A Good Enough Budget

Speaking Notes

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A Good Enough Budget - Introduction

What could we mean with a good enough budget?

I think the answer is rather obvious. A good enough budget is a budget that helps the country to prepare, approve and implement a budget that corresponds to its needs and possibilities.

Such a budget will in several respects not comply with the recommendations you can find in the OECD Best Practices for Budget Transparency, or in the IMF Code of Good Practices on Fiscal Transparency.

These two documents are very ambitious and I don’t think there is any country in the world that fully complies with all the recommendations. And I don’t think there ever will be. Nevertheless, the recommendations in these documents are sensible one by one. And they certainly should serve as guidelines when we develop our budgetary systems.

But we have to start with what we have. It is the existing system that must be developed step by step in a certain direction. It will not work if you try to introduce a drastically new system from one year to another. Such a project would be the work of technicians and Parliament would not accept it and the Government would not be able to manage the system. All parties involved must feel that it is their system, not somebody else’s system.

When you reform your budgetary system you must of course be acquainted with the OECD and IMF best practices. But I think it might be useful to start from the classical principles for how a budget should be designed. These principles emanate from the mid and late 19th century in Europe when parliaments took the control over the fiscal powers, i.e. they decided on taxes and expenditure.

Of course they wanted transparency, but they expressed it in another way, namely the four classical principles for a good budget: Unity, Annuality, Universality and Specification.

It is interesting to note that when the European Union drafted its Financial Regulations it explicitly based them upon these principles. They made exceptions to the four principles and they added some more principles. But that is quite alright.

I will to large extent follow these principles when I make my presentation. But before I come to these principles I will start with the legal framework for the budget.
1 The Legal Framework

It is of fundamental importance that there is a legal framework that clearly defines the distribution of fiscal powers between parliament and government and provides stability to the budget process.

The Constitution lays down how the power is distributed between the people, parliament, the government and possibly the head of state. The constitution should include provisions making it clear that it is parliament which in the first place has all fiscal powers, i.e. decides on all state revenue and expenditure, i.e. the budget.

Then it could be discussed what more should be said in the Constitution regarding the budget and which additional budgetary rules should be included in an Organic Budget Law, in Parliament’s Working Orders or in a Public Finance Act. It is not very important where the rules are and the location should be decided according to legislative practice in each country.

Some countries just have one or two articles on fiscal powers in the constitution and have the other important provisions in an organic budget law or in a Public Finance Act (Norway, Denmark, France, Hungary and Slovenia). This also seems to apply for Tunisia (draft constitution 13 Aug 2012, art. 34). Other countries have an extensive regulation in the constitution (Finland, Germany, Sweden, Spain, Portugal and Poland).

You might ask what is the difference between an organic budget law and a public finance act? The difference is that an organic budget law usually includes fundamental provisions and that this law cannot be changed as easy as an ordinary law or act. Like the constitution it might be necessary with two decisions or a decision with a qualified majority to change an organic law.

The government is an agent who is entrusted by the principal, i.e. Parliament, to implement an approved budget. The loop must be closed and the agent should report the outcome of the assignment. Consequently, the government should present the final accounts to Parliament. This is also a necessary condition that a good enough budget must fulfill and should be regulated in the constitution or in an organic budget law.

The approval of the budget by parliament is usually the most important issue any parliament deals with. It is politically and economically very important. And Parliament deals with the budget every year. There must be a specified process described in the organic budget law or the working orders of the parliament facilitating the process and making it likely that the budget will be approved before the start of the new fiscal year. There should be provisions stipulating when the draft budget shall be submitted, when counter proposals shall be presented, how the
preparation in committees shall be carried out, the number of readings, voting procedures etc.

And there must be provisions regulating how a situation shall be managed where no budget has been approved before the beginning of the fiscal year.

In order that the draft budget is prepared and presented in the way parliament wants and it is implemented and accounted for in manners that are clear and acceptable to parliament there must be a Public Finance Act laying down rules and regulations that are not of a constitutional character.

The legal framework I have now described is necessary in order that the budget shall be formulated, approved, implemented and accounted for in a proper manner. Only when a legal framework of this kind is in place the conditions for a good enough budget are fulfilled.

2 The Budget Process – Forecasts

It is difficult to achieve a good enough budget without a good enough budget process.

The first part of the budget formulation process consists of forecasting, the second of negotiations. Let’s start with forecasting.

