

# Typically Dutch

by  
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## 1. Purpose and contents

This paper aims to identify a few features of institutions and policies in the Dutch public sector that can be characterised as “typically Dutch” and that, moreover, may be considered as worthy of further thought, or perhaps even as a source of inspiration, for countries that are presently thinking about the modernisation of their public sector. This aim implies two limitations that ought to be emphasised at the outset.

First, I have tried to select topics that are not very common in the OECD area. Partially under the influence of international organisations such as the OECD, many modernising developments nowadays take place more or less simultaneously in separate countries. This paper will not address such developments, however important they may be. This implies that I have not concentrated on themes such as the use of performance information in budgeting or the introduction of public-private partnership projects (PPPs). Rather it will address some “typically Dutch” characteristics of institutions and policies. Of course this does not mean that it would be impossible to find some similarities in other countries. When we address “arm’s length agencies”, for instance, it is clear that some other countries have gone in the same direction. Indeed, the United Kingdom has been an important source of inspiration in this respect for Holland. However, we can still say that Holland’s present policy has some unique features. The same is true for the other topics that will be discussed.

Second, I have tried to concentrate on features that have been improvements in Holland and that may lead to improvement elsewhere. Of course I also entertain some ideas about Dutch features that are uniquely bad. I shall not mention them here, but they certainly exist and it might even be useful to other countries to learn about them, but that is probably something for another occasion than this paper. Furthermore I have tried to concentrate on institutions and policies that are particularly relevant to Central, Eastern and South-Eastern European countries. In this respect I have assumed that these countries are still in a process of institutional build-up. This probably implies that they are more open to new ideas and to institutional innovation than many (other) OECD countries, where existing institutions and policies have become entrenched in vested interests. This means that I have not shied away from features that in Western European countries would have little chance of implementation.

The paper is organised as follows. In Section 2, I provide some basic facts about the organisation of the public sector in the Netherlands. This is necessary to place the following sections in the right perspective. In Section 3, I treat two institutional features of the budget process (the demand side of the public sector), namely: the multi-annual expenditure framework and the role of the Central Planning Bureau. In Section 4, I treat two institutional features of public service delivery (the supply side of the public sector), namely: the role of the non-profit sector and the role of arm's length agencies. Section 5 contains some concluding remarks.

## 2. The Dutch public sector

The Dutch public sector is comparable to that of France and Germany but larger than that of the United Kingdom. General government expenditure was EUR 200 billion or 47% of GDP in 2001. In France, Germany and the United Kingdom, general government expenditure was 52%, 49% and 41% respectively in 2001 (OECD, 2003). Like Germany, but unlike France and the United Kingdom, government is quite decentralised. Central government expenditure including social security and public health was EUR 131.4 billion or 31% of GDP in 2001 (France 47%, Germany 36%, United Kingdom 33%). In North America, central government is substantially smaller: central government expenditure was less than 30% of GDP in 2001 in Canada, Mexico and the United States (OECD, 2005).

The present size of central government net expenditures is the outcome of a long process of gradual retrenchment since the beginning of the 1980s. Originally this process was directed at the limitation of the growth of the share in GDP; since 1987 there is an actual decrease of the share in GDP, which has accelerated since 1997, but come to a halt in 2001.

Figure 1 shows this development and also makes clear that the retrenchments have almost exclusively taken place in the areas of private goods: subsidies, public contributions to the non-profit sector, social transfers, social services, health, and education. These services are typical for the welfare State. The level of net expenditure on public goods – defence, public safety and order, infrastructure, basic research, general public services, development assistance, general transfers to subnational government, and interest – has roughly remained stable as a share of GDP. These are the services that are characteristic for the more traditional tasks of the State.

In Holland, central government expenditure is divided into three budget sectors: social security, health, and the State sector. Social security is mainly covered by social insurance and mainly funded by social insurance premiums. However, there are also some parts of social security which are part of the State budget (but not of the State sector) and funded by taxes (mainly welfare,

Figure 1. **Central government net expenditures on public and private goods as share of GDP**

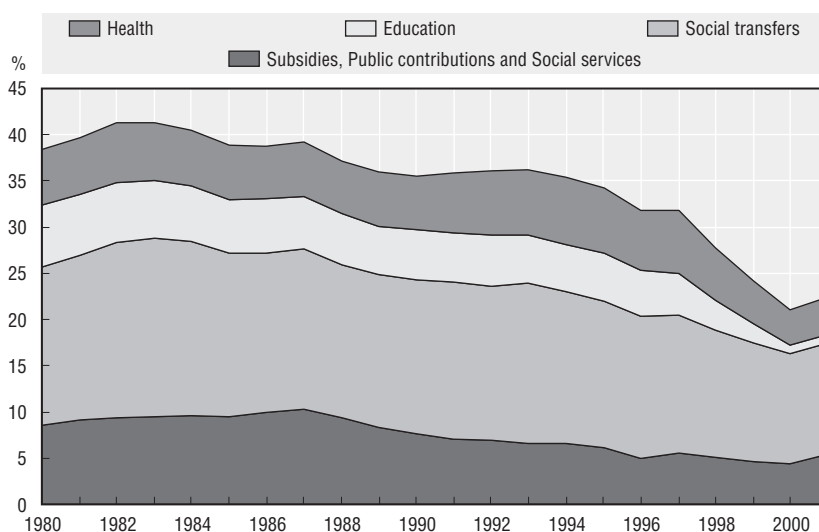


Source: OECD (2005), *Reallocation: The Role of Budget Institutions*.

