International Federation of Accountants

Global Seminar on the Sovereign Debt Crisis

Vienna: 19 - 20 March 2012

Speech by the Hon. Ruth Richardson

Former New Zealand Minister of Finance 1990 - 1993

The public finance crises are being played out in real time.

There is no hiding place.

Europe is on fiscal fire, the American economy continues to falter and China's chase will be blunted by some inconvenient fiscal truths.

Is it a case of 'We are all Greeks now'?

> "The troika have had to do some arithmetic gymnastics in order to make the numbers add up but their optimistic assumptions are unlikely to hold. EU officials insisted the plan would withstand scrutiny, despite scepticism. It is not just imaginative accounting, a German official said. It would not have taken 13 hours of negotiation if it were".
>
> *'Greek accounting cannot hide the urgency for growth', FT, 22 February, 2012*

It is very evident that the world has been afflicted by a severe case of 'Greek Accounting'.

Imaginative accounting and arithmetic gymnastics have become the toxic norm for state entities. Was a private entity to behave in this fashion, at the very best the banks and then the bailiffs would exact swift sanctions, while at the very worst, criminal sanctions would be applied.

In the case of the USA it was the rating agency that blew the whistle:

> "The downgrade reflects our view that the effectiveness, stability, and predictability of American policy making and political institutions have weakened at a time of ongoing fiscal and economic challenges ..."
>
> *S&P in late 2011 stripping the USA of her AAA credit rating.*

The sovereign debt crisis has been an accident waiting to happen:

- foolish and unfunded promises by politicians to their electorates
- ponzi schemes that depend on robbing the unsuspecting young to pay the over grasping old
- an ingrained entitlement mentality

- fudged public finances

So why have sovereign entities continued to stick to this delusional and ultimately ruinous course? While profligate public policy must shoulder much of the blame, the adherence to a crude cash accounting regime has conspired to disguise the true cost of the unsustainable public finance burden until the crisis hit.

But the penny is dropping

> "We'll be recommending that all resources be put on the budget and that public finance needs to be transparent and accountable"
>
> *President of the World Bank releasing the China 2030 Report, 23 February, 2012*

The drive for transparency and accountability lay at the heart of New Zealand's pioneering efforts over two decades ago to adopt accrual accounting and performance management in the state sector. In common with most other nations NZ suffered from an antiquated public sector management system, as wasteful as it was dysfunctional and unaccountable.

Worse still the debt and deficits sirens were getting louder.

In the search for remedies NZ ultimately eschewed the favourite political palliatives of waste busting quangos, salami slicing cuts, sinking employment lids etc in favour of fundamental, comprehensive and principled reform. The sweep of the reforms initially centred on the twin imperatives of securing transparent and accountable management of human and financial resources in the public sector.

While the task called for leading edge thinking and highly sophisticated technical expertise on the part of the officials, as a politician at the time it was the big ideas that excited and attracted all party support. The notion that government should be conducted in the open, that resources should be matched by results, that dealing to debt and deficits was imperative, that the new standards of accountability would ultimately discipline fiscal recklessness.

While there was a growing realisation that the country was running out of fiscal runway, the politicians lacked the tools to get a grip on public finances and correct the course, let alone ensure that their political platform was able to be translated into effective action. It was as if the public sector was on destructive auto-pilot with politicians either unwilling or powerless to influence except at the margins.

In an unprecedented public sector management revolution, NZ tied the public sector to the same accounting mast as the private sector, moved from budgeting for inputs to outputs and introduced performance management regimes into all state entities. The old adage that if you can't measure it, you can't manage it rang true!

The triumph of the twin standards of transparency and accountability completely re-defined the terms of the political debate. Whether on the so-called left or right of the political spectrum, modern politicians demanded modern management tools.

The first dividends came with a dramatic re-shaping of the public sector landscape.

The size of the public sector was halved; there were clearer definitions of the performance sought and unambiguous managerial accountability for delivery. Strong performance incentives were instituted and financial performance was reported in adherence to GAAP standards. High quality reporting distinguished between operating and capital expenditures and provided comprehensive information about both assets and liabilities.

