The Challenge of Decremental Budgeting

by

Daniel Tarschys*

At the start of the decremental decade of the 1980s, governments encountered many difficulties in making ends meet. This article discusses some of the problems of post-expansive stagnation and the merits of certain techniques such as indexing, global norms, decentralising hard choices and the well-balanced package.

* At the time of writing, Daniel Tarschys was MP, Ministry of the Budget, Sweden. This paper was written for the second meeting of OECD Senior Budget Officials, 2-3 June 1981, as the background paper for the discussion on formulation and implementation of resource reallocation decisions.
Introduction

In June 2009, the OECD Working Party of Senior Budget Officials (SBO) celebrated its 30th anniversary. In a context of financial crisis, the SBO recalled its origins and some of the pressing topics of that time: off-budget and tax expenditures, budgeting for entitlements, and the agonies (challenge) of decremental budgeting, to name a few. Discussion papers were written on each of those topics, and the first two were later published in the OECD Journal on Budgeting. The SBO decided in June 2009 to continue its policy of disseminating its work, and decided to publish this additional discussion paper from its second meeting in 1981. Some of the techniques described here have been revisited over the years, as the SBO continues to explore and develop ways to improve the budget process.

The agonies of decremental budgeting

Is it merely an illusion that government budgeting is becoming ever more difficult? Old hands in the business like to remind us of fiscal years in the past that were just as bad as the one we are now beating our brains about. Yet as we enter the “decremental decade” of the 1980s, there are at least some reasons to maintain that the problem of making ends meet in public finance has indeed become more intractable than it used to be.

First of all, there is the general downturn of the world economy and the tendentially rising rates of inflation. Virtually all OECD countries have come to feel the pangs of post-expansive stagnation. While the recurring oil shocks are often advanced as the most important triggers of the deceleration of growth and acceleration of inflation, the causal pattern behind these developments is of course much more complex. At any event, the result has been the simultaneous weakening of revenue bases and exacerbation of demands on public resources.

Second, there is the unusually strong thrust of established programmes and transfers. No earlier recession has ever hit governments with so wide a spectrum of activities and responsibilities. The introduction of planning and the proliferation of entitlements and public services in recent decades have given the evolution of the modern state a particular momentum. The ratio of government expenditures to gross national product (GNP) has continued to increase throughout the western world, and in many countries it has attained levels that were previously considered as inconceivable and self-destructive. The predictions of strategic ceilings for public spending – Leroy-Beaulieu’s 12-13% of GNP, Clark’s 25% of GNP, and Friedman’s 60% of GNP – have all been surpassed.

Third, there is the remarkable immobility of highly mobilised societies. Modern industrial states exhibit many signs of institutional arteriosclerosis. With a vast number of interests organised, articulate, and well-entrenched, the established social structure has become more impervious to change, and efforts to set new priorities meet with stubborn resistance. Increased rationality at the top collides with increased rationality in all other parts of the system. Whether “overloaded” or not, modern governments find it increasingly hard to cope
with the huge empires nominally under their control. And this becomes particularly evident under economic austerity when turfs are defended with great skill and vigour.

While there is always room for the argument that tough choices are the heart and soul of the budgetary process under any circumstances and that difficult decisions must be made whether the economy is flourishing or collapsing, these features intertwined with each other do add new dimensions to the conventional problematique of public resource allocation. Today’s budgeteer carries a burden which at least in some respects seems heavier and unwieldier than that of his/her predecessors. How is it handled? As we look across borders, there appear to be many common traits in the current budgetary strategies of different governments. The diffusion of new ideas is relatively rapid, but it could probably be even more rapid and even more efficient than it is. And such diffusion is particularly important in an area where the life expectancy of new inventions is rather short. In budgeting, many new techniques work well for a while until spending departments learn how to cope with them; then they may still work, but not so well. To retain their lead, budget officers have a lot to gain from the creative imitation of their colleagues. The purpose of this paper is to introduce some problems that might fruitfully be discussed by senior budget officials.

