The New Zealand Fiscal Management Approach

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New Zealand Treasury

June 2016

ABSTRACT

The Fiscal Management Approach (FMA) is the core tool, or the 'rules of the game', for ensuring that the government's decisions are consistent with their fiscal strategy. It constitutes a flexible set of rules applied to the day-to-day operations of government to inform decision-making. This includes the setting of allowances for new spending (and/or revenue reductions), setting constraints on between-Budget spending, and allowing automatic stabilisers to work over the economic cycle. In recent years, the FMA has contributed to the achievement of the return to surplus target in 2014/15 and net government debt that is low relative to most developed nations. The FMA has evolved and been improved since it was first introduced. The purpose of this paper is to capture the FMA as it stands, and provide some examples of how it is applied in practice. Further, we review how effective the FMA has been and reflect on some of the challenges presented by the current approach and any opportunities for further improvement.

Part 1: An overview of the current fiscal management approach

1. Introduction

The Fiscal Management Approach (FMA) is the core internal tool, or the 'rules of the game', for ensuring that the Government's decisions are consistent with their fiscal strategy. It was last formally documented in 2003 when the FMA was introduced as we now know it, although it built upon the "fiscal provisions" framework used from the late 1990s.[1]

The FMA has evolved and been improved since 2003. These changes have been documented in a number of different reports. The purpose of this document is to capture the FMA as it is currently, and provide some examples of how it is applied in practice, as well as to note some of the challenges it causes and any opportunities for further improvement.

2. Responsible Fiscal Management

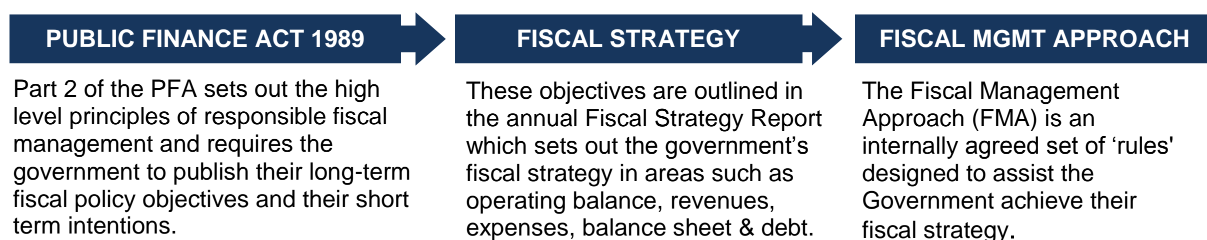
New Zealand's fiscal policy framework differs from many other comparable countries in that *principles* are legislated for and governments are required to set their own fiscal targets, rather than the legislation prescribing any *mandatory targets*.

The principles of responsible fiscal management are outlined in Part 2 of the Public Finance Act 1989 (PFA) and include reducing and maintaining debt to prudent levels, and once those levels have been reached, running operating surpluses, managing fiscal risks facing the government, having regard for the impact on present and future generations, and ensuring that the Crown's resources are managed effectively and efficiently.

The PFA requires the publication of a Fiscal Strategy Report (FSR) which must be delivered on Budget Day. In this report the government must outline their specific long-term objectives and short-term intentions, and the extent to which these objectives and intentions are consistent with the principles of responsible fiscal management.

The FMA constitutes a flexible set of rules applied to the day-to-day operations of government to inform decision-making and assist them in achieving their fiscal strategy. This includes things like the setting of allowances for new spending (and/or revenue reductions) and setting constraints on between-Budget spending.

Figure 1: New Zealand's Fiscal Policy Framework



[1] New Zealand Fiscal Management Approach - An Explanation of Recent Changes, The New Zealand Treasury (2003). http://www.treasury.govt.nz/publications/guidance/planning/fmapproach

3. The Government's Fiscal Strategy

The government's fiscal strategy is its plan for managing its finances, which includes spending, revenue and the portfolio of assets and liabilities on the Crown balance sheet. New Zealand governments frequently express their fiscal strategies using goals for public debt and the gap between spending and revenue (that is, whether the Crown accounts are in surplus or deficit). The Public Finance Act 1989 (PFA) requires the government to produce a fiscal strategy every year and to set it out in a transparent way.

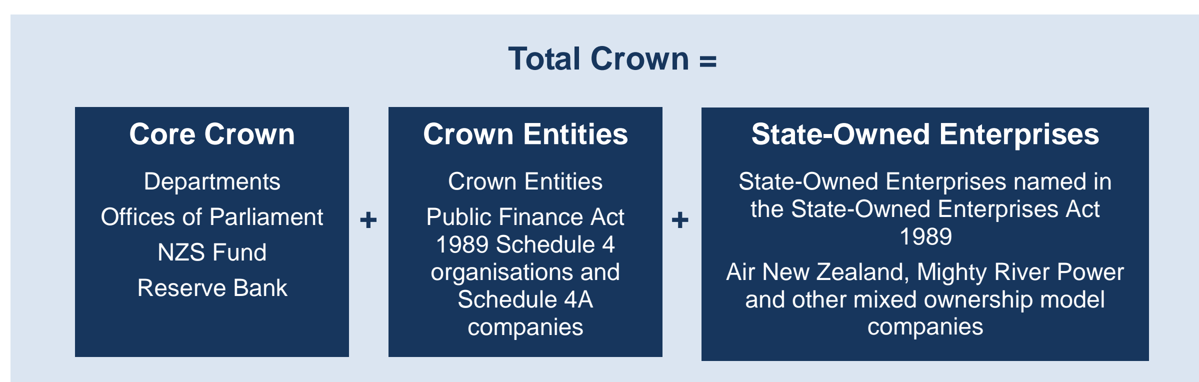
The government discloses its fiscal strategy through its short term intentions and long term objectives as set out in the Budget Policy Statement (BPS), released ahead of the Budget, and confirmed in the Fiscal Strategy Report (FSR), released alongside the Budget. The Government's current short-terms intentions are outlined in the 2016 FSR, published in May 2016. These intentions include maintaining rising operating surpluses (before gains and losses) and reducing net debt to around 20 per cent of GDP in 2020.[2]

The long term intentions outlined in the 2016 FSR include; reducing net debt to within a range of 0 per cent to 20 per cent of GDP; ensure net worth remains at a level sufficient to act as a buffer to economic shocks and; control the growth in government spending so that, over time, core Crown expenses are reduced to below 30 per cent of GDP (see Figure 2 for a definition of core Crown).

Refer to Appendix 1 for a complete list of the Government's current short term intentions and long-term objectives.

The FMA can support the government achieve these targets by helping to manage expenses and revenue decisions and providing the information needed for the Government to make informed decisions.

Figure 2: Defining Total Crown and Core Crown



[2] Presently, a surplus is defined as a positive total Crown Operating Balance before Gains and Losses (OBEGAL). OBEGAL is the difference between total Crown revenue and total Crown expenses.

4. The Fiscal Management Approach

This section describes the various concepts and components of the FMA and how they work together to incentivise decision-making that helps the Government achieve their fiscal strategy. It is useful to remember that the rules presented here are not set out in legislation or standing orders; the rules are self-imposed by the government of the day.

4.1 Fixed Nominal Baselines

One of the most important features of New Zealand's FMA is fixed nominal baselines. Fixed nominal baselines means that the amount of funding an agency receives each year (the baseline) does not automatically increase to adjust for inflation. Instead agencies are expected to absorb price increases; in effect this can act as an annual efficiency dividend on government expenditure.

A small number of specific forecast items are excluded from this approach, such as legislative entitlements where it would not make sense to ask an agency to absorb an increase in demand for a benefit or subsidy that there is a legal obligation to provide.[3] In these cases, the increase in the cost of the policy is forecast and built into the profile of the appropriation. Examples of this include welfare benefits, which are adjusted for inflation, New Zealand superannuation which is indexed to the average weekly wage, and some education spending which is adjusted for demographic changes. More detail on how forecast appropriations are treated under the FMA is provided in section 0.

For the majority of expenditure, however, appropriations are 'fixed' and a specific policy decision is required to make adjustments. Funding increases are sought through the Budget process, where increases have to be met from a limited pool of funding allocated for new spending and traded off against spending proposals in all other areas of government. These pools of new funding are called the allowances. Operating and capital allowances are set during the strategic phase of the Budget process and are set at a level which allows the government to achieve their broader fiscal objectives.[4] As discussed in section 2 these objectives currently include maintaining rising OBEGAL surpluses and reducing net debt as a proportion of GDP to around 20 per cent by 2020. Allowances are an important lever for the government in achieving these objectives.

The FMA is done in nominal dollar terms, which means that when inflation is low, as it has been in recent years, the real amount of government services that allowances can purchase is higher. Population growth is also not directly taken into account with nominal amounts not done in per capita terms. High population growth, as in recent years, means that a given baseline or new allowance will be more difficult to manage within.