As a Minister, the ability to write a purchase agreement with the departmental head specifying the cost and quality of the outputs sought transformed the nature of the relationship between the politician and the 'machine'. In the manner of the relationship between a Board and the CEO, very familiar to me now as a professional director, the KPI's had specific metrics and reflected the strategic direction sought by the Government.

Requiring the government to be both open and strategic in its fiscal decisions and insisting on proper portfolio management of all public assets and liabilities amounted to a heroic and institutional effort to "keep the bastards honest".

The legislative axis on which this idea built was the State Sector Act of 1988 and the Public Finance Act of 1989. Inheriting this fantastic framework I was able to score a proud global first for a Minister of Finance which saw the publication in 1992 of the first sovereign set of accounts and balance sheet in compliance with independent and classical accounting standards.

I have to say what was revealed was not a pretty sight, but the mere fact of being able to lift the bonnet on the true state of the public finances was a feat in its own right. The installation of gold standard accounting was a necessary but not sufficient condition of the restoration of fiscal health.

While there was undeniably a quantum shift in the quality of financial reporting, NZ ran the risk that it would have remained mired in debt and deficits had not the aggregate level of public expenditure been tackled and fiscal responsibility hardwired into our institutional arrangements.

Building on the institutional success with the legislated model for central bank independence and the accountable conduct of monetary policy I sought a legislative companion to govern the conduct of fiscal policy.

The Fiscal Responsibility Act of 1994 wrought a fiscal revolution by requiring successive governments to respect a set of principles that characterized responsible fiscal policy, to conduct and publish fiscal policy in a strategic context and to fully and frequently account for their fiscal stewardship.

There has been a seismic shift in political behaviour and public understanding and expectation as a result. In the first instance deficits were eliminated and debt reduced from dangerous to prudent levels. Pleasingly the nature of the political debate was so transformed that the fiscal bar was raised in a fashion that caused old habits to truly die.

No serious political party dares campaign on a platform that departs from the golden rule of fiscal responsibility.

And here is why.

One click away on the NZ Treasury website are a vast array of pre and post budget and fiscal strategy documents, half yearly and pre-election updates, the yearly Financial Statements and monthly tracking, as well as an Investment Statement that reports and enables greater scrutiny of the government's management of its assets and liabilities.

This means that budgets are never surprises; the Minister must outline the strategic options in advance.

This means that no party can campaign for office wilfully blind to the true state of the public finances; the pre-election publication of the books, independently verified by the Secretary of the Treasury sees to that.

This means that a government can take a portfolio approach when discussing the shift in capital priorities that may see some state owned assets sold in return for debt reduction or re-allocation to higher order state funded activities. Fiscal responsibility has become the norm, the role of the state can be addressed in a properly informed fashion and the public has come to expect government in the open.

It does not take the sacking of an elected, but derelict, government and the installation of a technocrat-led regime of uncertain duration, for a Minister of Finance to tell the public as the NZ Minister did a few weeks ago that :

> "The Government was spending and borrowing more than it could afford into the future. So it made sense to reorganize the Government's assets and redeploy capital to priority areas without having to borrow more. The Government's commitment to absorb the shock of the global financial crisis on its own balance sheet could not continue."

Reform is a constant, so NZ sees a fresh round of radical cuts in the public sector, innovative use of technology to deliver services, entitlement reform and minority share floats of State Owned Enterprises.

The question for this gathering is why so few sovereign entities have grasped the nettle of independent and comprehensive public accounts.

In truth NZ chose to be world leader because we were propelled to do so by a prior and impending crisis.

For most other nations in trouble it must surely be the case that:

> "the global financial crisis and sovereign debt concerns in other countries have reinforced the need for strong public sector management and for enhanced accountability around government finances"

as the 2010 Investment Statement of the Government of New Zealand warns.

Without surrendering ultimate decision making authority, what government would not want to apply the following fiscal principles:

- "reducing total sovereign debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total sovereign debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the sovereign in each financial year are less than its total operating revenues in the same financial year."