In order that the preparation phase shall lead to a draft budget the government agrees on in time, there must be a very detailed schedule starting in January or February and ending in September. All activities must be planned and all input should be specified in advance. When the process has been concluded the schedule should be reviewed and adjusted according to the experience gained during the process.

The Ministry of Finance must prepare a huge amount of budgetary and economic data for the process.

You must have the outcome of the budget for year n-1, which is the firm base. And of course you must have the budget figure for the current year (n). That, however, is an unreliable figure that cannot be used as a good starting point and you must as soon as possible have a forecast of the expected outcome of the current year (n).

You need economic and demographic forecasts. You need macroeconomic data and forecasts for GDP-growth, inflation, salary increases for (n) and (n+1). Large parts of the revenue and expenditure sides of the budget are sensitive to the macroeconomic development. Other parts of the budget are sensitive to the development of demographic data like number of children, number of persons entitled to social benefits.
The real starting point for the budget preparation is a detailed forecast of the revenue and expenditure of the budget for the year (n+1) with unchanged rules for expenditure and revenue (but adjusted for macro-economic and demographic development). This is the budget you would have if no policy changes were made. An estimate of this kind should be ready in March-April.

A revised version should be prepared when you have macroeconomic data and budget figures for the first 6 months of the current year (n).

What I have now described is very much the preparatory work that the Ministry of Finance must carry out on its own. Of course, you will have to ask line ministries for information and have data from the statistical office and from economic institutes. When this homework has been carried out the negotiations can start.

### 3 Budget Process – Negotiations

The negotiations between the ministers, constitute a controlled conflict that has to be settled. The result must be a draft budget the government agrees on. But it must also be a responsible budget. It belongs to the Ministry of Finance to make sure that the draft budget is responsible.

I think you can say that the design of the negotiation process to a large extent determines the outcome. Of course, you can achieve a good result with a lousy process, but it requires more work and more muscle and sharper conflicts.

The crucial thing is the initiative. The Ministry of Finance must have the initiative. If you sit down and wait for others to present their proposals you have already lost the negotiation.

A good way to take the initiative is to use a **top-down approach**. This means that the Ministry of Finance – with the support of the Prime Minister – at an early stage informs the line ministries of the total expenditure of the budget and how the resources shall be allocated to different areas or ministries and which shall be the major reforms. The base for this declaration is forecasts of revenue and expenditure made by the Ministry of Finance and of course a policy discussion within the government on priorities. Given the expenditure frames for their respective areas the ministers can allocate funds according to needs and priorities.

In order that an approach of this kind shall be possible the government must agree on the overall fiscal objectives and restrictions, e.g. the surplus or deficit, total expenditure or total taxes, total debt. The finally agreed overall budget will in this case not be a surprise to the Minister of Finance.

With this approach the conflicts will have to be settled within the government.
The opposite, and traditional, approach is a **bottom-up process**. In such a process the line ministers present their unrestricted demands and the Minister of Finance will have to try to reduce the demands to what is compatible with a responsible budget. In the end he will fail. The expenditures will be too large. As a consequence the taxes will have to be increased more than is feasible or the borrowing will be larger than is desirable.

This means that the conflicts have **not** been solved within the government. Instead the bill is passed on to somebody else; namely present taxpayers or future taxpayers who will have to pay interest on the loans.

I have seen the bottom-up approach slowly but surely lead to financial disaster, and I have seen the top-down process quickly lead to success.

### 4 Structure of the Budget – Unity

Now we come to the four fundamental principles for a good budget. Let’s start with Unity.

Unity simply means that there should be only one budget including all central government revenue and expenditure. Expressed in another manner, there should not be several separate state budgets, e.g. one for core state revenue and expenditure, one for capital expenditure, one for health insurance, one for unemployment benefits and a number of extra-budgetary funds or accounts for different purposes.

The financial relations between such budgets and funds are often complex. Therefore the existence of separate budgets makes it more complicated than necessary to prepare, understand and evaluate the budget proposal and the outcome.

For historical and institutional reasons it might be difficult to unify the budgets quickly. But every effort should be made to do so. If it is not possible to formally unify the budgets a consolidated budget should be presented. And it might also be useful to indicate the differences in coverage between the budget and the government sector in the System of National Accounts.

The principle of unity also has a formal meaning: No other revenue may be collected and no other expenditure may be authorized than those included in the budget. Here we have a link to the principle of Specification which I will comment on later.