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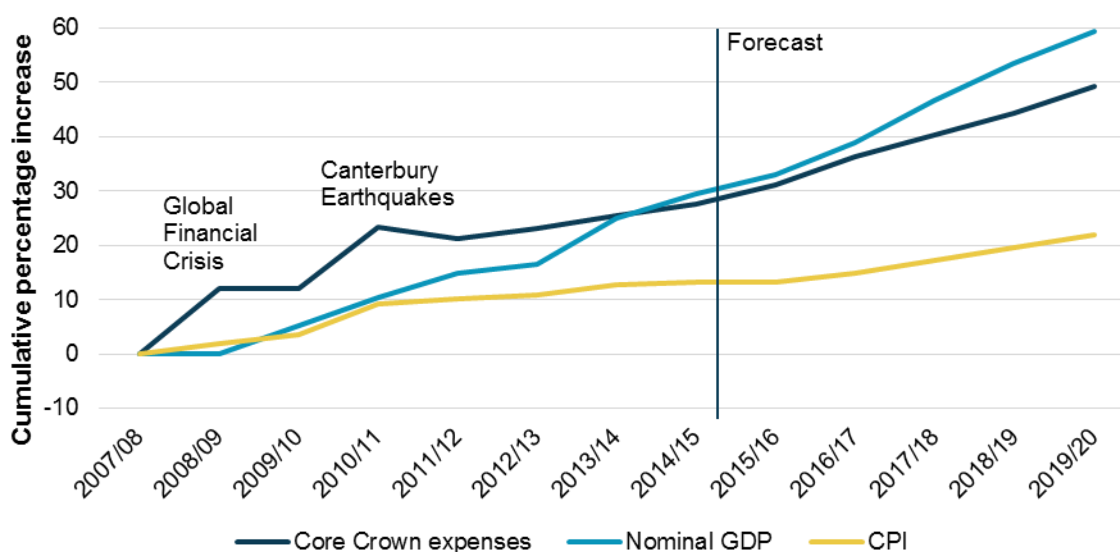
[3] As outlined in Cabinet Office Circular (15) 04, forecast items require Cabinet to agree a specific metric for determining costs based on an external variable and that there are strong policy grounds for excluding the item from the fixed nominal baseline approach, i.e. legislative entitlements are not all treated as forecast items. Permanent legislative authorities (PLAs) are treated as forecast items.

[4] Capital provides funding for assets that will increase the value of the Crown's balance sheet, operating expenses are for all other types of expenditure (including the costs for provision of goods and services).

In reality, although no given department is guaranteed an increase in funding, the total of core Crown expenses will typically grow faster than inflation. This reflects a real increase in government expenditure, perhaps to fund new initiatives or reflecting the impact of other drivers of spending such as growth in the population. Nominal GDP is the total value of output from the economy in current prices. When growth in government expenditure is greater than growth in nominal GDP the share of GDP attributable to the Government is increasing. When growth of nominal GDP is higher the opposite is true.

We can see from Figure 3 below that core Crown expenses have, and are expected to continue to, rise faster than inflation, but have been declining as a share of GDP. This suggests that on average departments will receive funding over and above the increases in costs they face assuming the allowances are used for new spending (e.g., not tax reductions). This increased funding may be used to fund new initiatives. For agencies that do not receive a funding increase it is expected that they can cover increased costs with improvements to efficiency.

Figure 3: Cumulative growth in expenses since 2008/09 (Budget Update 2016)



This approach means that the government applies a high level of scrutiny to new spending. In order to receive funding for cost pressures[5], the burden of proof rests on agencies to demonstrate that it will not be able to deliver services effectively within existing funding levels. The government must then trade off increasing spending on existing programmes against any new policies.

Other approaches are used in other countries. For example, in Australia the majority of spending is indexed to CPI or one of a number of Wage Cost Indices. Departmental spending (which constitutes about 6 per cent of total government spending) is then adjusted for an annual efficiency dividend, usually at a rate of about 1.2-1.6 per cent.[6]

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[5] 'Cost pressures' refers to the pressure on agencies arising from increases in volume (demand for a service) or price (cost of a service).

[6] Australian Department of Finance, Personal Communication (23 July 2015)

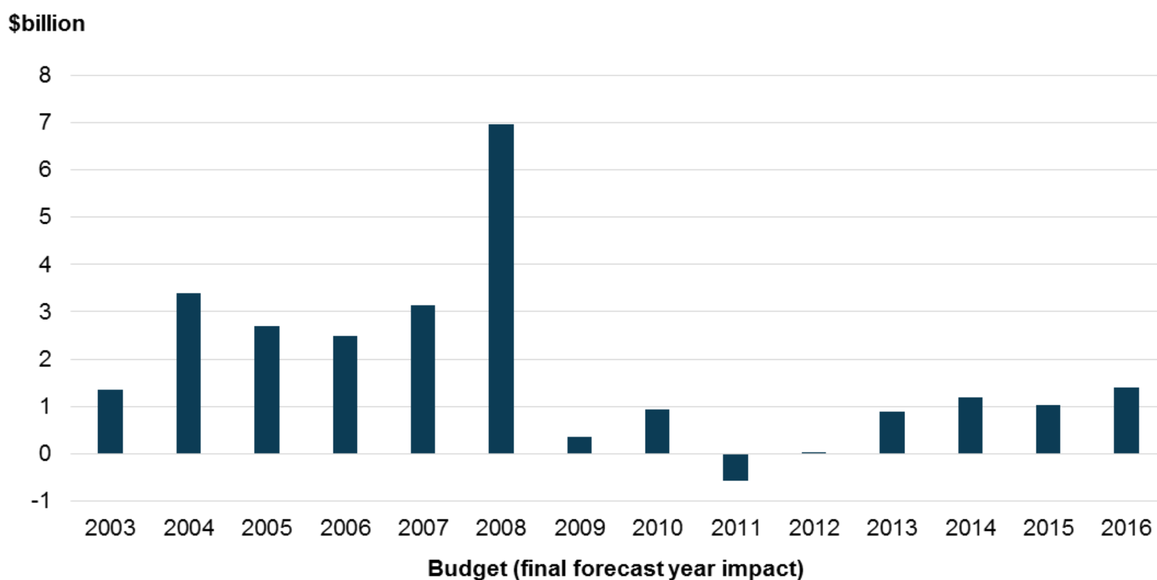
4.2 Operating Allowance

The operating allowance is the pool of new operating funding available at each Budget. The allowance is set in advance of Budget in accordance with the Government's fiscal strategy. The Budget Policy Statement, usually published in December, is where the government sets out their intended allowances for the following Budget. Figure 4 shows the operating allowances from 2004 to 2016.

The allowance is a net amount allocated for new policy initiatives or cost increases in existing policy. It may be allocated either to expenditure or revenue policy changes. Given that the bulk of the allowance is usually allocated to the expenditure side, it is often referred to as an allowance for new spending.

Importantly, the allowances are a net concept. Spending increases and any revenue reductions are offset by savings initiatives or revenue raising initiatives. In Budget 2016 for example, on average over the forecast period – gross new operating spending is $2.1 billion, however this is offset by $500 million of savings initiatives – including the removal of the 'one for two' emissions trading scheme subsidy and the tobacco excise increase – meaning that the net operating allowance for Budget 2016 is $1.6 billion.