for people without income who cannot claim other benefits, and benefits for war victims). Social security consists of insurances with universal coverage (old-age benefits, child benefits, widow and widower benefits, and a basic disability benefit) and those which only cover employees (unemployment benefits and an additional disability benefit). The insurances with universal coverage provide a benefit equal to the net minimum wage. The insurances for employees provide benefits related to previous income. The budget sector of health expenditure consists of two public compartments covered by social insurances. The first compartment consists of a basic package of cure expenditures. Approximately two-thirds of the population, defined by an income ceiling, are covered by the obligatory care insurance. The remaining third (the highest income group) is insured privately for the basic package (or not insured). Their coverage is not part of public expenditures. The second compartment consists of care expenditures (homes for the elderly, homes for revalidation, ambulatory care, psychiatric care). It is covered by an obligatory universal social insurance. In addition to these compartments, there is a third compartment of additional health expenditures for voluntary services, funded by additional private insurance and private contributions, which is not part of public expenditure. The third budget sector is the State sector. It is divided into approximately 20 chapters, roughly coinciding with the ministerial departments.

Public expenditures are authorised by annual budget laws and permanent social insurance laws. The budget laws cover the State sector and small parts of the social security and health sectors. A substantial part of expenditures for private goods (education, social services, subsidies and public contributions, social transfers) authorised by annual budget laws is based on substantive laws (entitlements). In these cases the budget authorisation is materially provided permanently by the substantive laws. The social insurance laws cover the largest part of social security and health expenditures. Figure 2 gives a more detailed picture of the developments since 1980 in the domain of private goods.

Figure 2. **Central government net expenditures on private goods as share of GDP**



Source: OECD (2005), *Reallocation: The Role of Budget Institutions*.

The retrenchments have mainly occurred in the area of subsidies to the market sector and social transfers. During the 1970s and early 1980s, many subsidies to the market sector were introduced or increased to support traditional manufacturing sectors such as shipbuilding, aircraft-building, the automobile industry and the steel sector. These subsidies were gradually phased out as it became clear that these industries were not sustainable in the Dutch circumstances. Presently there is hardly any industrial policy left in the Netherlands. The remaining subsidies to the market sector (approximately EUR 5 billion in 2000) are mainly for technological innovation, environmental

protection, and agriculture. The other sector where huge retrenchments have taken place is social security. There have been important policy changes, especially in the sphere of disability benefits, unemployment benefits, and welfare. The net disability and unemployment benefits were almost equal to the net former wage. For the disability scheme, the replacement rate was decreased to 70% for an elderly disabled person and to an even lower rate for a younger disabled person. Moreover, in the 1970s and 1980s, disability benefits were misused on a grand scale in Holland, as disguised unemployment benefits (because they were more favourable than unemployment benefits). Because of its political sensitivity, this problem has been a major theme of Dutch politics since the early 1980s. It is still not entirely solved, although the present cabinet has taken further important steps to normalise the situation.

### **3. Budget institutions**

#### **3.1. The multi-annual expenditure framework**

Almost all OECD countries nowadays formulate multi-annual expenditure frameworks. These frameworks are statements about the targets for the major macro-budgetary variables: total expenditures, total revenues, and the deficit in the context of macroeconomic forecasts about the development of the national economy.

The expenditure frameworks are usually published and submitted to parliament every year either in advance of the budget or on the same occasion as the budget. Mostly they cover a period of three, four or five years, including the budget year, and are made up anew every year on a rolling basis. However, apart from these common features, practices concerning multi-annual frameworks differ in very fundamental respects, in particular:

- The integration with the budget: sometimes the numbers of the budget are consistent with the targets of the first year of the multi-annual framework, sometimes not; if the budget contains multi-annual estimates, this may also regard the out-years (the years after the budget year).
- The treatment of second-order effects: macroeconomic circumstances determine the budget targets, but budgetary and general economic policy also determine the macroeconomic circumstances; full integration with the budget implies that second-order effects are accounted for in the macroeconomic forecasts.
- The reconciliation with the numbers of the multi-annual framework of the last year: an explanation of the reasons for changes in the budget targets since the last year and a specified breakdown of these changes; a special case occurs when the the numbers of the last year have to be identical to

those of the present year (so that reconciliation is not necessary apart from exceptional pre-specified circumstances).

A multi-annual framework that is fully integrated with the annual budget, including second-order effects, and that cannot be changed from year to year apart from exceptional, pre-specified circumstances is called a fixed multi-annual expenditure framework (as opposed to a flexible one). Since 1994, the Netherlands has a fixed multi-annual expenditure framework. This is not entirely unique in the OECD area: Sweden, the United Kingdom and the United States (until 2002) also had such frameworks. The Dutch one, in contrast to the Swedish and British ones, is not rolling, but periodical: it is decided at the beginning of each parliamentary period (usually once in four years).<sup>1</sup> The expenditure ceilings of the framework cannot be adjusted, but the EMU deficit is not allowed to exceed a pre-specified signaling value, presently 2.5% of GDP. This implies that expenditures have to keep distance from the ceiling of the framework if the signaling value of 2.5% of GDP is reached. This occurred in the budget year 2003.