The government must present the reasons for its proposed budget to parliament. The explanatory notes should include a description of the macro-economic situation and development upon which the budget is founded. Furthermore, there should be
explanations and motives for all major changes. These explanations should clarify the political priorities of the government both as regards revenue and expenditure.

Unavoidably, the budget and the explanatory notes will be a quite large document. Usually it is a matter of thousands of pages. Hardly anybody will read all of it. People, including members of parliament, will read only the parts they are most interested in but not the whole document. In order to make the budget available to a broader public a brief and simplified version should be presented. It could be called a citizens’ budget.

5 Structure of the Budget – Universality

The principle of universality is quite straightforward. It simply means that all revenue shall be used in order to cover all expenditure.

In practice this means that no tax or fee should be earmarked for a specific purpose or intended to finance a specific expenditure.

It also means that all revenue and expenditure should be accounted for in full without any adjustments against each other. In other words – gross budgeting and no netting – should be used.

One reason for this principle is of course to achieve transparency. Another reason is that linking a specific revenue to a specific expenditure tends to lead to an irrational allocation of resources. Low priority activities might continue just because there is money available while other high priority activities will have insufficient resources.

However, in some cases it might be practical to link some revenue to some expenditure, e.g. smaller income from user charges, income from the sale of scrapped equipment etc. But a tax should never be linked to a specific expenditure or activity. Any exceptions from the principle of universality should be clearly stated in the Public Finance Act.

6 Structure of the Budget – Annuality

The meaning of annuity is simply that the budget is for one year and that an appropriation for a specific purpose should be spent before the end of the year. If not the appropriation is cancelled.

This principle raises the issue of the accounting base – the timing. Should accounting be carried out on a cash basis or on an accruals basis?
The **cash basis** is of course the traditional accounting technique. It means that revenue and expenditure items are recorded when the payment occurs. It is a simple method and it is easy to understand. And it has the advantage that the result of the budget can easily be reconciled with the borrowing requirement.

**Accrual accounting** means that revenue and expenditure are referred to the period where they belong regardless of when the payments actually take place. In practice it means that revenues are recognized when the invoice it sent out and expenditure is recorded when you receive an invoice. And capital expenditure is distributed over a longer period than one year through depreciations.

A full accruals system is difficult to operate. E.g. the taxes a government collects often relate to income earned during an earlier period. It might also be misleading to identify and distribute capital expenditure over a longer period. And there will be a big difference between the bottom line of the budget and the borrowing requirement. A complicated reconciliation will have to be carried out.

But there are different methods of modifying the accruals accounting base. E.g. using it only for recurrent expenditure, but not for capital expenditure, or for tax revenue.

In my view there should be no rush in moving from full cash to different stages of accrual budgeting and accounting. A transition from cash accounting and budgeting to full accruals or modified accruals is one of the most difficult and costly steps that could be taken by any government institution. In an advanced surrounding it takes several years and requires a lot of training.

So if you have a cash based budget system, stick to it. And record revenue when it is actually paid and recognize expenditure when it is paid. There is an IPSAS code for cash based accounting.

However, I have seen abuses of the cash system. It can easily happen that arrears are being built up towards the end of the year. But we cannot allow that invoices that should have been paid are piling up in the drawers in December because there is no money left. The opposite case is that there is money left which is used by the budget holder to pay an advance to a company delivering goods or services instead of having the appropriation cancelled. The Public Finance Act should include provisions that mitigate such abuses. E.g. you could apply accrual principles to these transactions.

But in some areas it is necessary to have a multi-annual perspective. That is the case regarding e.g. major investments in roads, buildings, administrative equipment and arms. The goods are commissioned in one year but are delivered one or several years later. In those cases it is feasible to use a system of commitments. This means that Parliament, to a specified extent, authorizes the government to order goods that will be delivered and paid for after the end of the next fiscal year. But it is not necessary to use a commitment system for recurrent expenditure. If parliament grants an
authority to make commitments, parliament also agrees to put up the money when it is needed.

One aspect of the principle of annuality could also be that the government should ask the Parliament to authorize the government to borrow in order to finance the difference between revenue and expenditure. Borrowing today is an obligation for the state to pay interest and repay the loan in the coming years. Consequently, deficits have a multi-annual character and an explicit authorization to borrow should be given.

7 Structure of the Budget - Specification

The budget is a specified plan for the government’s expenditure and revenue for the coming year. But how should it be specified? Well, that is the privilege of the principal, i.e. Parliament to decide. The government, as the agent, should present the budget with a structure and a degree of specification that corresponds to the wishes of Parliament. In theory, at least. In practice, however, it is the government that has the initiative and specifies the budget in a way that seems feasible.