Figure 4: Operating allowances 2003 to 2016



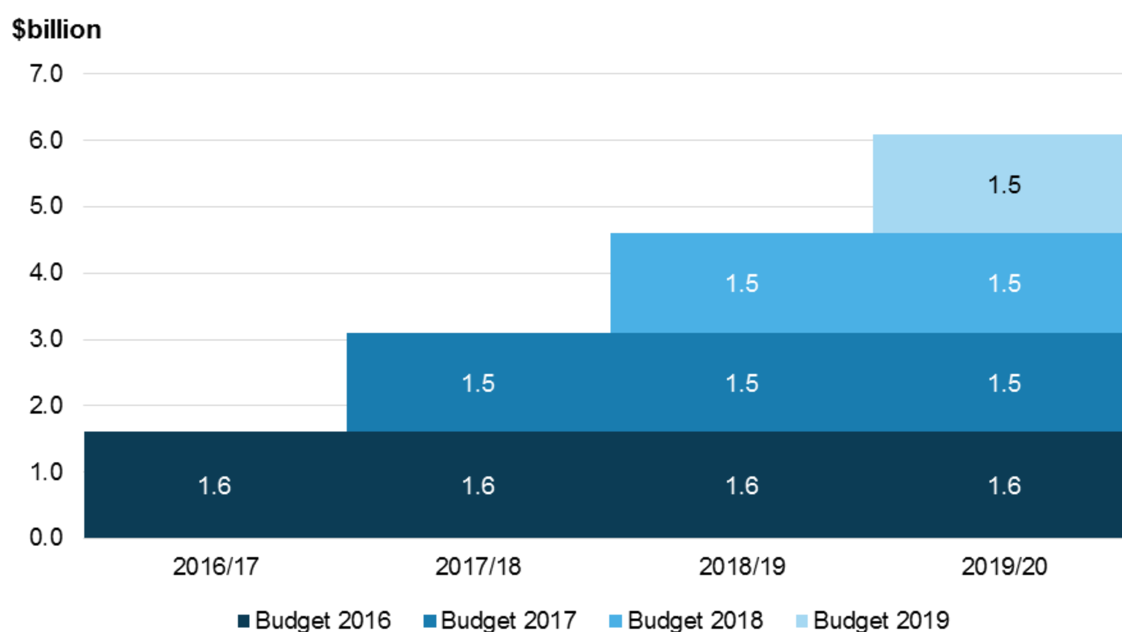
The allowance forms a self-imposed cap on expenditure growth (less any revenue changes). As discussed above baselines do not automatically adjust for inflation, therefore, all changes to expenses and revenue are funded from the operating allowance. All new policies and almost all increases in the cost of existing policies are funded out of the Budget allowance.

The starting presumption is that all new expenditure counts against the operating allowance. However, some notable exceptions are:

- Changes in the cost of debt servicing, the Jobseeker Support benefit or tax revenue (but not tax rate) changes to help avoid pro-cyclical fiscal policy.[7]
- Impairments and revaluation and other changes due to large assets and liabilities (these items are highly volatile, and are often non-cash).
- Previously forecast growth in expenditure, most notably New Zealand Superannuation which is forecast to rise by over $800m per annum by 2019. Note that changes to these forecasts are charged against the allowance, see section 3.4.

As Figure 5 shows, the operating allowance for Budget 2016 was $1.6 billion per year *in perpetuity*, meaning that over the forecast period (2016/17 to 2019/20) Ministers had $6.4 billion to allocate.[8] Each Budget a new operating allowance is available for allocation, meaning that by 2019/20 a total of $6.1 billion a year of new funding will be allocated to baselines.

Figure 5: Budget 2016 and future operating allowances



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[7] Pro-cyclical fiscal policy is either, expansionary (increased spending or tax cuts) fiscal policy in a boom or contractionary (reduced spending or tax increases) during a trough or recession. This is generally avoided in order to better manage the economic cycle. For example, if unemployment rises in a time of economic recession and the government were to charge this cost against the operating allowance it would crowd out other spending which could risk exacerbating the downturn. .

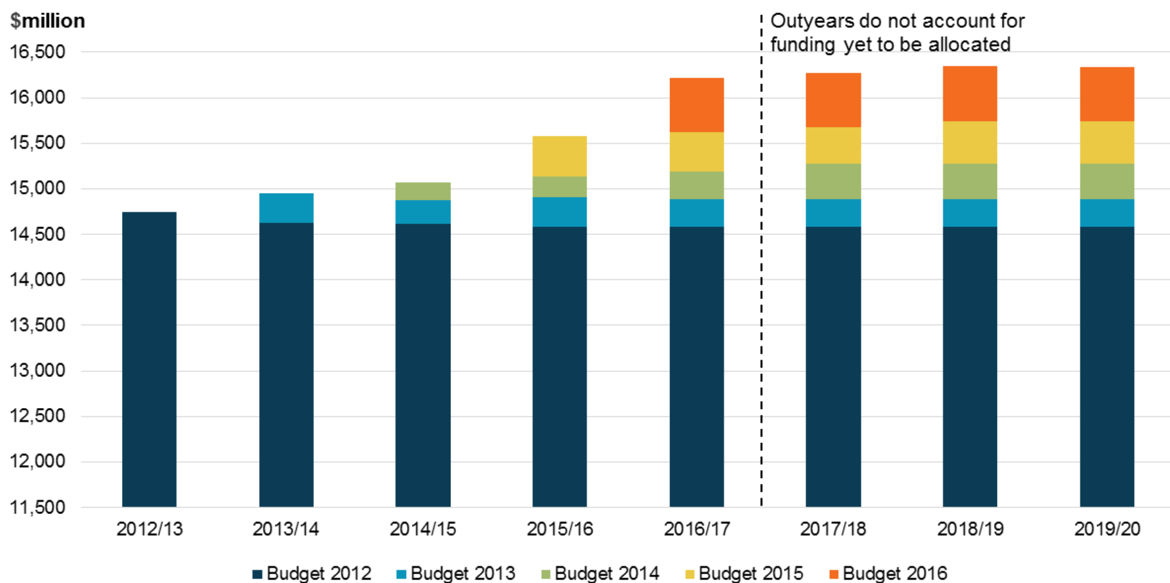
[8] Budget initiatives are often announced as an amount of operating funding ‘over four years’.

In addition to forming a cap on expenditure, the allowance approach is also useful for incentivising prioritisation. The decision making phase of the Budget process, which takes place from December to April, requires Ministers to discuss relative priorities with the aim of forming a package of high value initiatives that achieve their priorities, as set out in the Budget Policy Statement. It is preferable that all new spending proposals be considered through the Budget to ensure consistent prioritisation.

Allowances are included in fiscal forecasts as 'forecast new spending' to make the forecasts more credible and better link the forecasts to the government's fiscal strategy. This means that decisions in future Budgets shouldn't impact the government's fiscal targets. Decisions already made are allocated to the relevant area, unallocated amounts are shown as forecast new operating spending even though some may be used for revenue changes.

This means that for particular areas where most growth in spending is expected to be funded from the operating allowance, forecasts of future spending do not necessarily reflect the most likely future spend in that portfolio. For example, forecasts of future health spending in the economic and fiscal updates do not include any allocations from future Budgets, however, particularly in the case of the health portfolio, it is likely that it will receive increases each Budget.

Figure 6 – Forecasts of Health spending from Budget 2012-2016



4.3 Capital Allowance

Similar to the operating allowance, the capital allowance is set ahead of a Budget and describes the new funding available for capital projects over and above what is already in departmental baselines.

In 2012 it was agreed that for the next four Budgets the capital allowance would be entirely provided for by the proceeds of the sale of minority shareholdings in electricity companies and reducing the Government's stake in Air New Zealand. These proceeds were used to establish the ‘Future Investment Fund’. In effect, the Future Investment Fund was used to provide a ‘net zero’ capital allowance from 2012 to 2015.

The Future Investment Fund has now been fully allocated and a new capital allowance was established in Budget 2016. The capital allowances over the forecast period will be treated as a multi-budget allowance similar to the ‘envelope’ approach used with the Future Investment Fund.

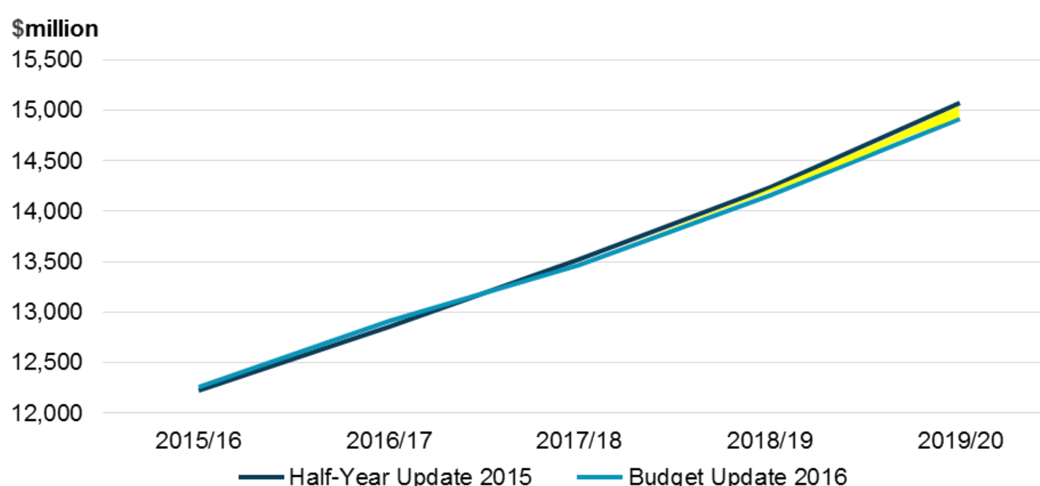
Unlike the operating allowance which is provides funding per annum in perpetuity, the capital allowance provides one off funding injections. The net impact of an agreed initiative on net debt over the next 10 years is counted against the capital allowance in the Budget in which the funding is allocated.