1. Indexing

Under inflation, successive adjustments must be made to wage and price increases. Yet by what mechanism, by what standard, and how often? This has emerged as a major problem in contemporary policy making, and in the present squeeze the finance ministries of many countries appear to spot interesting potentials for economies in a more careful and sophisticated design of such adjustment procedures.

The pros and cons of indexing are well known. Spending ministries, transfer recipients, and other beneficiaries of government outlays all press for long-term commitments in real terms. Indexing promotes stability and security in policy programmes and facilitates multi-year planning. But on the other hand, it also ties the hands and feet of future decision makers. With a very large proportion of the public outlays subject to automatic adjustment, the remaining scope for discretionary decision making will shrink considerably and may disappear entirely with a weak development on the revenue side. Indexing of expenditures may also be hazardous for price stability; if cost increases are fully compensated for, there is little to hold back demands for higher prices and wages in the public labour market and in the provision of goods for the public sector.

In view of these drawbacks, there seem to be many second thoughts about indexation at present. A number of governments are involved in attempts to tinker with the established systems. In Italy, proposals to change the construction of the *scala mobile* have been highly controversial. A famous but unsuccessful attempt was made a few years ago by the West German government to adapt the adjustment of old-age pensions. In Denmark, the government has introduced the concept of the “social wage” which eliminates some elements of personal income from the base used for computation of certain social benefits. In Sweden, energy prices and indirect taxes have been deleted from the index base employed to adjust the value of social benefits and the central government income tax. The government has also declared its intention of reviewing the whole bulk of government expenditures with a view of scrapping indexed adjustment mechanisms wherever that appears to be feasible.
Some key considerations at present in the field of adjustment to inflation seem to be the following:

- To what extent should commitments be made in real terms and mechanisms for automatic adjustment thus be built into policy programmes? Is it possible to scrap such mechanisms entirely in some areas and return to discretionary annual adjustments? Or is it preferable to opt for semi-automatic arrangements such as adjustment by specific institutions (boards or arbitrators, bipartite or tripartite commissions, legislatures, etc.)?

- Can further gains be made by centralising the adjustment procedure and/or homogenising the methods employed in it? An alternative strategy is to differentiate between policy sectors or budget items, constructing various computation techniques for different kinds of outlay.

- What is the proper basis for indexation? In most countries, the systems are tied to either wages or prices. During the 1970s, however, there appears to have been a trend towards more composite bases. Many countries now index by a mixture of prices and wages, while others have tried to eliminate particular ingredients from their baskets (indirect taxes, energy, etc.).

- How often should adjustments be made? Under trigger-operated systems, the key variable is the magnitude of the thresholds. Otherwise, the adjustment costs will depend mainly on the length of the predetermined intervals. The construction of automatic adjustment mechanisms is a promising field for new technical inventions.

- Should the compensation be full or partial? While spenders or recipients always press for stable commitments, ministries of finance tend to prefer systems where allowance is made for assumed productivity gains or where there are other incentives for spenders to resist inflationary pressures.

2. Global norms

The Keynesian revolution, whatever its merits, must be blamed for one significant lacuna in contemporary budgeting: the lack of solid standards for the evaluation of deficits. In the 1960s and 1970s, we learned that balancing the economy was more important than balancing the budget. Spending departments were particularly keen to pick up this message. Yet what is to be done when both the economy and the budget are out of balance? Governments in many countries now seem to be groping for some artificial norm to replace the dethroned ideal of equilibrium between revenue and expenditure. The purpose of such a norm is to reinforce budgetary discipline by imposing strong restraints on all actors involved. While the norm performs important functions as a confidence-building signal to the domestic and international environment, its most immediate task is probably to commit the governmental apparatus itself to budgetary stringency.

