission into Australian Government Administration* (the Coombs Report).[3], and the outgoing Fraser Government had left it with *The Review of Commonwealth Administration* (The Reid Report)[4], both of which were concerned with improving the efficiency of public administration, rather than any agenda of reducing the size of government. That was to come later.

The Reid Report recommended several financial reforms, such as a phasing out of line item appropriation for administrative expenditure, relaxation of centralized controls on overseas travel and consultancies, and early development of a 'new financial management improvement program'. In response the Hawke Government instituted the 'Financial Management Improvement Program' (FMIP), designed to liberate the public service from the constraints of rules and accounting standards which were getting in the way of efficient management.[5]

No reasonable person would quibble with the need for reform of Commonwealth financial management and accounting practices, which were characterized by micromanagement and inflexibility.  The main provisions of the old practices were cash appropriation and line item budgeting. Being cash-based, they generally provided no separation between recurrent and capital expenditure (other than major capital acquisitions), and each item of administrative expenditure – salaries, overtime, travel, telephone, stationery for example – had its own 'line' appropriation. The results were sometimes amusing (public servants running out of telephone funds but travelling instead), most often wasteful, and almost always bewildering. For administrative expenditure reform was essential, and the private sector provided a reasonably sound model.

The old system had few supporters, but one voice in the wilderness was that of Aaron Wildavsky, a renowned scholar of budgeting and public finance, who pointed out a virtue of the old system. His argument was that it was so ridiculous that no-one took it seriously. Above all, according to Wildavsky, it was merely treated as a financial mechanism with little connection to broader public policy.[6] Wildavsky's warning was not so much a defence as a warning about the search for perfection in budgeting – a prophetic warning as it turned out.

Reform did occur, and eventually the public sector was to adopt many of the financial management and accounting practices of the private sector, and these were eventually incorporated into an accounting standard.[7] Chief among the reforms was the adoption of accrual accounting, which, just as in a private firm, distinguishes between cash flows and accruals, and requires government departments to produce financial reports essentially similar to those used in the private sector. The accrual concept sits at the core of financial accounting.

Such standards serve the private sector reasonably well. In well-run private firms managers do not necessarily take financial accounting too seriously. They understand the conventions and assumptions that go into producing financial reports – arbitrary allocation of overheads, use of conservative methods of valuation and adherence to certain arbitrary conventions – and therefore they understand the limitations of such data. Financial accounting is primarily an *ex-post* exercise – an 'account' of how money has been spent.

In fact, there is a completely different, more eclectic discipline of *management accounting* that managers use for decision-making; managers know that there is no accounting system which can reveal a 'true cost' of a product, the 'true value' of an asset, or the price a product should command.

Financial accounting, by contrast, is for external reporting to financial stakeholders – creditors, tax authorities and shareholders – who are concerned about their financial interests but who have little interest in the firm's products.[8] Managers understand that costs as shown up in financial accounts are only loosely connected with those costs which would be revealed in more careful management accounting analysis.

To take one example, balance sheet valuation of a firm's assets are usually only about half of the value placed on that firm by the market. (BHP Billiton shares, for example, trade at four to five times their balance sheet value.)

But such skepticism was not to hold in the public sector. Within a short time accrual accounting was being sold with a missionary zeal and a certitude which allowed no room for skepticism or for the overriding of its findings with more considered judgements. For example public servants were told they could use accrual accounting to determine the full cost of their agencies' activities, with statements such as:

> 'Accrual information also enables the full costs of an organization's operations and activities to be measured.'[9]
>
> and
>
> 'Accrual accounting will provide ...a clear picture of the full cost of the goods and services our agencies provide'.[10]

In short, there was a conflation of financial and management accounting, without regard to their different purposes. Such a conflation would be serious enough in the private sector, but it is particularly serious in the public sector, for two reasons – the different nature of public sector production and the relation of governments to their stakeholder .

First, activities are generally in the public sector because of some form of market failure. As Herman Leonard, Professor of Accounting at Harvard's Kennedy School of Government says 'The hard jobs are left to the public sector'. The re are areas where the private sector cannot provide, or, if it can, will do so inefficiently or ineffectively. Some activities come into the public sector because of:

> *external costs and benefits* – costs and benefits which are real but which do not show up in financial statements and do not fall on or accrue to the agency in question. For example the 'profits' of a bypass road are realized in travel time savings, reduced vehicle wear, lower local pollution etc;
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> *public good characteristics* – it may be impossible for the provider to re-coup payment through charges, or there may be waste associated with under-ultiized resources if charges are levied. 'Pure' public goods, such as weather forecasting, fall into both categories. Often the 'users' of services are not the beneficiaries of services. For example, immigration security screening confers benefits on the community as a whole but not on the 'users'.
>
> *capital market distortions* – communities in their choices consistently tend to be more patient than private capital markets. The discount rates in private capital markets are much too high to allow for investment in long term environmental protection, for example.