4.4 Forecast Changes and In-year Revisions

As discussed in 4.1 above, agency baselines do not automatically increase to manage demand and price changes. All new funding to meet the cost of new policy and agency cost pressures that cannot be met from existing baselines is met from the operating allowance. This deliberate mechanism – referred to as fixed nominal baselines – assists the government in controlling public expenditure.

There are, however, a number of deliberate exceptions where appropriations are forecast rather than fixed and the expected increase is built into the profile of the appropriation. These exceptions mostly apply in the case of legislative entitlements where the cost of the programme is outside agency control, such as New Zealand Superannuation or Early Childhood Education subsidies. Refer to Appendix 2 for a list of forecast appropriations.

Figure 7: Variance between New Zealand Superannuation forecasts

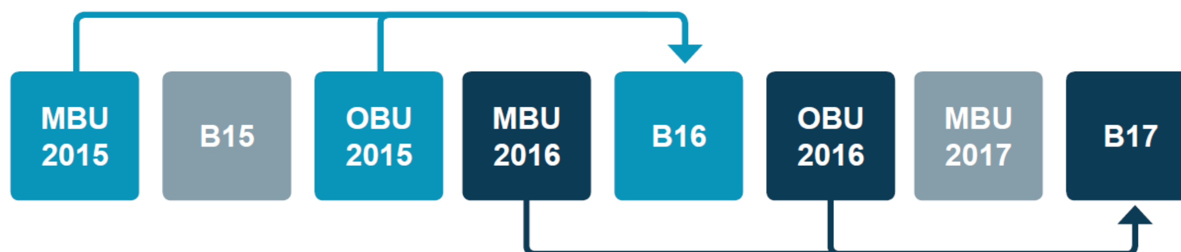


The figure above shows the variance (in yellow) between two forecast rounds. This variance is charged against the allowance through the in-year revisions process, rather than the overall annual increase to the cost of the policy – which has been included in previous forecast rounds.

Forecast appropriations do not go entirely unscrutinised. In order to provide some control on forecast expenditure and to give Ministers more visibility over existing policy settings, variances against the previous set of forecasts or *forecast changes* are charged against the operating allowance through a process called *in-year revisions*.

The net impact of forecast changes captured at the March Baseline Update (MBU) and the October Baseline Update (OBU) in a calendar year is charged against the following Budget's operating allowance. This is done on a calendar year basis in order to minimise the need for late adjustments to Budget decisions – the changes captured in the MBU immediately prior a Budget are rolled forward as a charge against the next Budget (see Figure 7).

Figure 8: How baseline updates impact in-year revisions



As an example, if at MBU 2015 new population projections were released that meant that the forecast cost of early childhood education subsidies was to increase by $20 million a year, but then at OBU 2015 this was revised down by $5 million a year, the net impact on the Budget 2016 operating allowance would be $15 million a year.

If the net impact of these changes is above forecast, the government has a smaller remaining amount of the operating allowance to allocate at Budget. Conversely, if the net impact is below forecast the government has a larger amount of the operating allowance to allocate at Budget.

In practice, in recent years the net impact of in-year revisions has generally come in negative – however, this favourable movement has been used to improve the fiscal position rather than allow for increased spending. Judgement always needs to be applied with the in-year revisions process given there is uncertainty about their impact each year and there could be large one-off impacts that would be difficult to adjust for.

There are a number of common baseline changes that are picked up through the in-year revisions process and charged against the operating allowance:

- *Changes to price or volume of entitlements,* revisions to benefits in Votes Social Development, Building and Housing, and Revenue flow through in-year revisions (except for changes to the unemployment benefit as this could make fiscal policy more pro-cyclical). A few examples of included items are New Zealand Superannuation, Early Childhood Education subsidies, Kiwisaver, Homestart, Sole Parent Support, and Accommodation Assistance.
- *Exchange rate movements* were previously excluded from allowances but are now managed within. Examples include Foreign Affairs and Trade consular services, international subscriptions,
- *Changes in expected revenue,* this does not apply to general tax revenue as this acts as an automatic stabiliser. A wide range of revenue is captured through in-year revisions, including energy royalties, court fees and fines, immigration fees and levies, occupational licensing and capital charge revenue[9].

[9] All government departments pay capital charge (currently calculated at 8 per cent of a department's net assets) to provide for the government's cost of capital. It creates an incentive for departments to

- *Changes in price set by external bodies,* including changes made under Permanent Legislative Authority. Examples include legal aid, judicial review costs, MP salaries, Judges' salaries, Coroner's salaries etc.

Other baseline changes submitted via baseline updates that are excluded from the in-year revisions process include fiscally neutral changes (such expense transfers or fiscally neutral adjustments), non-departmental depreciation, and impairments and revaluations due to fluctuations in assets and liabilities.

4.5 Contingencies and Between-Budget Spending

To ensure consistent prioritisation, it is preferable that all proposals seeking new funding are considered through the Budget process. However, in practice Cabinet frequently considers proposals requiring new funding between-Budgets. With this in mind, at Budget time portions of the allowance are set aside in contingency to provide for between-Budget decisions.

The *Between-Budget Contingency (BBC)* is a general operating contingency that provides for operating proposals that arise between Budgets.[10] A call on the BBC should only be made if the proposal cannot be delayed until the following Budget and requires funding urgently and if the agency seeking the funding can demonstrate that the initiative cannot be funded from baselines. The total funding available in the BBC is decided at each Budget for the forthcoming year and is subject to variation. Some examples of calls on the BBC include funding for extending surveillance related to the Queensland fruit fly risk in Auckland in 2015 and funding for the 2015 Northland by-election. In Budget 2016 the BBC was established at $50 million per annum.

Tagged Contingencies are set aside at Budget for initiatives where further specific work is required before Cabinet will agree to appropriate the funding. Tagged contingencies are also used in circumstances where an initiative is commercially sensitive or negotiations have yet to take place, e.g. state sector wage negotiations. As with the BBC, tagged contingencies are charged against the operating allowance and included in the fiscal forecasts when they are established,[11] so drawing them down does not impact the fiscal indicators or future Budget allocations. Unless otherwise agreed tagged contingencies expire on 1 February the year after they were established.

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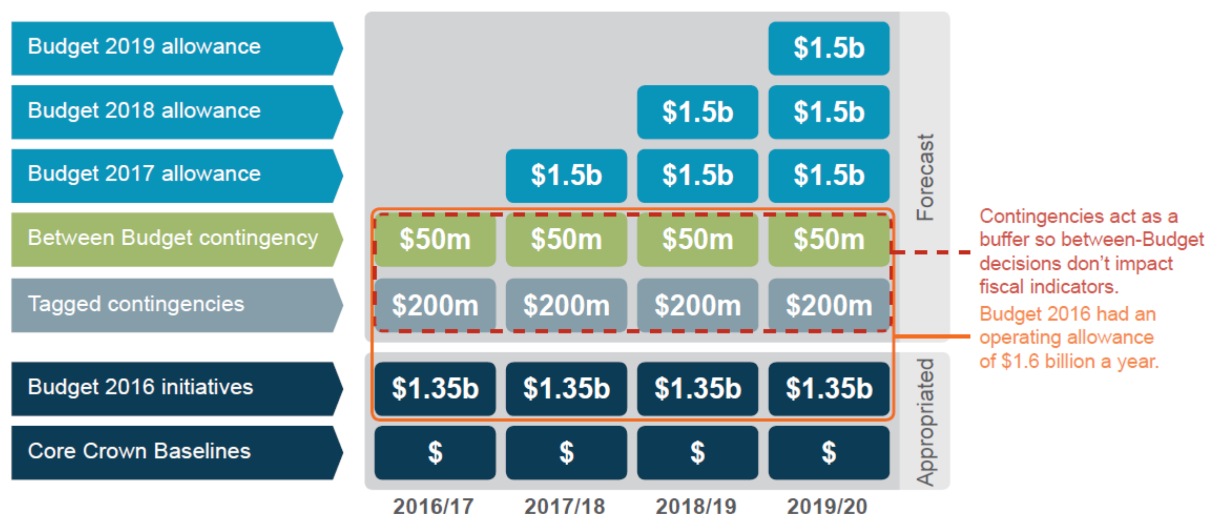
make proper use of working capital and to dispose of surplus fixed assets. Capital charge is an intra-Crown transaction and therefore fiscally neutral.

[10] The BBC does not provide for between-Budget capital proposals which are generally charged as a precommitment against the next Budget's capital allowance.

[11] Items in contingency are not published on Budget day and are presented in forecasts as an aggregate figure described as 'Unallocated contingency'.