Various aspects of the fixed expenditure framework as it applies in the Netherlands are worth noting:

- It is not enacted in law, but is part of the coalition agreement that is established at the beginning of each parliamentary term. This implies that the coalition parties which form the government are bound to it and cannot change it without putting the entire coalition agreement and thereby the cabinet in jeopardy. This gives the framework a status that is even stronger than a law: law can always be changed on its own merits by a parliamentary majority.
- The targets of the framework cover the total of net public expenditure, including mandatory expenditure, such as health, education, and social security. This implies that all setbacks have to be compensated, if necessary by changing the law when setbacks are due to macroeconomic circumstances under existing legislation; thus the framework is more inclusive than those practiced in the United Kingdom and the United States. In the United Kingdom, mandatory, so-called annually managed expenditure (AME) is excluded from the targets and subject to a separate regime of bi-annual review. In the United States, mandatory spending and tax revenues are subject to a regime that requires only compensation for legislated changes, not for setbacks and shortfalls under existing legislation.
- The status of targets varies: the target for total net public expenditures is unalterable. However the framework also contains subtargets for the three budget sectors of State, social security and health and for the chapters of the State budget (roughly coinciding with the ministries). Reallocation among the budget sectors, among the chapters of the State budget, and

among gross expenditure and non-tax revenues is possible and occurs frequently. This feature is of course necessary to maintain flexibility and adjustment to new developments or changing political priorities during the cabinet period, but is often overlooked.

- The targets of the framework are expressed in real terms. Every year the numbers are translated in nominal terms in view of the most recent inflation estimates of GDP by the Central Planning Bureau.

It should be emphasised that a fixed expenditure framework is fundamentally different from a flexible framework as practiced in most other OECD countries. It is not a document that is accidental or complementary to the budget, but an essential part of it. In fact it functions like a fiscal rule, namely an agreed constraint on the annual budget (including multi-year estimates) that is supposed to apply annually for at least a number of years. This particular kind of fiscal rule has a number of advantages in comparison to the more common structural or nominal deficit rules applied in other OECD countries:

- In contrast to nominal deficit rules, it retains the automatic stabilisation effect at the revenue side of the budget, in particular as regards tax receipts, as long as the deficit remains below a pre-specified level (in the Dutch case, below the signaling value of 2.5% of GDP, which is based on the EMU ceiling of 3%).
- In contrast to structural deficit rules, it is easy to understand and not subject to the complicated and somewhat arbitrary computation methods required to determine the structural deficit.
- It provides tranquility in the budget process and a long planning horizon for the ministries. In principle, ministers know their budgets long in advance; annual budget discussions with the ministry of finance and in the cabinet can be limited to reallocation proposals. This contrasts positively with the annual upheaval which is characteristic for the budget process in many countries that practice nominal or structural deficit rules.
- It puts the responsibility for budgetary discipline on the shoulders of the spending ministers, rather than on the minister of finance alone. This changes the character of budget discussions in cabinet. There is less tendency to gang up against the minister of finance, and more scrutiny of fellow ministers' budgets (in order to explore the possibilities for reallocation). In coalition cabinets, that usually have "weak" ministers of finance (not able to impose savings on spending ministries unilaterally), this is an important advantage.

There are also consequences that may be considered as more problematic, although not necessarily as disadvantages, and that are worth mentioning:

- Since spending ministers cannot appeal to existing laws or policies to defend their budgets, they need to be free to respond to changing circumstances quickly and decisively. This means an increased role of supplementary appropriations law and a decreased role for the guarantees embodied in entitlement legislation. It also means a diminished role for parliament, because policy changes have often already been implemented long before the supplementary appropriations proposals reach parliament. Of course changes in entitlements cannot be implemented without parliamentary approval, but here the room for maneuver for parliament is often very small because parliament too is bound to the coalition agreement and has to find its own compensatory savings if it wants to dispute changes in entitlements proposed by ministers, on penalty of putting the cabinet in danger.
- The very inclusive character of the expenditure targets in the Dutch multi-annual framework, in particular the inclusion of mandatory expenditures, diminishes the automatic stabilisation effect. Some social security expenditures tend to fluctuate with the economic cycle, and their inclusion leads to room for new expenditures during economic upswings and to retrenchments during recessions. On the other hand, there are also many entitlements that do not fluctuate with the cycle, like those for health, education, and social security other than unemployment and social welfare, so that this aspect has to be nuanced.
- Fixed expenditure frameworks provide an incentive to loop around budgetary discipline by enacting subsidies and benefits in the form of tax expenditures. Indeed, the Netherlands have seen a considerable increase in tax expenditures since the introduction of fixed expenditure frameworks in the beginning of the 1990s. This problem is being addressed but not yet really resolved.

Fixed expenditure frameworks are not really an “advanced” or “sophisticated” budgetary institution. Indeed, it may be argued that they are much simpler to implement and easier to understand for the political community than many other fiscal rules or policies practiced in the OECD area. Simultaneously they concentrate the mind on the most elementary problem of financial management: that of budgetary discipline. This is important not only for the old democracies of the West but also for many young democracies and countries that are in a state of transition.

### 3.2. The Central Planning Bureau

The Dutch Central Planning Bureau was established shortly after World War II, with a task rather different from what it soon became. Indeed, its conception was very much influenced by pre-war ideas about planning of the entire national economy that existed in circles of the Labour Party, and about corporatist ordering of the private sector that existed in circles of the Catholic People's Party. Although the planning task of the Central Planning Bureau was from the outset designed as advisory and indicative, the idea was certainly that the Bureau would advise about every ministerial initiative in the social-economic-financial domain in order to guarantee central co-ordination. Furthermore, the Bureau would function as the top advisory body for the production plans in the branch-wise ordered private sector. In practice this did not happen (Drees, 1959).