Think credit rating downgrades, forced fiscal austerity, and public anger on the streets.

- "once prudent levels of total sovereign debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the sovereign do not exceed its total operating revenues."

Think balanced budget behaviour as the rule, not the exception

- "achieving and maintaining levels of sovereign net worth that provide a buffer against factors that may impact adversely on the sovereign's net worth in the future."

Think why Australia and NZ weathered the GFC without a credit rating downgrade, but remember that 'worth' has to exist as a credible measure in the first place

- "managing prudently the fiscal risks facing the sovereign."

Think Europe without a clue about the fiscal risks when the likes of Greece were allowed to become signed up members of the club in the first place.

- "pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years."

Think the political football being played with tax rates in the UK and USA versus the consistent adherence to a broad-base, low-rate regime that constitutes the gold standard.

What government would not want to be explicit about the strategic fiscal choices the country has and to be open about the priorities and trade-offs. Markets don't like surprises, nor do electorates. There is much to be said for the 'wisdom of the crowds'.

The Foreword to the Investment Statement I referred to previously bows in that direction as follows:

> "New Zealand has been a world leader in the transparency of the Government's accounts since the early 1990's, and remains one of only a few countries that prepare a sovereign balance sheet according to independent accounting standards. This transparency has a number of benefits, including our sound sovereign credit rating. But there is always room to improve.
> The introduction of the Investment Statement to the regular suite of financial reporting documents will further strengthen this framework. It will assist our drive to help New Zealanders to get a better handle on government spending and the risks to the Crown's financial position and on the extent to which this may be undermining or crowding out opportunities for growth-enhancing private sector investment in NZ"

What government would not want to budget in a fashion that matches resources to results.

It is absurd in this day and age to imagine that successful policing for example is simply a function of a fat budget and numerous Mr or Ms Plods.

Or that successful schooling is simply a function of buildings, teachers and classroom materials.

Or that defence of the borders is just a function of customs officers and computers.

What government would want to have lazy capital on their 'balance sheet' when crucial front end and high priority services are being starved of resources.

What political challenger would want to fly blind at election time where the government of the day had all the financial cards in their hands, and upon upending that regime in the ballot box, discover to their horror that the cupboard was bare.

And most of all, what government would not want to arm itself with the fiscal truth so that pre-emptive action could be taken rather than being washed away in a fiscal tsunami.

I know only too well the political temptation to kick the can down the road.

Politicians have been complicit in the delusion that economic and social liabilities can be incurred without regard for the fiscal consequences, short and long term. The only sure way to break that cycle is to arm politicians and public alike with nothing but the fiscal truth and the whole truth, and trust that this will prove to be the game changer.

The lesson from NZ is that as the institutional regime changed, so did the political incentives and the consequent fiscal behaviour.

While politicians did not become public finance saints overnight, and there were the inevitable lapses, all ultimately became converts to the code.

Undeniably the golden rules have stood the test of time.

The current debate is how best to strengthen the regime rather than resiling from the institutional framework.

Legislated spending limits are now contemplated which would decree that expenditure will grow no faster than the annual increase in the rate of population growth multiplied by the rate of inflation.

This is designed to add a new requirement to be reflected in the principles of fiscal responsibility and reporting provisions that governments will not introduce expenditure appropriations that would at any point in the future exceed the spending limit. As with the original code there is a requirement on the Minister of Finance to explain any breach of the spending cap to Parliament and to outline what actions will be taken to ensure that expenses remain within the cap for the future.

The crowd is understandably angry with governments.

The pressure is on politicians world-wide to abandon rubber numbers and fiscal delusion in favour of credible figures and fiscal responsibility.

The road to fiscal rehabilitation is a grinding one with electorates seeing their expectations shattered and governments having to live in straightened circumstances.

Those familiar with the work of Schumpeter (as we all should be at a gathering in Vienna), will know of the force of creative destruction.

This is a time to learn the lessons of fiscal destruction, and embrace creative public policy solutions.

Governments intent on keeping out of trouble in the future could do worse than taking a second look at NZ's pioneering efforts.

#   #   #