There are few other examples of funds that are available for between-Budget allocation including the *Justice Sector Fund*[12], and the *Better Public Services Seed Fund*[13]. Both of these funds are funded from underspends rather than new funding. As with tagged contingencies these funds were included in the fiscal forecasts when they were established so decisions taken through the year do not impact the fiscal indicators (see Figure 8).

Figure 8: How contingencies fit into the big picture



4.6 The Tax Scorecard

The Tax Policy Work Programme Scorecard is a fiscal management tool designed to allow flexibility in tax policy. Non-significant items which increase or decrease tax revenue are recorded on the Scorecard and allowed to offset each other, rather than having to be funded from the operating allowance or BBC. In this way, sensible tax policy measures can be considered in aggregate as part of a coherent tax strategy, rather than in isolation. The balance of the Scorecard is the sum of all revenue positive and negative changes up to the end of the forecast period, and must remain positive.

4.7 Fiscally Neutral Changes

Fiscally neutral changes are not counted against the operating allowance. In most cases these changes do not require Cabinet approval and can be agreed by the appropriation Minister and the Minister of Finance (Joint Ministers), provided they fit within the delegations outlined in Cabinet Office Circular (15) 04. These changes can be agreed any time of year with an exchange of letters between Joint Ministers, but are most often agreed through an omnibus process as part of the March and October baseline updates.

[12] The Justice Sector Fund (JSF) was established in 2012 to provide the Justice Sector with financial flexibility across the sector and promote whole-of-sector prioritisation.

[13] The Better Public Services (BPS) Seed Fund was established in 2013 to speed up the delivery of collaborative BPS reform priorities.

5. Reporting Processes

5.1 Baseline Updates

The PFA requires Treasury to produce an economic and fiscal update twice a year[14] – the Budget Economic and Fiscal Update (BEFU) published in May/June, and the Half-Year Economic and Fiscal Update (HYEFU) published in November/December. Ahead of these updates, agencies submit revised forecasts in a process referred to as the March Baseline Update (MBU), prior to BEFU, and the October Baseline Update (OBU), prior to HYEFU.

Baseline updates also provide an opportunity for agencies to seek approval for fiscally neutral changes and reflect between-Budget decisions. As part of the baseline update report, Treasury provides the Minister of Finance with an update on the in-year revisions position. The net position of the MBU and OBU in a calendar year will impact the following Budget allowance, see section 0.

5.2 Road Check Report

The 'road check' report is a document provided to Budget Ministers[15] prior to the Budget Policy Statement and the Fiscal Strategy Report to ensure that important fiscal decisions can be made with the latest information. The road check provides Budget Ministers with an overview of the economic and fiscal outlooks based on current (known) policy settings. This is based on preliminary economic and fiscal forecasts and is timed such that Ministers are able to implement a policy response (if desired) that will be captured in the final forecasts.

While the main focus is often on operating and/or capital allowances, other significant policy changes are also incorporated, and their impact on the government's fiscal strategy documented. Should the preliminary forecasts identify any inconsistencies with fiscal strategy objectives, the road check will include advice that is consistent with these circumstances, the principles of responsible fiscal management, and the fiscal strategy.

Previous road checks have dealt with changes or rephasing of operating allowances and the OBEGAL impact of policy decisions such as ACC levy reductions and social housing.

[14] The PFA also requires the Treasury to publish a Pre-Election Economic and Fiscal Update, which can mean that in an election year three economic and fiscal updates are produced.

[15] Budget Ministers refers to the Prime Minister, the Minister of Finance, and the Associate Minister(s) of Finance.

5.3 Reviews of the Fiscal Management Approach

The fiscal management approach has been a core part of fiscal strategy since it was introduced in its current form in 2003. However, since this introduction there have been numerous reviews and changes to the FMA in order to ensure that it is still fit for purpose.

One of the most substantive changes was a product of a review in 2010. This resulted a widening of the coverage of operating allowances. Previously operating allowances did not include revisions of benefit forecasts or the impacts of baseline updates. The starting assumption now is that everything is included within the operating allowance. See section 4.2 for more details on the coverage of the operating allowance.

6. The Fiscal Management Approach in Practice

One of the most common areas of confusion when discussing the FMA is understanding 'what counts'. The answer really is that everything counts in one way or another. Even if it doesn't count against allowances, it will still count against the fiscal indicators. If Ministers agree to exclude an expense from the operating allowance, the increase in expenses will directly impact the operating balance and debt. Sometimes we describe this as 'hitting the bottom line'. This section provides some examples of the FMA in practice.

6.1 Setting the allowances

Ultimately, the level of operating and capital allowances are set by Ministers. The Treasury assists Ministers in making this decision by providing relevant information and advice.

Allowances will often be set by Ministers during election campaigns and tend to remain fairly stable over the election term. This is because stable operating allowances allow for greater planning, increased credibility and allows monetary policy settings to be adjusted accordingly. Despite this, in some cases, it may be appropriate for Treasury to provide advice on allowances, this will typically be done through the 'road check report' (see 5.2).

Treasury's advice on the level of operating allowances will consider a range of factors including progress towards fiscal objectives, the economic cycle, information on cost pressures and political commitments.

Projections of progress towards the Government's fiscal objectives will always be taken into consideration. A change to the operating allowance will naturally flow through into government expenditure or revenue and this will impact the surplus or deficit that the government achieves. Inevitably, this will impact on the timing and ability of the Government to achieve its fiscal objectives. Projections showing increases in debt, for example, would suggest a need for lower allowances over the projection period as a whole.

Advice on the level of allowances is also informed by is the current position in the economic cycle. It is important that discretionary fiscal policy does not add to volatility in the cycle by increasing pressures in an upswing or deepening any recessions.[16]

Cost pressures may also affect advice on the level of allowances. As discussed above the framework of fixed nominal baselines mean that departmental cost pressures that cannot be absorbed need to be funded from operating allowances. The level of allowances needs to be set at a level that is realistic given known cost pressures. Information on cost pressures is based on discussion with agencies as well as information provided in departments' four year plans, in, and other information provided throughout the Budget process.

Political commitments may also impact on the level of allowances. Often the elected party's manifesto may make certain spending commitments or commitments to future tax cuts. In this case the recommendations should reflect the level of operating allowance required to fund such commitments.

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[16] In 2013 the Public Finance Act (s26G(1)(f)) was amended to include a specific reference to the fiscal strategy needing to have regard for the interaction between fiscal policy and monetary policy.

In a recent example, allowances were decided upon before the 2014 election for the upcoming three years. Initially, when ministers were considering the appropriate operating allowance to set, they commissioned work to assess the level of operating allowances that would be consistent with no upward pressure on interest rates. This work involved economic modelling in consultation with the Reserve Bank and found that allowances of up to $1.5 billion per year would be consistent with this requirement. This was also considered to be consistent with known cost pressures and ensured the Government remained on trach towards their fiscal objectives.

6.2 Comparing treatment of forecast changes and cost pressures

There are some inconsistencies in how volume pressures and forecast changes are treated across the state sector. These inconsistencies are largely a result of historical appropriation structures, or the different types of programmes in each Vote and the incentives to drive effective forecasting, rather than constructs of the FMA.

Inconsistencies of treatment between different portfolios or Votes is not ideal as it make the FMA difficult to communicate. However, achieving perfect consistency is not necessarily ideal either as much of the inconsistencies are a result of certain institutional settings that have been put in place for a particular policy reason.

6.2.1 Health

Vote Health receives an operating increase annually to fund cost and demographic pressures in DHBs and Ministry-managed services, and any other new initiatives. All new funding comes from the operating allowance at Budget. There is no automatic adjustment for demographic pressures or inflation. As with all Votes, reprioritisation of existing baselines can also be used to manage pressures.

To assist with planning DHBs are generally provided an early signal pre-Christmas of the increase they can expect from the next Budget.

6.2.2 Education

Vote Education also usually receives an operating increase annually from the operating allowance at Budget. Increases to operations grants, and new initiatives are all funded from the operating allowance. Increases to teachers' salaries are also funded from the allowance but the cost of multi-year settlements have been met from a single Budget in recent times making the Education allocation volatile from Budget to Budget (though generally are set aside in contingency so are not announced).

Education also has forecast appropriations relating to areas like early childhood education entitlements which automatically adjust for demand. Any variances from forecasts are charged against the operating allowance.

Forecast changes in Vote Education have been treated slightly differently to other forecast changes. The net impact has been charged against a Vote Education allocation within the operating allowance (or in Budget 2015 included in the social sector package), rather than

the general ‘in-year revisions’ Budget allowance. How the government uses allocations to manage the Budget process can change from year to year.

6.2.3 Social development

Benefits make up the majority of Social Development’s baseline. Most of these are treated similarly to early childhood education entitlements – the variances from forecasts are charged against the following Budget’s operating allowance.