What should be the main structure?

**Revenue** should be classified according to the main sources; e.g. taxes on household income, tax on income from capital, company income, taxes on consumption, customs duties, other indirect taxes, income from state companies, fines, fees etc. A specification according to a SNA standard should be the starting point. The estimated revenue from all different taxes should be specified. And the income items should not be earmarked for specific purposes (the principle of universality). The structure and the specification of the revenue side of the budget should not be a major problem.

When we come to the **expenditure** side of the budget we must make a choice between an administrative structure and a programme structure.

**Administrative structure**

The traditional manner to specify the expenditure is according to an administrative structure. This means that you allocate the expenditure to some 15 or 20 ministries and a handful of other institutions, e.g. Parliament, the President, the courts, the supreme audit office etc. The result would be a specification into 20 to 30 **chapters**. Then the ministries would have to be subdivided into **articles** for departments and agencies. The third level would be a specification into **lines** according for expenditure categories like salaries, premises, office material, travel costs, hospitality and other recurrent costs. Capital expenditure should also be specified.
How far you would have to go in specification depends on the degree of delegation parliament is prepared to accept. In my view parliament should decide on the allocation to chapters and articles. When it comes to the cost category lines I would suggest parliament decides on three lines: salaries, other recurrent costs and non-recurrent costs. More details could be included as information.

The budget is of course initially prepared with a higher degree of specification as regards the cost category lines. And it up to the government to decide how detailed budget it should use for the different executive entities during the implementation of the approved budget. It is a matter of how much flexibility the government – or the Ministry of Finance – wants to delegate to the ministries, departments and agencies.

**Programme structure**

One of my first tasks in the Swedish Ministry of Finance in the late 1960s, early 1970s, was to assist in developing and implementing a system for Planning, Programming and Budgeting for the Ministry of Defense. The system worked reasonably well. Later on we introduced results based budgeting for the whole state sector. I have also tried to convince a number of countries in Eastern Europe to introduce RBB. I have supported the introduction of RBB and RBM in the UN family. I have also participated in the introduction of RBB/RBM in the Council of Europe where I am President of the Budget Committee. Six weeks ago I chaired a seminar in the CoE the purpose of which was to improve the system for RBB/RBM which is currently used in the organization.

You can safely conclude that generally I am in favour of Results Based Budgeting. However, today I would be very cautious to recommend a government to move from an administrative structure to a fully-fledged system for RBB/RBM. The reason is that it is a very complicated process, the very best staff is needed for intellectually demanding exercises, accounting and reporting systems must be revised, it takes several years and is costly to implement in a first version. And the tangible advantages are not obvious for a long time. Usually governments have more urgent development needs to attend to.

But on the other hand, the purpose of spending public money is to achieve results, improve the situation for the people in different respects. All governments have objectives. I think that the explanatory notes that accompany the draft budget should in a handful of areas include descriptions of the objectives the government want to achieve. And what has been achieved. E.g. reduce the crime rate, improve the capabilities to read and write and do mathematics. These were areas where Tony Blair, in the UK, put up clear objectives. In my country we had an objective to build one million flats in ten years and another one to reduce the number of persons killed in traffic accidents.

It can also be useful present the budget, as information, in another structure than the administrative. E.g. you can present it divided into purposes or functions according to
the SNA COFOG structure. That will also provide a better understanding of what money is spent on.

**Implementation**

And now we come to the implementation of the budget.

The tax revenue figure is a forecast which will be more or less accurate. The administrative expenditure is a plan and the outcome can be controlled by the government. The size of the social transfers to households is a forecast. This means that there will always be larger or smaller discrepancies between the budget and the outcome.

Therefore the implementation of the budget must be carefully monitored by the Ministry of Finance. Monthly reporting and monitoring is necessary. There is no other way. The outcome of every line in the budget must be reported and analyzed. And a forecast should be made for the rest of the year. Sooner or later during the implementation it will become obvious that there will be larger and smaller discrepancies. How can these be handled?

The government must have some flexibility to transfer money from one line in the budget to another. E.g. to reallocate expenditure between articles within a chapter, and between lines within an article. However, the government should not be allowed to increase the lines for salaries. The extent to which the government is allowed to make transfers of this kind should be laid down in the Public Finance Act.

It might be useful to have an item in the budget called a contingency fund or something similar. Not a very big sum. And the rules stipulating when the government may use it should be clearly stated in the Public Finance Act.