In short, while accrual accounting may help with day-to-day administration (which was the original path of reform), it has severe limits when it comes to public sector programs.

Second, financial accounting standards are designed for those whose stake in an enterprise is primarily a financial one. But as citizens our 'stake' in government is far more intimate than our stake in a corporation. As a shareholder I may not care much whether BHP mines for iron ore or copper, or whether Westfield develops shopping centres in Sydney or Seattle. The market will sort out the allocation of minerals and shopping centres. But I do care whether public funds are spent on defence or education, and whether drought relief is spent in marginal electorates or in places where it is needed. To BHP or Westfield I am a mere shareholder; to government I am, or should be entitled to consider myself to be, a citizen. And I do not expect private firms to reveal their plans in public, but I do expect the government, *my* government, to put before Parliament its plans for scrutiny; that's the essence of budgeting in a democracy.

This redefinition to a corporate model can be seen in the Commonwealth's budget documentation. These documents have become exemplars of financial accountability, with full presentation of revenue, expense, cash flows, and balance sheets, with supporting statements such as financial sensitivity analysis. Much of the Commonwealth Budget papers is devoted to a reconciliation between two slightly different accounting standards. This financial detail has been at the expense of economic detail – detail on the purposes of public

expenditure. Budget papers, as they have evolved, have become detailed *ex post* accounts of how money has been spent; that is the function of financial accounting, but regarding governments' plans there is now much more consolidation of appropriations and much less policy explanation.

Budget Paper 1, for example, which used to go into a great deal of description about how funds are allocated by program, with long term historical analysis, is now skimpy in terms of policy detail. It gives a certain amount of macro context, such as an outlook for the world economy, but at a micro or program level it is light on when it comes to explanation or other policy content. For example, the $92 billion appropriation for social security and welfare, almost comprising half the Budget, comes with less than a page of explanation. And many important items of spending are no longer revealed; for example the Commonwealth used the appropriation to the Department of Employment and Workplace Relations to fund its $55 million advertising campaign for 'Work Choices", even before it produced the legislation.

To summarize, in budget papers, meaningful information about how governments *plan* to raise and spend funds has been replaced by huge amounts of historical detail about how governments *have* raised and spent funds.

Perhaps the most absurd presentation in budget papers is the balance sheet, shown below.

**Australian Government Balance Sheet 30 June 2006**

| | $ billion |
|---|---|
| Assets | |
| Financial assets | 150 |
| Other assets | 46 |
| Total assets | 196 |
| | |
| Liabilities | |
| Superannuation | 100 |
| Securities on issue | 58 |
| Other | 47 |
| Total liabilities | 205 |
| | |
| Net worth | -9 |

Source: Budget Paper 1, 2006-07.

Consider, for example, the $46 billion of "other assets". That's just over $2000 a head. Is that all our common-wealth is worth? (Note, however, that the present government has dropped the term 'Commonwealth'.)

What value does this balance sheet place on our social capital, our human capital, our environmental capital, our institutional capital – all of which can be influenced by government policy? 'None' is the answer, for these assets, which are difficult to measure but are nonetheless real economic assets, are not counted by financial accounting. Financial accounting is constrained by what is known as the 'money measurement' concept, resulting

often in unrealistically low valuations. For example, heritage and cultural assets are valued in the balance sheet at only $8 billion, or $400 a head. Again, financial accounting is constrained by conventions of historical cost depreciation; the older an asset the less is its book value – a concept which curators at the National Gallery and the War Memorial may find amusing, but which is in line with the thinking of the men of the counting houses.

Economists know that asset valuation in the public sector is difficult – to the point of being practically meaningless – mainly because the many of the returns on those assets accrue to the public in terms of services, rather than in the form of financial revenues to the owners, and because there are vague notions of ownership (who 'owns' the Hume Highway, for example?) But meaninglessness has never been an impediment to financial accountants. The figures must be produced.

On the liability side, does that $47 billion cover our liability to repair the damage of 200 years of over-exploitation of our natural resources, or the cost of replenishing our run-down skills base? No. It is limited to financial assets only. But in a wider sense, an economic sense, these are liabilities; we will have to meet these costs some time in the not too distant future.

If documents such as this could be kept in context, such absurdities would not really matter; the only issue would be the small amount of administrative waste in producing irrelevant documents. But it does matter, because the government takes the balance sheet seriously. That bottom line of 'net worth' is the focus of the Treasurer's debt obsession, which is purely a fiscal obsession, rather than responsibility for all our collective assets – our common wealth.

This financial obsession is what George Brockway calls 'a triumph of finance over economics'[11], or of accountability over responsibility.