The exception to this is the Jobseeker Support benefit as its inclusion could make fiscal policy more pro-cyclical – i.e. it is an automatic fiscal stabiliser. Because of this we allow the Jobseeker Support benefit to be excluded from the allowance, rather, it directly impacts the bottom line.

Any other increases to Social Development’s baseline, i.e. for new programmes, would be met from the operating allowance.

6.2.4 Justice sector

For the most part, the Justice Sector is expected to meet demand pressures from within baselines. Any new funding would be met from the operating allowance.

The Justice Sector also has the ‘Justice Sector Fund’, which serves as a tool to reallocate underspends across the Justice Sector.

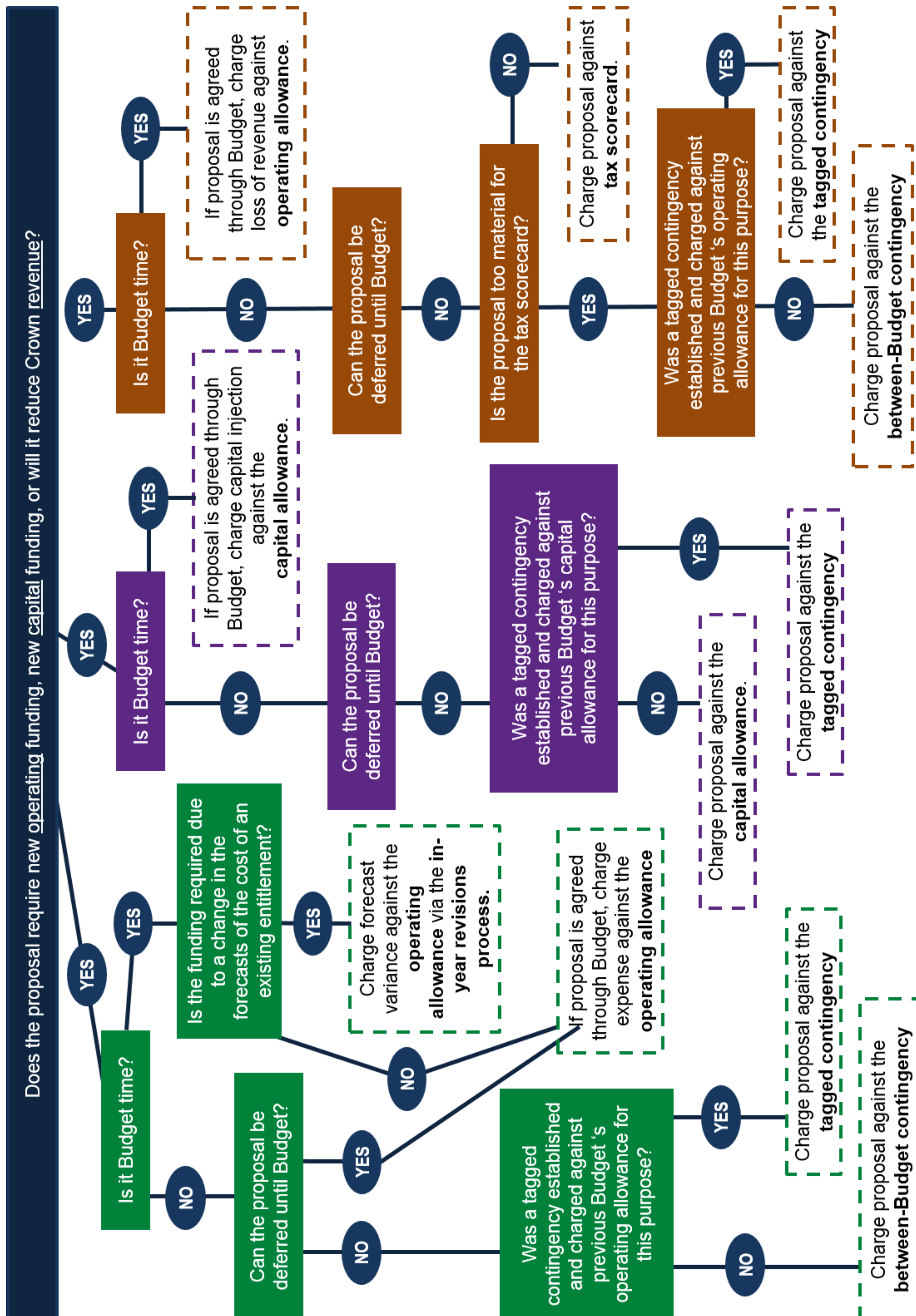
6.3 Treatment of Canterbury Earthquake expenses

Following the major earthquake in Canterbury on 22 February 2011 $5.5 billion was set aside in the Canterbury Earthquake Recovery Fund (CERF) as part of Budget 2011. This fund was outside of the operating allowance. Excluding the CERF, Budget 2011 was “net zero” in terms of the operating allowance to ensure net debt remained on a prudent track in the medium term.

The CERF was exhausted in 2012/13 from which point Canterbury earthquake recovery expenses were treated like all other expenses in the Budget process and charged against the operating allowance.

6.4 Navigating the Fiscal Management Approach

This flowchart shows how to treat a new spending or revenue proposal under the FMA.



Part 2: Assessing the current approach

No fiscal management approach can stay unchanged over time. New challenges will present themselves and opportunities will arise to make improvements. Rules are increasingly tested as an approach matures. Refreshes – or even overhauls – are required from time to time to reduce the risk of gaming and to fix inconsistencies that can arise. This section highlights some of the strengths and challenges with the current system and posits some potential opportunities for change that could be looked at.

7. Strengths of the FMA

The FMA has helped support favourable fiscal outcomes, including a government debt position that is relatively low compared with most developed nations. It provided the tools that helped the Government achieve its short-term fiscal intentions, particularly the return to surplus in 2014/15, which was a target set in 2011 and achieved with a $0.4 billion OBEGAL surplus shown in the accounts for the 2014/15 year, but also a reduction in core Crown expenses to below 30 per cent of GDP. In addition, it has helped ensure the Government is on track to meet its long-term fiscal objectives such as prudent net debt levels.

Fixed nominal baselines and tight allowances has forced agencies to look hard at their baselines and provided a strong incentive for operational efficiency. We can assume that this facilitated much of the reprioritisation and the 'indirect savings' that contributed to New Zealand's fiscal consolidation.[17]

A key strength of the FMA is its flexibility. Most recently the government's focus has been on consolidating core Crown net debt, but if they wanted to focus on another objective the existing tools would allow them to do that. The allowance system provides a highly effective lever for fiscal control – it enables government to put pressure on the state sector or take it off as appropriate. Additionally, the framework is not laid out in statute, standing orders, or the Cabinet manual, this means it can be changed or ignored at any time – the risk being that Ministers may not meet the objectives outlined in their fiscal strategy.

The response to the Canterbury Earthquakes provides a good example of this (see section 6.3). The Government ran a "net zero" Budget for general expenditure and established a separate fund to meet the initial costs associated with the earthquakes. When this fund was exhausted, Ministers decided to bring investment in the Canterbury recovery inside allowances to allow marginal new investment to be traded-off against marginal new investment in other portfolios.

The other sign of the FMA's success is its longevity – we have now had fixed nominal baselines and allowances for over 20 years. Ministers appear to find the approach useful.

[17] Returning to surplus: New Zealand's recent fiscal consolidation experience, Bose, D., Philip, R., and Sullivan, R. (2003). Paper presented at Banca d'Italia Workshop on Fiscal Policy on 31 March-2 April 2016.

8. Challenges of the FMA

8.1 Focussing on the margins

One of the biggest challenges of the current approach is it focusses the Budget process almost exclusively on the marginal new spend – making it difficult to scrutinise baseline expenditure.

Agency baselines are not renegotiated through the Budget process and discussions instead focusses on new spending proposals and cost pressures, which describes funding sought to maintain existing policies.

In theory, asking Ministers to make trade-offs between cost pressures and new initiatives incentivises them to examine the effectiveness of existing policies in order to make a judgement on whether they are higher or lower value than new spending proposals. In practice, there will always be a limit to how much of this sort of analysis and discussion is possible – it is not usually practical to ask Ministers to make significant changes to existing policy settings within the time frames of the annual Budget process.

This is not to say that Ministers don't make significant changes to existing policy settings, but it is more common that these changes will arise after a period of detailed review, a good example being the Defence Midpoint Rebalancing Review (DMRR) undertaken in 2013. DMRR involved a full costing of the Defence Force out to 2030, based on the strategy outlined in the Defence White Paper and agreed by Cabinet.[18] In this instance, the review resulted in an increase to the New Zealand Defence Force baseline.