Under the influence of Keynesian ideas, the whole idea of central planning of the private sector was soon abandoned, although specific forms of regulatory interference such as general price and wage regulation continued until the 1970s, and milder forms of intervention through subsidies and tax expenditures continue until today (industrial policy, later technological policy, agricultural policy). The main changes in the tasks of the Bureau that occurred already under its first director, Prof. J. Tinbergen, were: a) the Bureau advised only on specific policy proposals, either at the request of the government or on its own initiative, rather than on all proposals in the social-economic-financial domain, so that the pretended advisory role concerning the central co-ordination of policy in this sphere never took hold; and b) the "central plan" that the Bureau published annually was never (advice for) a central plan but rather a forecast of macroeconomic developments resulting from policies already decided rather than being proposed. Instead of being an advisory body, the Bureau developed almost into its opposite: in its forecasting role, it takes great care in avoiding all normative language or expressions that could be interpreted as recommendations or policy advice. Recommendations only occur in special studies, but there too the Bureau operates very cautiously and tries to make sure that its arguments are based on broad consensus in the scientific community and that its reasoning cannot be criticised as partisan or politically biased. The Bureau can follow these policies because it is based on formal law that guarantees its independence. Indeed, its director is nominated purely on the basis of economic expertise, and it regularly occurs that he (no women so far) is a member of a political party that is not included in the government coalition (which is also the case at present). It seems plausible that it is precisely because of these policies, adhered to meticulously by subsequent directors, that the Bureau has developed into a unique feature of the Dutch institutional arrangement.

How does the Bureau operate presently? I shall concentrate here on the forecasting role, as that is the most interesting part of the Bureau's activity from an international perspective. That role is closely connected to the budget cycle, but also to the quadri-annual establishment of a new multi-annual expenditure framework.

As far as the budget cycle is concerned, the Bureau publishes twice a year a macroeconomic forecast, misleadingly called the "Central Economic Plan (CEP)", and the "Macroeconomic Explorations (MEV)". Both are based on the same short-term macroeconomic model of the economy. The MEV is submitted to parliament and published in September simultaneously with the budget for the upcoming year (coinciding with the calendar year). It contains forecasts for all important macroeconomic variables (output, employment, inflation, imports, exports) including the effects of economic, social and financial policies that have been decided since the last year, including the upcoming budget. In order to allow cabinet to adjust its policies in the light of their effects, the Bureau sends in the beginning of June its provisional views in a confidential report to cabinet, the so-called Queen's MEV. At that date, the outline of the budget (including the net expenditure totals for the budget sectors and chapters of the State budget), including major policy initiatives, has been decided, but adjustments at both the expenditure and revenue side are still possible.

The CEP is published in March. In contrast to the MEV, it does not include the effects of the upcoming budget, which at that time has not yet been decided, but rather provides the basis for the budget discussions through a macroeconomic forecast on the basis of current policy. For that purpose, it updates the forecasts of the previous MEV about the effects of current policies that may turn out differently than earlier expected or that may have been changed by new initiatives or in response to external circumstances (including compensation measures). In addition, the macroeconomic situation may have changed. Preceding the CEP, there is again a confidential "provisional CEP", sent to cabinet in January or February, that is used by the minister of finance during the preparation of his/her expenditure targets. The cabinet decides about the outline of the expenditure side of the upcoming budget (the totals of the budget sectors and chapters of the State budget) in March or April on the basis of an outline letter of the minister of finance which responds to the budget requests by the spending departments.

The Bureau also plays an important role during the design of the coalition programme and the multi-annual expenditure framework, which takes place at least every four years (at a smaller interval if the cabinet falls before completing its term). This role consists of three parts. First, almost a year before the elections, the Bureau puts up a medium-term forecast, assuming unaltered policies. Second, before the election campaign starts, the Bureau

forecasts the economic consequences of the platforms of the major political parties. Third, after the elections, the Bureau forecasts the consequences of the coalition programme and the multi-annual expenditure framework.

The Bureau's medium-term forecast is available at the time the political parties start writing their platforms. Since medium-term forecasting is a more uncertain activity than short-term forecasting, the Bureau often presents various scenarios which represent favourable or less favourable external circumstances. The political parties put up their platforms starting from the Bureau's base projections and aiming at policies that improve the outcomes in the eyes of the voters they want to attract.