The global norms now in use relate either to total spending or to the government deficit. In some cases, the targets are internal to the government budget in the sense that they define a ceiling for debt financing of public outlays without any reference to the economy at large. Thus, the recommendation made by the Japanese Fiscal System Council in 1967 prescribed that the rate of reliance on government bond issues should be reduced to less than 5%. In 1979, the figure was set at 10%. A more frequent solution, however, is to link either deficit or expenditure to the GNP. In the Swedish case, the recovery plan presented by the government in the 1980 supplementary budget announced that the budget deficit ought to be reduced by 1% of GNP in each of the next few years. The United Kingdom has set goals...
for its balance in terms of money supply and the public sector borrowing requirement (PSBR),
and the Dutch have declared that a deficit exceeding 4-5% of the net national product is
inconsistent with a satisfactory external balance and a reasonable share of the capital
market for the private sector. The norm of the Canadian government sets a limit for the
annual increase of public spending. In the Canadian White Paper of 14 October 1976, Attack
on Inflation, it was declared that the trend of total spending by all governments should not
rise more quickly than the trend of the gross national product.

The new norms have been successful in some ways but less successful in others. The
general impression seems to be that the norms have indeed contributed to budgetary
discipline. Budget officers have found them invaluable in their continuing dialogue with
the spending departments. Yet it is also irrefutable that far more targets have been set than
met. There may be a strong case for enunciating norms even if they turn out to be
unrealistic, but if they are hardly ever attained their symbolic power is likely to wane after
a few years. The value of implausible targets must be assessed both from a political and an
administrative viewpoint. For the government, the question is whether the short-run
benefits of declared firm intentions outweigh the risk of being ridiculed by the opposition
for not having achieved one’s objectives. And for the budget officers, there is always a
question of preserving authority and credibility in relation to the spending departments.

There is a strong need for comparative cross-national evaluations of the use and
effects of global norms. Such studies could shed light on, inter alia, the following three
problems:

● What degree of scientific legitimation could be offered for global budgetary norms?
Some governments have preferred to present their targets as a volitional commitment to
a certain social development, without any sophisticated scholarly underpinnings.
Others wrap up their objectives in popular versions of current economic theories:
monetarism, public choice, the concept of crowding out, the Laffer curve, etc.

● Exactly what should be related to what? A main reason why so many governments have
failed to reach their targets has been their inclusion of uncontrollables into the
objectives or quotas. A recent trend is therefore to refine the concept of public outlays so
as to delete items that may ruin the whole enterprise or that seem irrelevant to the
established targets. There may also be other motives for distinguishing between
different types of expenditure. In Japan, for example, there are statutory rules against
debt financing of expenditures other than those for public works, investments, and
loans. This is known as the principle of construction bonds. While the government has
been unable to observe this principle in the 1970s and has had to resort to special deficit
financing bills, there is now a goal to restrain public bond issues within the amount
permitted by the principle of construction bonds by the fiscal year of 1984.

● An unresolved problem is the reconciliation of global norms with the requisites of
stabilisation policy. The beauty of global norms lies in their stark simplicity; they are
easy to propagate and to apply. Yet by the same token they may be too rigid from the
viewpoint of conjunctural policy needs. A possible solution is to formulate norms in
terms of multi-year goals allowing for some fluctuations along the road, but this may
also lead to a weakening of the useful restraints on the spending departments.
3. Hard choices decentralised: frames, envelopes, caps, ceilings, limits, lids, and cheese slices

The success of ministries of finance depends to a great extent on their ability to spread the treasury spirit in wider circles. The enormous amount of budgetary problems engendered by the modern government apparatus and modern society cannot all be solved at the top. Ideally, all administratively financed organisations should be imbued with the same thrift, imagination, flexibility and courage to terminate obsolete activities and commitments. In the real world, these virtues are not quite as diffused as would be desirable, and certain educational instruments are therefore employed to enhance them. Many of these are physical restrictions aimed at decentralising hard choices.