*How this came about*

We can do no more than speculate about how this redefinition of government emerged – as a corporate entity relating to its stakeholders only in the sterile language of finance, rather than as an entity in a responsible relationship with its citizens. It is easy to point the finger at the ideology of 'smaller government'. As shown in the next section where we examine the *Intergenerational Report*, such a construction allows the government to engage in cost-shifting, because once costs are moved off-budget through privatization, even if this is at a greater cost to the community as a whole, they are no longer the responsibility of government.

But there are other possible explanations.

Administrative incompetence is a strong contender. While, in private corporations, competent analysts, comfortable with management accounting, can be found in senior management ranks, analytical skills are not valued highly in the public service, particularly a politicized public service in which loyalty to the Executive Government is the main criterion for promotion. We have no institutions such as France's Ecole Nationale D'Administration, which develops a set of professional skills for public servants. At the ministerial level there are manifestations of outstanding ignorance of economic matters, such as Treasurer

Costello's inability to distinguish between real and nominal interest rates, or Finance Minister Minchin's celebrated statement:

> I'm always concerned as Finance Minister if government business enterprises incur losses. In general terms, that's one of the reasons why, in principle, it's not necessarily a good idea for governments to own businesses.[12]

By any economic theory, apart from those underpinning the old centrally-planned soviet republics, businesses which can make a profit in a fair and competitive market are precisely those which should *not* be in the public sector. Barring the possibility that Minchin is a closet communist, ignorance is the most compelling explanation.

Another strong candidate for explanation is to be found in the work of James Scott of Yale University. The bureaucratic mind, he suggests, is subject to a process of reductionism. Bureaucrats develop simple models of complex systems, and, in times, come to see nothing beyond those simple models.[13] It is possible, particularly with the strong sales pitch which was applied to accounting reform, that bureaucrats have come equate the task of public administration with the simple and clear-cut task of good bookkeeping.

Nowhere is that more evident than in the *Intergenerational Report*.

## The Intergenerational Report – a justification for cost shifting

The *Intergenerational Report* is a prime example of budget documentation losing sight of the broader economic picture. This narrow fiscal focus tends to bias public policy towards moving costs off-budget even if such cost-shifting leads to economic inefficiencies or inequities.

As an example, consider the Report's projections on health spending, reproduced below:

**Projected Commonwealth health spending (per cent of GDP)**

| | 2001-02 | 2006-07 | 2011-12 | 2021-22 | 2031-32 | 2041-42 |
|---|---|---|---|---|---|---|
| MBS subsidy | 1.09 | 1.10 | 1.15 | 1.33 | 1.56 | 1.78 |
| PBS subsidy | 0.60 | 0.63 | 0.79 | 1.31 | 2.15 | 3.35 |
| Hospital and health services | 1.16 | 1.16 | 1.20 | 1.34 | 1.51 | 1.63 |
| Other | 1.12 | 1.14 | 1.16 | 1.22 | 1.29 | 1.37 |
| All health | 3.96 | 4.02 | 4.30 | 5.20 | 6.51 | 8.13 |

These projections, implying a fivefold growth in expenditure on the Pharmaceutical Benefits Scheme (the PBS) have understandably produced something of a panic. The PBS is under heavy pressure to yield savings.

But this form of presentation is a construction of the bureaucratic mind – the mind of the financial accountant – that does not take a system-wide view. In health care, pharmaceuticals can reduce demands on hospital services and can help people lead fulfilling and productive lives. (In a firm making automobiles managers would not worry if their outlays on plastic polymer were rising if plastics were replacing more expensive steel.)

It would be far more relevant if this data were presented in a style relating more closely to purpose (outputs or outcomes). The following is an illustration of how there could be a more meaningful disaggregation of health expenditure:

**Projected Commonwealth health spending (per cent of GDP)**

| | 2001-02 | 2006-07 | 2011-12 | 2021-22 | 2031-32 | 2041-42 |
|---|---|---|---|---|---|---|
| Health for the aged | x.xx | x.xx | x.xx | x.xx | x.xx | x.xx |
| Youth and adolescent health | x.xx | x.xx | x.xx | x.xx | x.xx | x.xx |
| Aboriginal health programs | x.xx | x.xx | x.xx | x.xx | x.xx | x.xx |
| Other | x.xx | x.xx | x.xx | x.xx | x.xx | x.xx |
| All health | 3.96 | 4.02 | 4.30 | 5.20 | 6.51 | 8.13 |

That form of presentation is likely to be of interest to a public servant concerned with the question 'for whom are we spending the money' rather than 'on what inputs are we spending this money?'

More basically, however, this form of presentation, being confined to Commonwealth expenditure, covers only part of what the nation spends on health. The table below, based on simple projections of data published by the Institute of Health and Welfare[14], shows projections of the *total* components of health expenditure.