Reviews like this do occur across the state sector in a fairly ad hoc manner, and potentially an effective way to increase visibility and scrutiny of existing programmes might be to embed more formal evaluation processes such as periodic comprehensive or selective spending reviews into the Budget cycle.

Spending reviews are common practice in a number of OECD countries including the United Kingdom, the Netherlands and Canada.[19] These processes can be highly resource intensive, so some thought would have to be given to the scope and regularity of such reviews and what would work best in the New Zealand context.

The four-year plan process provides some insight into an agencies baselines. The purpose of these documents is to provide a snap-shot of how an agency intends to manage within baselines and achieve their strategic intentions across the medium-term.

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[18] Defence Midpoint Rebalancing Review, New Zealand Ministry of Defence (2013). http://www.defence.govt.nz/reports-publications/dmrr-2013/contents.html

[19] Spending Reviews, Robinson, M. (2013). Paper presented at OECD Senior Budget Officials Conference in Paris, 2-4 June 2013. http://www.oecd.org/gov/budgeting/34thannualmeetingofoecdseniorbudgetofficialssbo.htm

8.2 Treatment of volume pressures and forecast changes

As discussed in section 6.2, there are some deliberate inconsistencies in how volume pressures and forecast changes are treated across the state sector. For example, all increases to Health spending are negotiated through the Budget process, whereas some of the spending in Education is funded through forecast changes and in-year revisions, so are more automatic. These increases do count against the allowances as well, but the different processes can cause confusion.

To reduce some of this confusion and provide more certainty for agencies over the medium-term, there might be an argument to move away from fixed nominal baselines and index more expenditure to a measure of inflation. The Australian experience suggests there would be advantages and disadvantages to this. Their system of wage cost indices means that the Department of Finance has more access to information about the componentry of the baseline spend and visibility of cost drivers, however the trade-off is that they do not have an equally strong lever of fiscal control.[20]

The New Zealand allowance system can provide an important lever for incentivising efficiency and effectiveness. There are already a number of items that are automatically adjusted (as detailed in Appendix 2). While there may not be a case for shifting to a system of automatically adjusted baselines, there may be a case to add more items to this list. Part of addressing this confusion is about efforts on the part of the Treasury, such as this paper, to communicate the FMA more widely.

8.3 Managing multiple objectives

The flexibility to manage different objectives is one of the key strengths of the FMA, but it can be difficult to manage multiple objectives at the same time – such as when fiscal indicators and targets are not of the same nature. The FMA is designed to focus on net debt. The indicator and target for net debt is on a cash basis and refers to the core Crown. When the 2014/15 return to surplus target was set in 2011, the FMA shifted focus somewhat to OBEGAL, a *total* Crown measure that includes the activities of State Owned Enterprises and Crown Entities (see Figure 2). These institutions are considered autonomous from the Crown, but they are still within the total Crown. Ministers have more direct control over the activities in the core Crown than that total Crown, which at times presented challenges for decision-making. In 2014, when interest rates began to rise, there were also challenges in managing the impact of Budget decisions on the economic cycle (eg, revenue reductions may have a different impact from new spending).

Similarly, the FMA deliberately does not ‘count’ tax forecast changes against the allowance as these are largely driven by changes in economic conditions and to do so might promote pro-cyclical fiscal policy. However tax revenue is highly sensitive and this can reduce the FMA’s ability to manage the OBEGAL directly. This was relevant for when the return to surplus target was specified for a particular year but is less important with medium-term debt targets.

[20] Australian Department of Finance, Personal Communication (23 July 2015)

8.4 Creating the right incentives

The FMA is largely about creating the right incentives. It aims to incentivise decision-making consistent with the government's stated fiscal strategy and incentivise operational efficiency across the state sector. As for other incentives, could the FMA do more to incentivise cross-agency collaboration, long-term decision making, and the investment approach?

Part of the answer is in how Ministers choose to use existing tools. Budget allocations and initiatives are generally considered by agency or sector, however recently there has been a lot more focus on incentivising cross-agency collaboration with theme based, liability based, or population based Budget allocations.

In relation to the investment approach, meaning the focus on early investment to achieve better long-term results and reduce future liabilities, the four year forecast period can mean that while Ministers are required to count the costs of the investment against allowances the benefits, which will often sit outside the forecast period, are not counted at the time the investment is made. There may be an argument for thinking about different ways of counting expenditure depending on the expected rate of return, such as extending the FMA's definition of fiscal neutrality beyond the four year forecast period. Other tools in the system help provide incentives for reducing long-term liabilities, such as long-term fiscal objectives and outcomes based results frameworks.

There could be better links between the FMA and the long term fiscal statement, which could make greater use of the FMA in communicating the key issues and challenges. Similar to the investment approach, the longer term impact of decisions made within the FMA could be better drawn out, or a policy with a modest short-term cost could have large savings or larger costs beyond the forecast horizon.

9. Conclusion

The purpose of this paper was to clearly lay out how the current approach works, both in theory and practice.

It is important to remember that the FMA forms part of the picture – there are other tools available to Minister to achieve their objectives, such as outcomes-based targets (e.g. Better Public Services Results) or planning and reporting requirements.

Overall, the New Zealand FMA has provided a useful and enduring set of tools available to Ministers that has assisted them in meeting fiscal targets. It provided the tools that supported the Government respond to two significant economic shocks, return to surplus in 2014/15 and reduce government expenses to less than 30 percent of GDP. There may be a case to make some minor changes to the approach – no framework will remain static overtime – however, there does not seem to be a strong case for significant change.

Appendix 1: Short-term Fiscal Intentions and Long-term Fiscal Objectives

The table below lists the Government's short-term fiscal intentions and long-term fiscal objectives as set out in the 2016 Fiscal Strategy Report.

	Short-term intentions	***Long-term objectives (10 years)***
Debt	Our intention is to reduce net debt to around 20 per cent of GDP in 2020. Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 30.4 per cent of GDP in 2019/20. Net core Crown debt (excluding NZS Fund and advances) is forecast to be 23.1 per cent of GDP in 2018/19, 20.8 per cent of GDP in 2019/20 and is projected to be 19.3 per cent of GDP in 2020/21.	Manage total debt at prudent levels. Manage net debt within a range of 0 per cent to 20 per cent of GDP.
Operating Balance	Our intention is to maintain rising operating surpluses (before gains and losses) so that net core Crown debt begins to reduce in dollar terms (subject to any significant shocks to the economy). The operating balance (before gains and losses) is forecast to be 0.3 per cent of GDP in 2015/16. The operating balance (before gains and losses) is then forecast to be 0.3 per cent of GDP in 2016/17 and 2.2 per cent of GDP in 2019/20. This is consistent with the long-term objective for the operating balance. The operating balance is forecast to be 3.2 per cent of GDP in 2019/20.	Deliver operating balances sufficient to meet the Government's net capital requirements, including contributions to the NZS Fund, and ensure consistency with the debt objective.
Expenses	Our intention is to support fiscal surpluses by restraining the growth in core Crown expenses and managing these to below 30 per cent of GDP. Core Crown expenses are forecast to fall from 29.7 per cent of GDP in 2015/16 to 28.3 per cent of GDP in 2019/20. Total Crown expenses are forecast to be 36.4 per cent of GDP in 2019/20. This assumes a new operating allowance of $1.5 billion in Budget 2017 and for the remainder of the forecast period, growing at 2 per cent thereafter.	Control the growth in government spending so core Crown expenses are below 30 per cent of GDP.
Revenues	Our intention is to support fiscal surpluses by growing revenue in dollar terms, although maintaining it at broadly the same proportion of GDP. Total Crown revenues are forecast to be 38.8 per cent of GDP in 2019/20. Core Crown revenues are forecast to be 30.6 per cent of GDP in 2019/20. Core Crown tax revenues are forecast to be 28.2 per cent of GDP in 2019/20.	Ensure sufficient operating revenue to meet the operating balance objective.
Net worth	Our intention is to strengthen the Crown's balance sheet as a buffer against future adverse shocks. Total net worth attributable to the Crown is forecast to be 36.4 per cent of GDP in 2019/20. Total Crown net worth is forecast to be 38.4 per cent of GDP in 2019/20.	Ensure net worth remains at a level sufficient to act as a buffer to economic shocks. Consistent with the debt and operating balance objectives, the Crown will build up net worth ahead of the full fiscal impact of the demographic change expected in the mid-2020s.

Appendix 2: Forecast appropriations

The table below lists all forecast appropriations for the 2016/17 year. Variances against previous forecast (forecast changes) are charged against the operating allowance through the in-year revisions process (see section 0).