Since the elections of 1986, it has become customary that each major political party asks the Bureau to forecast the economic consequences of its draft election platforms (Graafland and Ros, 2003). The Bureau starts from the base assumptions of the medium-term framework and adds to it the measures contained in the party's electoral platform. The results are returned and may lead to adjustments, until outcomes are reached that the party finds acceptable. The Bureau publishes its reports on the election platforms in advance of the elections. These reports play a certain role during the election campaign ("The Central Planning Bureau says that my party will create 15 000 more jobs than your party when in government", "Yes, but only in the public sector, and since your party will increase the deficit by 1.7%, your policies are not sustainable, whereas my party will decrease the tax burden by 0.85% of GDP so that GDP will grow by 2.3% next year and 3.1% in later years"). Whereas in other countries dismissing an opponent's claims about the wonderful economic consequences of his/her proposals is often a favoured weapon of attack, this weapon is more or less cut out now in Dutch politics. Political debate on economic matters has become remarkably technical, but also more responsible (some would say dull). The latter is not so much caused by the fact that debate about consequences has become impossible. That could also have led to more politicisation because politicians have to distinguish themselves by different policies, rather than by different alleged consequences of basically similar policies. Responsibility (and dullness) has rather increased because the more extreme ideas tend to be removed from party platforms, after the Central Planning Bureau has shown not only their beneficial effects, but also their adverse effects, particularly on incomes of specific groups. Another consequence of the involvement of the Bureau with the election programmes is that election programmes have become more precise. Indeed, the Bureau can only make a forecast if a measure is spelled out quite clearly. If a measure is vague in the draft that the Bureau receives (for instance, "increase support for" instead of a precise percentage increase in a concrete subsidy in a concrete law), it will indicate that the party has to make it more precise and that otherwise it will be neglected. This practice has proved to be effective in forcing parties to be precise in their electoral promises.

One could ask why Dutch political parties are willing to have their proposals analysed by the Bureau. Of course it is not only curiosity about what the Bureau has to say about them, but also electoral considerations. The parties seem to fear more the accusation of not daring to face the consequences of their proposals than the possibility of getting a mediocre grade. Submitting their proposals seems to be the less risky strategy, especially since the process is confidential so that proposals can be adjusted until an acceptable outcome is obtained before the Bureau report is published. A party that did not submit its proposals in the parliamentary elections of 2002 was the List Pim Fortuyn. Apparently this did not harm the party because it became in one blow the second largest party in parliament, even though its leader was murdered a few days before the vote. Since then, the List Pim Fortuyn has declined and, some say, been incorporated into the traditional political culture of the Netherlands. Perhaps the party will even submit its programme to the Bureau at the next elections! Nevertheless, the political discontent that suddenly erupted in 2002 has not entirely disappeared and may surface again. It remains to be seen whether the discipline on the side of the parties that makes possible the role of the Bureau will be proof against the political struggles of the future, which may be of a rougher kind than we have seen in the last two decades.

After the election, the Queen nominates an adviser, called “informateur”, who has to negotiate with the party leaders in order to reach agreement about a coalition programme including a multi-year expenditure framework. The adviser will ask the Central Planning Bureau on several occasions during his/her work to make forecasts about the economic consequences of the proposals on the table. This information might be reason for the negotiating parties to change their minds. Sometimes Bureau information is so damaging for a draft agreement that has been hammered out in a long and painful process that the intended coalition breaks down and other parties have to be brought into the negotiating process. This happened on the occasion of the last cabinet formation (beginning 2003), when the Labour Party was removed from the intended coalition after two months of negotiations and was replaced by the Liberal Party. At the end of the process, the coalition programme will be published, including the Bureau’s forecasts for the cabinet period. The coalition programme will also contain the expenditure framework (total net expenditure and net expenditure per budget sector and State chapter for the entire cabinet period). The coalition programme is an important document because it cannot be changed partially without undermining the entire structure and thereby the cabinet as such. Over the last 20 years, there have been partial revisions of coalition programmes, but only rarely, and under very particular external circumstances.

Having an independent bureau responsible for the official economic forecasts of the government has the advantage that the forecasts cannot be influenced by the cabinet of the day. Cabinets always tend to paint black scenarios about the course of affairs they found when taking office, and rosy scenarios about the consequences of their own policies. This is impossible in Holland, as far as economic forecasts are concerned. Other OECD countries sometimes lean on private sector research institutes to attain the same objectivity, for instance Germany and the United States (for a comparative perspective on institutional arrangements, see the work of Hagen<sup>2</sup>). However, research institutes use different models which lead to different results. Taking averages as is done in Germany and the United States is a solution, but makes it impossible to have a discussion about the theoretical backgrounds of the numbers that are actually used (because different models may have different theoretical backgrounds). Of course, lively competition in macroeconomic modeling and forecast information in a country helps to improve quality, but for that purpose it is not necessary to do away with an official forecast institute. The fact that an official forecaster is held accountable in the scientific community for its errors, especially in the presence of alternatives, tends to work as an effective incentive as well.

## **4. Delivery institutions**

### **4.1. The non-profit sector**

Holland has a uniquely large private non-profit sector. This goes back to the 19th century when the large confessional communities (Catholics, various kinds of Protestants) established their own schools and pre-welfare State health and social security organisations. In the beginning of the 20th century, the labour movement established its own non-profit sector. Later in the 20th century, the welfare State was built upon the existing “pillar structure” in the private sector rather than being raised from the ground in the public sphere, as happened in other countries. The welfare State led to a large extension and public funding of the services of these organisations, but the organisations themselves remained in the private sector.

Funding is given in the form of subsidies (in the legal sense), but because the organisations are non-profit, these flows are not considered as subsidies in the economic sense. Hence they are denoted here as public contributions.

Private, non-profit organisations usually exist alongside public, often municipal organisations that provide the same services and that are funded on an equal basis by the central government. These flows, too, are denoted as public contributions. The private, non-profit sector dominates primary and secondary education (70% of public funding in 2003 went to private schools). It also dominates the health sector (for instance, 100% of public funding for

hospitals, residential care for the elderly, and residential and daycare for the handicapped goes to private suppliers). In general, approximately 25% of net central government expenditure (including social security and health care) goes to the private, non-profit sector.