The **frame** is a finite sum of money appropriated for a particular sector or set of programmes, often defined as a multi-year commitment. Sweden’s defence expenditures are locked into a frame determined for a span of five years, and all emerging needs in this sector must be met by making reductions inside the frame. This has strengthened pressures for rationalisation and promoted the useful competitive dialogue between critical semi-experts (navy versus army, etc.) which is so often lacking in fields where the aspirations of one profession are not as dependent on restraint as in another. But efforts to apply the frame method to other budgetary sectors have not been successful as yet. A main obstacle appears to be the lack of natural boundaries for the lumping together of different programmes.

The **envelope** system recently introduced in Canada implies the setting of government-wide expenditure targets for nine policy sectors. Major budgetary decisions within these sectors are delegated to the Cabinet Committee on Priorities and Planning and to policy committees on social development, economic development, foreign policy and defence, and government operations. A similar system is under consideration in New Zealand.

Experiments with **caps**, **ceilings**, and **limits** of various kinds are under way in many countries. The United Kingdom has taken a lead in the use of cash limits. Staff ceilings are widely used. A tougher version is the global or selective restriction of new recruitment. Under the Finnish system used a few years ago, vacant positions were left unfilled until the matter had been considered by the ministries. In New Zealand, departments are directed to shed 1.5% of their staff annually by attrition or transfer. The disestablished positions are then available for reallocation to high priority areas. The mechanism is known as the **sinking lid**. In still other countries, selective limits are imposed on the resource use of different agencies or sectors. Multi-year staff reduction plans are common in phasing-out situations.

A universal technique in austerity budgeting is the across-the-board cut fixed at a certain percentage of the previous year’s outlays. In Swedish budgetary jargon, this instrument is known as the **cheese slicer**. Across-the-board cuts sometimes take the form of undercompensation for inflation or the deduction of assumed productivity gains. The widespread popularity of the method is probably connected with the minimum of information requirements and conflict costs involved in its application. When there is little unity or courage in political and administrative leadership, the cheese slicer is frequently the easy way out of a financial squeeze. While it fails to discriminate between high and low priority areas and areas with different potentials for savings, it has at least the appearance of being fair. Its chief merits lie in its simplicity and comparative acceptability. In contrast to selectively profiled approaches, the use of the cheese slicer entails no stigmatisation of particular programmes or agencies. But its negative sides also deserve close attention. Cutting the cat’s tail inch by inch is not always easier than performing one single operation; after some years, small annual
cutbacks tend to undermine both employee morale and operational efficiency. Another hazard is that repeated cheese-slicer cuts may contribute to a gradual deterioration of the resource mix, since various untied expenditures vital for the sound operation of the programme or agency will often be the first to be sacrificed. A third problem is that the cheese slicer will often be handed down to the bottom of the organisational hierarchy. The across-the-board cut is ideally a method of delegating authority to organisational levels that have a better overview and understanding of priorities and potentials for savings, but the recipients may often be tempted to pass the buck even further.

A more general problem inherent in most of these techniques is their endemic bias for preserving established programmes. When confronted with a demand to cut back expenditures by, say, 3%, few political or administrative leaders will have the energy to save 5% in order to make room for new policies. Yet if modern governments are to be saved from stagnation in the present economic situation, such redeployment manoeuvres are very much called for. In the further development of physical restrictions, it would probably be useful to give more consideration to the needs for mobility, flexibility, and innovation. The “tit for tat” idea practised in many countries – meaning that an administrative unit may use the money it manages to save for other purposes – appears to be one promising road towards this goal.

Physical restrictions also entail great circumvention risks. If there is a ceiling for the use of one “currency” – such as manpower or government funds – spending departments and agencies often find other ways of achieving their ends. Consultants could be hired instead of new regular staff, regulation may be used as an alternative to the purchase of services, and new slack may be created by reducing the quantity or quality of the agency’s output. Well-known to the students of the “success indicators” problem in socialist economies, these distortions deserve close attention in the design of budgetary steering mechanisms.