Type of forecast change

A – Changes to price or volume of benefits and entitlements

B – Changes in expenses driven by changes in demand (requires Cabinet agreement to specific metric based on policy grounds)

C – Changes in price set by external bodies

D – Impacts of exchange rate movements

E – Changes in expected revenue caused by an external factor

F – Impairments and revaluations

G – Depreciation and other

Forecast appropriations

Vote	Appropriation	Type
Audit	Remuneration of Auditor-General and Deputy Auditor-General PLA	C
Building and Housing	KiwiSaver HomeStart Grant	A
Building and Housing	Occupational Licensing	E
Building and Housing	Building Regulation and Control	E
Building and Housing	Residential Tenancy and Unit Title Services	E
Building and Housing	Housing Assistance	E
Business, science and Innovation	International Subscriptions	D
Conservation	Subscriptions to International Organisations	D
Courts	Impairment of Fines Receivable	F
Courts	Impairment of Debt Established to Recognise Contributions towards Family Court Professional Services	F
Courts	Coroners Salaries and Allowances PLA	C
Courts	District Court and Environment Court Judges' Salaries and Allowances PLA	C
Courts	Employment Court Judges' Salaries and Allowances PLA	C

Vote	Appropriation	Type
Courts	Māori Land Court Judges' Salaries and Allowances PLA	C
Courts	Supreme Court, Court of Appeal and High Court Judges' Salaries and Allowances PLA	C
Customs	World Customs Organisation	D
Education	Early Childhood Education	A
Education	Depreciation (capital charge comes through as a technical adjustment)	A
Education	Primary Education	A
Education	School Transport	A
Education	Secondary Education	A
Education	Capital Expenditure PLA	A
Energy	Repayment of Crown Energy Efficiency Loans.	E
Energy	Royalties petroleum	E
Energy	Royalties gas	E
Energy	Whirinaki Electricity Generation	E
Energy	Energy Resource Levies - Gas	E
Environment	United Nations Environment Programme	D
Environment	International Subscriptions	D
Environment	Framework Convention on Climate Change	D
Environment	Allocation of New Zealand Units	G
Finance	Solid Energy New Zealand Limited – Payments for Environmental Rehabilitation PLA	B
Finance	Government Superannuation Fund Authority – Crown's Share of Expenses PLA	B
Finance	Unclaimed Money PLA	B
Finance	Unclaimed Trust Money PLA	B
Finance	Administration of Crown Borrowing, Securities, Derivative Transactions and Investment PLA	B
Finance	Administration of Guarantees and Indemnities Given by the Crown PLA	B
Finance	International Financial Expenditure PLA	C
Finance	Unwind of Discount Rate Used in the Present Value Calculation of Payment for Shares in International Financial Institutions PLA	C
Finance	Dividends from State-owned Enterprises	E

Vote	Appropriation	Type
Finance	Dividends from Crown Entities	E
Finance	Dividends from Crown Research Institutes	E
Finance	Dividends – Other	E
Finance	Export Credit Office	E
Finance	Other Current Revenue	E
Finance	Other Fees	E
Finance	Unclaimed Money	E
Finance	Reserve Bank Surplus	E
Finance	Interest from Securities and Deposits	E
Finance	Interest on Housing New Zealand Corporation (HNZC) Loans	E
Finance	Rentals from Crown Overseas Properties	E
Finance	Capital Charge – Departments	E
Finance	National Provident Fund Schemes- Liability Under Crown Guarantee PLA	G
Finance	Government Superannuation Fund Unfunded Liability PLA	G
Foreign Affairs	Consular Services	D
Foreign Affairs	Services for Other New Zealand Agencies Overseas	D
Foreign Affairs	Policy Advice and Representation – International Institutions	D
Foreign Affairs	Policy Advice and Representation – Other Countries	D
Internal Affairs	VIP Transport	B
Internal Affairs	Former Governor-General annuities and other payments PLA	B
Internal Affairs	Former Prime Minister annuities	B
Internal Affairs	Former Prime Minister domestic travel	B
Internal Affairs	Travel for Former Governors-General and Prime Ministers PLA	B
Internal Affairs	Annuities to Former Governors-General, Prime Ministers and Widows PLA	B
Internal Affairs	Rates Rebate Scheme	B
Internal Affairs	Executive Council and Ministers' Salaries and Allowances PLA	C
Internal Affairs	Tuwharetoa Maori trust board	C
Justice	Impairment of Legal Aid Debt	B
Justice	Impairment of Offender Levy	B
Labour Market	Immigration Services	B

Vote	Appropriation	Type
Lands	Depreciation	C
Lands	Surplus Government Properties - Sales	E
Lands	Land Tenure Reform Sales	E
Lands	Database Licence Fees and Royalties	E
Lands	Pastoral Lease Rentals	E
Lands	Surplus Government Properties - Rents	E
Lands	Sundry Operating Revenue	E
Lands	Administration of the Overseas Investment Regime	E
Lands	Proceeds from Sale of NZ Transport Agency	E
Lands	Land Tenure Reform Acquisitions	E
Lands	Transit Sales	E
Lands	Crown Land MCA	E
Lands	Property Rights MCA	E
Lands	Depreciation	E
Lands	Bad and Doubtful Debts	E
Maori Affairs	Taranaki Maori Trust Boards	G
Official Development Assistance	Management of Official Development Assistance Programme	D
Ombudsmen	Remuneration of Ombudsmen PLA	C
Parliamentary Commissioner for the Environment	Remuneration of the Commissioner for the environment	C
Parliamentary Services	Party and Member Support – Act (MYA)	C
Parliamentary Services	Party and Member Support – Green (MYA	C
Parliamentary Services	Party and Member Support – Labour (MYA)	C
Parliamentary Services	Party and Member Support – Maori (MYA)	C
Parliamentary Services	Party and Member Support – National (MYA)	C
Parliamentary Services	Party and Member Support – New Zealand First MYA	C
Parliamentary	Party and Member Support – United Future MYA	C

Vote	Appropriation	Type
Services		
Parliamentary Services	Accommodation of Members and Travel of Members’ Families PLA	C
Parliamentary Services	Members of the House of Representatives' Salaries and Allowances PLA	C
Primary Industries and food Safety	Subscriptions to International Organisations	D
Prime Minister and Cabinet	Governor-General’s Programme PLA	B
Prime Minister and Cabinet	Governor-General’s Travel Outside New Zealand PLA	B
Prime Minister and Cabinet	Govenor-General's Programme PLA	C
Prime Minister and Cabinet	Fees for the Commissioner of Security Warrants PLA	C
Prime Minister and Cabinet	Governor-General’s Salary and Allowance PLA	C
Revenue	Child Support Payments PLA	A
Revenue	Family Tax Credit PLA	A
Revenue	In-Work Tax Credit PLA	A
Revenue	KiwiSaver: Interest	A
Revenue	Child Tax Credit PLA	A
Revenue	Adverse Event Interest PLA	A
Revenue	Environmental Restoration Account Interest PLA	A
Revenue	Income Equalisation Interest PLA	A
Revenue	KiwiSaver: Tax Credit	A
Revenue	Minimum Family Tax Credit PLA	A
Revenue	Paid Parental Leave Payments	A
Revenue	Parental Tax Credit PLA	A
Revenue	Payroll Subsidy PLA	A
Revenue	Impairment of Debt and Debt Write-Offs	F
Revenue	Impairment of Debt Relating to Child Support	F
Revenue	Impairment of Debt Relating to Student Loans	F
Revenue	Initial Fair Value Write-Down Relating to Student Loans	F
Social Development	Accommodation Assistance	A

Vote	Appropriation	Type
Social Development	Childcare Assistance	A
Social Development	Disability Assistance	A
Social Development	Hardship Assistance	A
Social Development	Jobseeker Support and Emergency Benefit	A
Social Development	New Zealand Superannuation	A
Social Development	Orphan's/Unsupported Child's Benefit	A
Social Development	Sole Parent Support	A
Social Development	Special Circumstances Assistance	A
Social Development	Student Allowances	A
Social Development	Study Scholarships and Awards	A
Social Development	Supported Living Payment	A
Social Development	Transitional Assistance	A
Social Development	Veterans' Pension	A
Social Development	Work Assistance	A
Social Development	Youth Payment and Young Parent Payment	A
Social Development	Debt Write-downs	A
Social Development	Out of School Care Programmes	A
Social Development	Recoverable Assistance	A
Social Development	Student Loans	A
Social Development	Social Housing Purchasing MCA	A
State Services	Settlement of Legal Liabilities	G
Transport	National Land Transport Programme PLA	G
Transport	Membership of International Organisations	G

Abbreviations used in this table refer to appropriation types:

- PLA Permanent Legislative Authority
- MYA Multi-year Appropriation
- MCA Multi-category Appropriation

For more information on appropriations see the Treasury's Guide to Appropriations: http://www.treasury.govt.nz/publications/guidance/planning/appropriations/guide

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