The private, non-profit sector provides services that have the character of “private goods” in an economic sense. In principle these goods could also be provided without public contributions, but that would reintroduce the equity problems that existed before the development of the welfare State. Public funding solves these problems. However, keeping the service providers in the private sector has two advantages.

First, because they are private, these providers own their assets and can decide autonomously about their budgets. Regardless of legal status (usually foundations or associations), a financial surplus can be said to be owned by “residual claimants”. This implies that private, non-profit organisations are subject to an efficiency incentive that public organisations are lacking. This motive has regard to cost efficiency (producing goods at minimal costs) as well as to allocative efficiency (producing goods that maximise consumer welfare). The profit motive, which consists in the transferability of profits to the private income of owners, is not necessary for that purpose.

Second, because free choice among clients may be maintained, service providers are often (not always) subject to competition. Competition strengthens the efficiency incentive implied by private ownership. This is the case because competition implies that high price or bad quality not only decrease demand for the service of the provider but in principle abolish it.

The example of primary and secondary education gives an illustration. Roughly two-thirds of schools in these sectors are private. Private and public schools are financed on an absolutely equal basis by the central government. This applies to all employment costs. If a public school receives a certain amount per pupil for cleaning of the school building, a private school receives exactly the same amount. In a certain sense the funding arrangement is even more favourable to private than to public schools because municipalities are not allowed to provide discriminatory additional funding to their own schools. Every euro the municipality spends on its own schools in addition to the central government contribution has to also be given to all private schools within the municipal borders on the same basis. In contrast, private schools are free to spend on their own schools in addition to the public contribution. In practice, most private schools limit their fees to the funding for fringe benefits: excursions, sports facilities, teaching of voluntary subjects, and sometimes a smaller average class size. Private schools generally do not pay higher salaries to teachers.

This arrangement works exactly like a voucher system. Whereas in other countries (France, Germany, United Kingdom, United States) public funding of private schools remains a highly controversial issue, in Holland equal funding of private schools exists since 1917 (when it was laid down in the constitution) and has since then not been disputed. Public funding of private schools has been accompanied by full parental choice and competition. However, here there is some room for policy. In principle, parental choice would entail the right to establish a new school if minimal attendance standards are fulfilled and the closing down of schools if attendance falls below minimal standards. Indeed, school establishment rights and minimal attendance standards are laid down in the law, but in practice municipalities are keen to avoid the closing down of schools and may delay the establishment of new schools, especially if they are judged to contravene ethnic integration policy (for instance, Islamic schools). Municipalities can do this because they are responsible for the construction of schools, both private and public (investment in the outside as opposed to the inside of schools). In view of the constitution and the law, such maneuvering must take the form of voluntary co-operation between schools, but this does not always work smoothly. In the last few years, this has led to some new discussion about certain aspects of the equal funding principle, but it is not plausible that this will lead to a major revision given its constitutional anchoring and the vested interests of the private sector.

The education example also shows that private service provision in combination with competition is not an absolute guarantee for efficiency and quality. Indeed, during the last 40 years (starting in the mid-1960s), Holland has seen a similar degradation of its educational system, particularly in secondary education, as have many other European countries. However, this had to do with the regulation of course structure and content, which is the same for public and private schools, and not with funding methods. In Holland, as in other countries, educational policy has fallen prey to progressive educational reformers who thought that children with gifts for practical work could best be educated by keeping them away from anything practical in order to allow them the privilege of prolonged contact with their more intellectually inclined peers. Similarly, the government has weakened selection, has not extended school budgets in proportion to increased demand, has retrenched on teacher salaries, has let performance and examination standards deteriorate, and has encouraged school mergers.<sup>3</sup> In all these aspects, Holland is not different from other European countries. Nevertheless, it can be said that the voucher system and competition have had a certain mitigating effect on these adverse developments. Although private schools are subject to the law, they have proved creative in interpreting it, thus attracting pupils. Also the dominating presence of the private sector has induced a sentiment, both on the part of the private school

unions and on the part of parents, that “the school belongs to us and not to the politicians”, which has shored up resistance against too bizarre proposals.<sup>4</sup> Furthermore, in recent years increased recognition of what has happened has brought the ideals of social reform through educational reform into disrepute. This has also led to a certain recognition by politicians that schools now need tranquility for a number of years.

#### **4.2. Arm’s length agencies**

Executive agencies at arm’s length distance from the central government are a relatively recent phenomenon in the Dutch public administration.<sup>5</sup> Arm’s length agencies – henceforth called agencies – were first proposed in an interdepartmental policy study of 1991. This report was influenced by the ideas of New Public Management. The central argument was that efficiency could be improved when managers of executive agencies would obtain more liberties concerning inputs, such as personnel formation, contracting out, and cash management (including borrowing and saving). In return, agencies should be entirely transparent about their prices and the quality of their products. Such transparency would require an accrual system of accounting, the definition of products, and the computation of prices per product. The minister would remain fully responsible for service provision by the agency. The report was also inspired by the development of Next Step agencies in the United Kingdom that in 1991 had already been under way for some time.