4. The well-balanced package

Budgets in themselves are decision packages. In promoting the principles of the unity and the comprehensiveness of the budget, administrative reformers of the past have tried to escape from the financial laxity that so often follows from disjointed decision making in economic affairs. While spenders generally prefer to have their projects considered separately and ad hoc, budgeteers have a predilection for lumping things together and weighing one demand against all others at one time. This creates a natural tension in government offices, as budget ministries want to defer to the annual budget exercise questions that spending ministries insist must be settled by next Tuesday.

With the high pace and pressure of modern government, however, the ideal of annual decisions on everything is becoming ever more unattainable. Urgent matters arise that cannot be held back. “Fire brigade” operations are often requested, and the not-so-fine tuning of the economy that is prompted by the need to handle excessive demands in the labour market will frequently necessitate large-scale interventions at irregular intervals. Thus, most industrial societies are now growing used to the miniaturised version of the budget known as the government’s “new economic package”, the “mini-budget”, the “emergency brake”, the “cutback plan”, the “September arrangement”, the “November agreement”, or the “December settlement”. The noble art of packaging is becoming an important branch of budgetary wisdom.
Why are proposals so frequently thrown together into a bundle and presented at the same time? There seem to be several motives. One is the aim of critical mass: if the government is out to show its muscle, the sheer number of measures may help make the desired impact. Another and frequently more important motive is the need for political balance. Most packages emerge from deals between the government and other political and/or economic forces. By connecting a number of disparate proposals, the negative effects of some measures to certain concerned groups will be neutralised by other policy changes in a more favourable direction. In the well-balanced package, there is good news and bad news for everyone, and even if the bad news dominates, the ambiguity of the package helps mollify resistance.

Many empirical as well as normative questions about packages have as yet no answers. What are the typical techniques of composition? How are packages best presented? To what extent can future gains expected to result from proposed sacrifices in the short run be appreciated and visualised? Cross-country comparisons of policy packages and appraisals of their political and economic impact might be of great value for future efforts in this area.

5. Conclusion

In an expanding economy, the finance ministry can normally sit back and wait for others to report cost increases and to propose policy changes. Its own job will be to look into the dark corners of these reports and proposals, ask pertinent questions, and practise sound discrimination. Yet this less active role will not suffice in a society where the general growth rate has dwindled while the growth rate of public expenditures, through all built-in expansive mechanisms, remains unperturbed. With decremental budgeting on the agenda, budgeteers may have to assume a more active role in the process of policy development. When it comes to economies, cutbacks and rationalisation, spending agencies are not as eager to bombard headquarters with fresh suggestions. Institutional and procedural innovations as well as new methods of policy design and accountability will probably be needed to uphold some measure of control over public expenditure.

The national contributions to the 1980 and 1981 OECD meetings of senior budget officials reflect the widespread concern about weaknesses in current procedures and the universal search for new approaches. While the grand panaceas of the 1960s and 1970s – planning programming budgeting systems (PPBS), zero-based budgeting (ZBB), rationalisation des choix budgétaires (RCB), etc. – are slowly fading away and the reformist mood is now tilted towards piecemeal engineering and muddling through, the philosophy behind the magic acronyms is not dead. If used sparingly and with great discrimination, the tools of programme budgeting can still be of great relevance in the present economic predicament.

Yet their impact is much dependent on the extent to which some of the classical principles of budgeting will survive. The idea of the unity and comprehensiveness of the budget is now under a triple threat. First, there is the tendency towards an increasing number of ad hoc decisions and packages, noted in this paper. Second, there seems to be a general loss of central control, as a growing number of appropriations are entrusted to autonomous and semi-autonomous bodies such as state governments, municipalities, corporations, quangos (quasi-autonomous non-governmental organisations), and the
like. Simultaneously with the rapid expansion of public expenditures, the state appears to be withering away through the proliferation of independent units. And third, there is the great variety of “currencies” that governments now use in their transactions with society, as described in Allen Schick’s paper* on off-budget expenditure. What budget officers can keep track of through traditional bookkeeping may be a diminishing part of real government spending.