**Projected national health spending (per cent of GDP)**

| | 2001-02 | 2006-07 | 2011-12 | 2021-22 | 2031-32 | 2041-42 |
|---|---|---|---|---|---|---|
| Commonwealth government | 3.96 | 4.02 | 4.30 | 5.20 | 6.51 | 8.13 |
| State & local government | 1.92 | 2.16 | 2.44 | 3.12 | 3.97 | 5.07 |
| Private | 2.72 | 3.10 | 3.52 | 4.56 | 5.91 | 7.66 |
| All health | 8.60 | 9.28 | 10.27 | 12.88 | 16.39 | 20.85 |

The original Commonwealth projection, showing the Commonwealth Government's expenditure doubling to 2041, can easily be used to a justify for measures to reduce Commonwealth outlays. But this more comprehensive presentation, while retaining the same Commonwealth Government data, reveals a more complete picture, summarized below. This shows that on present trends, state governments and individuals will bear the greatest part of the growth in outlays.

**Ratio of 2041 to 2001 health spending as percentage of GDP**

| | |
|---|---|
| Commonwealth government | 2.1 |
| State & local government | 2.6 |
| Private | 2.8 |
| Total | 2.4 |

The policy inference to be drawn from such a presentation is quite different from the original presentation; there is no need to panic about Commonwealth expenditure. In fact, the questions implied by such a presentation are whether there is a need to take measures to rein in total health expenditures and whether the Commonwealth should be taking a greater share of this expenditure.

There is nothing radical about such analysis, which considers all costs – budgetary and private. In fact this is the basis pf the discipline of cost-benefit analysis. But, apart from some major infrastructure projects (and there aren't many of those), governments tend not to undertake benefit-cost analysis. Rather, their concerns relate more to budgetary outlays and receipts. In health care, for example, major changes such as subsidies for private insurance, have been introduced without any cost-benefit analysis.

Of course, a projection, in itself, should not drive policy. But what I have attempted to show is what this document may look like if it were presented in a broad economic context by a government which felt some responsibility for the community's welfare, rather than by a government which saw itself, like a private firm, required only to account for its own finances. In a private firm cost-shifting is clever business strategy; it goes down well with its financial stakeholders.

But in government cost shifting makes no sense, for those who benefit from budget cuts and subsequent tax cuts are also those who pay through other means, and in fact they often pay more when costs are shifted into a less than competitive private market, as in health care, or when public goods have to be financed by inefficient means of revenue-raising, as in advertising on public radio and television. Such is the case with advertising on SBS broadcasting, as commenced in 1992 under the Labor Government and extended by the Coalition. Advertising expenditure is essentially a sales tax, collected by private agencies, and it costs more than public funding because part of the cost of advertising lies in production, which does not accrue to the SBS. We still have to pay.

## Conclusion

This presentation is not a criticism of accountability, although it can be argued that much of what is presented in government financial accounts, particularly balance-sheet items relating to assets and liabilities, is largely irrelevant and probably misleading to those who do not have a sound understanding of the limits of financial accounting.

Rather, it is a criticism of the way in which financial accounting has tended to displace economic responsibility. Having borrowed financial management practices from the private sector, governments have forgotten that their role is very different from the role of corporations. Corporations, by and large, operate where markets work; governments take up the economic task where markets fail. Accounting information which is meaningful in the private sector is not necessarily meaningful in the public sector. And private firms' accounting is designed to serve those whose stake is limited to fiscal claims – as lenders, creditors or shareholders. That is a much simpler relationship than the relationship between citizens and their governments in a democracy.

This narrowed, redefined role of government sits easily with the ideology of 'small government', for it allows governments to avoid responsibility. When transfers replace of direct services, governments are no longer responsible for ensuring that money is spent wisely. It also sits easily with a government which wants to shroud its plans in secrecy, for such secrecy, for commercial competitive reasons, is standard practice in the private sector.

More basically, when governments redefine their relationship with the public to conform to a private business model, cost-shifting becomes easily, for governments confine their role to those expenditures which pass through their own budgets.

This criticism is not singularly directed at the present Coalition Government. The changes commenced under the Hawke-Keating Government, initially with the purpose of improving administrative efficiency, but they eventually merged into a new role for government. With its *Charter of Budget Honesty* – the charter which spawns the *Intergenerational Report* and the *Costing of Election Commitments* – the Coalition has gone further than the Hawke-Keating Government, but at the last three elections Labor has meekly abided by the loaded rules of the financial strictures of the *Costing of Election Commitments*, confining itself to narrow fiscal projections, and failing to explain to the electorate the broader economic implications of its programs.

Perhaps the most damaging aspect of this redefinition is that it has allowed governments – state and Commonwealth – to redefine economic management in terms of the narrower and more specific task of financial management. In that regard, those on the 'left' in Australian politics have not helped by criticizing governments for their 'economic rationalism'. Rather, their criticism should be that governments have abandoned economic responsibility in favour of financial accountability.

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