In reaction to the report, the cabinet decided to establish four agencies, namely by defining the status of agencies in administrative rules and by attributing this status to four departmental divisions. In the following years, the number of agencies gradually grew. Many ministerial divisions wanted to obtain the new liberties, and many saw that the new control regime on outputs was less constraining than the former one on inputs. In the beginning of 2004, there were 30 agencies, and 16 departmental divisions were in procedures to become an agency. Present cabinet policy is that gradually all executive divisions of ministries have to be agencies. The reorganisation has led to a complete overhaul of the central government. When it is complete, 80% of central government employees will work in agencies and only 20% will remain in the core ministries. It will have been one of the most far-reaching reforms to have taken place since the establishment of the Kingdom in the early 19th century.

In general it can be said that both agencies and core ministries are reasonably content with the results obtained so far. Agencies appreciate their new freedoms and would like to have them even further expanded. Core ministries appreciate the output and price information that has become available, however precarious its quality and coverage. Particularly, core ministries feel that the increased distance from the agencies enables them to

consider more objectively the performance of the agencies against the background of the alternatives: decentralisation to subnational government or contracting out. At the same time, the availability of the alternatives enables them to put more pressure on agencies to improve cost efficiency and to decrease prices.

Less enthusiastic so far have been the Court of Accounts and parliament. Already in 1998 and 1999, the Court of Accounts criticised many shortcomings in the financial management of agencies. In particular the Court considered the quality of information about costs and service quality as insufficient, as well as the way the core ministries used that information. Cabinet reacted to this criticism in 2000 with new regulations. Moreover, under pressure from parliament, cabinet was obliged to announce a moratorium on the establishment of new agencies until the shortcomings were corrected. In 2002, the regulations for the financial management of agencies were stepped up again. What is conspicuous in this process is that in all its reports the Court of Accounts is very critical about the financial management of agencies but does not challenge the main direction of cabinet policy. Indeed, it underscores time and again that it fully agrees with the basic ideas, namely:

- the separation of the financial management of executive agencies from that of the core ministries and the transfer of authority for the production process to the agencies;
- funding of agencies on the basis of outputs;
- adoption of an accrual system of accounting for the agencies.

What the Court criticises is that the cabinet proceeds full speed with the establishment of new agencies and the abolition of input controls whereas the conditions are not fulfilled:

- There is no complete separation of financial management from the core ministry: agencies keep using ministerial facilities without being charged for these services.
- Agencies are in many cases not funded on the basis of outputs, but on the basis of a lump sum only weakly related to performance.
- The accrual system in many agencies is still in its infancy and does not work properly.

It seems likely that the problems identified by the Court of Accounts will be solved in the near future. However, there are two other, more fundamental problems that may be harder to solve. These problems are:

- Agencies do not differ from the former ministerial bureaus as far as efficiency incentives are concerned: such incentives are lacking in both cases.

- In general, quality of outputs cannot be specified before the start of the production process.

These problems are of a microeconomic nature and have not always been recognised in the new public management literature that has inspired the agency initiative.

As far as the efficiency problem is concerned, there is often a naive idea in the new public management literature that the separation of financial management will lead to a cost efficiency incentive because it would imply that the agency can “keep the efficiency profit”. Although it is true that the separation of accounts would allow the agency to keep the efficiency profit,<sup>6</sup> it has no incentive to do so. The reason is that managers of agencies cannot take home profits and there are no other “residual claimants” in the agency who might have an interest in profits. Therefore it is always preferable to agency managers to drive up production costs by increasing salaries and non-salary benefits to employees than to create an efficiency profit. Indeed, if a minister discovers persisting efficiency profits under existing unit or lump-sum prices, he/she might be tempted to diminish the price or the lump sum. Instead of being subject to an efficiency motive, agency managers are subject to an inefficiency motive, namely to maximise benefits to employees, including themselves. In this respect, there is no difference at all between traditional ministerial bureau chiefs and agency managers. Perhaps the opportunities of agency managers to divest money towards employee benefits are even larger. Without adequate remedies, it is thus to be expected that agencies are less rather than more cost efficient than regular ministerial divisions.

As far as the output specification problem is concerned, the problem is well known from the private sector. In branches where competition works, efficiency is enforced by competition, not by the specification of outputs. In branches where there are hold-up problems due to product-specific assets or uncertainty, efficiency is enforced through an iterative process of output specification, in subsequent stages of the production process. This holds for the entire private service sector, for instance, catering, construction, software services. Although the contract starts with a price and a roughly indicated performance, the real specification of performance takes place only during contract execution. The original contract is called an open contract. The most obvious example of an open contract is the labour contract, which only specifies a salary and a job description. Concrete tasks are only assigned during the contract execution. In the microeconomic literature, the process of filling in an open contract is called “relational contracting” (Williamson, 1985). It is the main mechanism for efficiency control in the presence of a monopolistic supplier. This body of theory is entirely applicable to the public sector where agencies also enjoy monopolistic advantages. Any attempt to fix quality criteria in advance of production will lead to the syndrome of soviet

economics, in which the incentive to serve clients is replaced by the incentive to achieve planning targets. It is remarkable that this insight, which is more or less common sense among economists, has had so little impact on the new public management movement and, for that matter, on the debate about performance budgeting.

If residual claimants and competition are lacking, cost efficiency and service quality must be controlled by the client. For that purpose it is essential: a) that the client receives good information on costs; and b) that the client is allowed to interfere at any moment in the production process to bring down costs or specify quality, even if this means renegotiating the contract (including the price). The value of the agency initiative consists in the improvement of the information on production cost, not in improved incentives. Information is improved because the financial administration of the agency is completely separated from that of the core ministry and overhead is included in agency costs. Furthermore, the accrual system allows the computation of a unit price or a lump-sum cost-price for the services the agency produces.

Iterative quality control through relational contracting is thus by far the least developed part of the agency initiative. Nevertheless, this aspect is now the top priority of the co-ordinating ministry of finance, and its importance is gradually recognized by the wider financial management community. Basic ideas that are more or less agreed are:

- Relational contracting requires expertise and should be concentrated in (a) special unit(s) in the spending ministries.
- Relational contracting requires permanent negotiations between agencies and core ministries about the quality of price information and the quality and quantity of services delivered.
- Core ministries should hold specific legal competences to inspect and monitor the production process in agencies.
- Within spending ministries, two different roles with respect to agencies can be discerned: the ownership role which focuses on cost efficiency, and the client role which focuses on quality of services (allocative product efficiency<sup>7</sup>). The ownership role can best be taken on by the financial division of the spending ministry, the client role by the policy-making division (the division that has made the policy that the agency is executing).

A point that is still being discussed is where the interface unit(s) in charge of relational contracting should be located within the spending ministries and, related to that, who should take the lead in the supervision of agencies: the financial directorates or the policy-making directorates. In view of efficiencies of scale, it seems attractive to concentrate the supervisory role in a single unit in the financial directorates, but if this solution is chosen, it is

essential that the policy-making directorates are given a clear auxiliary role in the actual control and contracting task, because they are the only ones who really can judge service quality.

## 5. Conclusions

Fixed multi-annual expenditure frameworks and the strong role of the Central Planning Bureau are two features of Dutch budget institutions that are uncommon in the OECD area. Both institutions might – in some form, modified and adapted to local circumstances – be useful and attractive to countries in a transition process.

The single largest advantage of fixed expenditure frameworks is that they bring tranquility to the budget process and that they allow spending ministers to plan in advance. The most difficult aspect of the frameworks is that they require strict budgetary discipline and a certain flexibility in existing expenditures in order to adapt to new developments through reallocation. This tends to weaken the position of parliament and to strengthen that of spending ministers. However, in political systems with a “weak” minister of finance, which is usual in multi-party parliamentary systems, this should be seen as an advantage rather than a disadvantage.

The establishment of an independent central forecasting bureau might also be a useful step for countries in transition. In order to avoid risks of political bias, a forecasting bureau in a transition country should probably focus on forecasting and relinquish an advisory role. Even if political parties are initially suspicious and reluctant to consult the bureau on the consequences of policies, the mere existence of the bureau may lead in the longer run to a more disciplined debate about financial and economic policy.

Perhaps the main idea to remember about the huge Dutch non-profit sector is that there is an alternative for State-dominated service delivery in education, health and social services, without sacrificing solidarity with low-income groups. The modern name for this idea is vouchers, but in Holland this idea goes back to the 19th century. It simply means that there is competition between alternative suppliers and that public funding follows the client rather than the supplier.

Finally, as far as agencies are concerned, it is important to keep in mind what the essence of the reform is, what it will achieve, and what it will not achieve. The essence is that the financial management of the agency is fully separated from that of the core ministry, that the agency produces cost-price information on the basis of accrual accounting, and that it is financed on the basis of a unit or lump-sum cost-price. What the reform achieves is good information on service costs, which makes it possible to assess cost efficiency and to compare agency performance with market alternatives. What it does

not achieve is providing an incentive for cost efficiency or service quality to agency management. For that purpose, relational contracting is essential. Given that the task of relational contracting requires expertise, it may be advisable to concentrate it in a special unit of the financial directorate of the spending ministries. The actual supervision of agencies requires the expertise of the policy-making divisions of the spending ministries. A way to bring this expertise to bear is to include representatives of these divisions in the teams that are charged with the monitoring and renegotiating of agency contracts.

## Notes

1. The United States had periodical expenditure frameworks as well under the Budget Enforcement Act (1990). This Act specified ceilings for discretionary expenditures for a number of years and required compensation for all policy changes in revenues and mandatory expenditures. Revisions and extensions of the ceilings took place towards the end of the periods. The Act expired in 2002. The present administration wants to revive the Budget Enforcement Act and make its planning period equal to that of the president's term in office (Blöndal et al., 2003).
2. For instance: Hagen (1992); Poterba and Hagen (1999).
3. For years school mergers were openly advocated on the basis of "economies of scale", flowing from the prevailing funding systems. This was of course flawed reasoning, since economies of scale cannot be derived from funding systems. Indeed, optimal school size is very hard to determine, but parents, children and teachers seem to prefer schools that are quite small and such preferences should not easily be discarded.
4. In the United Kingdom, for instance, the grammar school was abolished in the 1960s, thus effectively closing down a recognised expressway for smart children from low-income families to the academic top. In the Netherlands, a similar proposal to abolish the "gymnasium" (with an emphasis on the classic languages in addition to the regular programme preparing for university) has been defeated. Now the gymnasium is one of the fastest increasing and flourishing forms of secondary education.
5. Arm's length agencies should not be confused with independent public corporations funded by government. Independent public corporations are a common phenomenon in the entire OECD area. However, the problems described with respect to the financial management and supervision of agencies also apply to public corporations. In Holland, the developments in this domain are more or less similar for agencies and public corporations.
6. Agencies are allowed to "own" (in an administrative sense) assets to the value of 5% of their average income in the last three years.
7. There is also allocative factor efficiency, which is part of cost efficiency.

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