If there are deviations from the budget that are larger than can be handled within the government’s flexibility measures or if there are major changes in revenue or expenditure which are threatening the overall balance of the budget the government should submit an amendment budget to parliament.

8 **Accountability for the Implemented Budget**

When parliament has approved the budget it is the task of the government to implement it and to report the outcome to parliament.

So, at the end of the fiscal year the government shall prepare a report on the implementation of the budget and submit it to parliament. The accounts shall be structured exactly in the same way as in the budget approved by parliament.
Let’s assume that you have a budget on a cash basis. Then, in addition to the budget accounts there should also be a statement of cash receipts and payments. There should also be a statement of change of cash assets and of the debt at the beginning and the end of the fiscal year. There are IPSAS recommendations for how cash based reporting should be carried out.

If you have a budget on an accruals basis or a modified accruals basis you should, in addition to the budgetary management accounts, also present financial statements comprising the financial position, the financial performance and the cash flow.

The accounts and statements shall be scrutinized by the external auditor, the State Audit Office or something similar, who shall present its opinion to parliament. Parliament should have an opportunity to discuss the accounts and the auditor’s opinion.

9 Low Priority Elements

In the IMF and OECD best practices there are a number of elements I think should be given a low priority. I will mention a few.

During the last decade so called Fiscal Councils have been established in a number of countries. The intention has usually been that these Councils should make independent examinations of the fiscal policy proposed by the Government. The tasks include review of the macroeconomic assumptions on which the budget is based and examination of whether the Government observes the fiscal objectives, fiscal rules and regulations. Fiscal Councils can also make policy recommendations. The intention is of course that a Fiscal Council shall contribute to a better and more sustainable fiscal policy being pursued by the Government and Parliament.

I don’t think the creation of a Fiscal Council should be a high priority task. It is difficult to find the very competent staff needed. We are talking of three to five internationally renowned economists and a competent secretariat. And if this staff can be found, why not recruit some of them to the Ministry of Finance? It takes time for a Council to earn a good reputation - so no effect in the short run. And what is the underlying assumption – that the Government is incompetent or dishonest?

If you really think that something must be done in this respect I would recommend that you start with building on the existing infrastructure. It will be less costly and you will achieve results quicker. You could 1) Strengthen the analytical capacity of the Ministry of Finance, 2) Strengthen the analytical competence of the Budget Committee of Parliament, 3) Strengthen the analytical capacity of the State Audit Office and give it additional duties, or 4) strengthen the analytical capacity of the Central Bank and give it additional duties.
**Medium Term Fiscal Framework.** The budget process usually regards one year. But the decisions taken, the reforms decided, often don’t have a full financial impact the very first year. The expenditure will most likely increase in the coming years. Therefore it is often necessary to make partial multi-annual estimates when deciding on reforms. This is a responsibility that lies with the Ministry of Finance. But it is hardly necessary, or worth the effort, to make a complete medium-term estimate for the whole budget and make it public. In my view a Medium Term Economic or Fiscal Framework should not be a high priority. The efforts should be directed towards making good budgetary and macroeconomic forecasts for one year. That is difficult enough!

In the IMF and OECD best practices you will also find recommendations regarding a number of other reports.

A **pre-budget report** that should encourage an informed debate on the budget and the economy before the draft budget is submitted to parliament.

A **mid-year report** that provides information on the implementation of the current budget.

A **pre-election report** that provides economic information that can inform the electorate and stimulate debate.

A **long-term report** covering 10 to 40 years which assesses the budgetary implications of demographic and economic changes.

Reports of these kinds may be worth longing for, but they are costly to produce and when it comes to forecasts the quality will most likely not be very high. So, in my view, they should not be high priority projects.

And **tax expenditures.** What is that? It is tax revenue forgone as a result of selective reductions of tax rates. E.g. a lower than normal value added tax on some goods or services. It is often difficult to estimate the tax revenue lost as a result of a tax expenditure. What should be the benchmark you compare to, what is or would be a normal tax rate? Although tax expenditures often substitute expenditure programmes I don’t think it should be a high priority task to devote large efforts in order to calculate and present the costs of all tax expenditures.
10 Conclusions

The structure of the budget in any country reflects its history and traditions. That is how it should be. But the budgets and the budget procedures should be developed in order to make them more transparent and rational.

Small steps should be taken every year to improve the budget. But the reforms should be made in a cautious and controlled manner involving only minor risks.

In order to have a good enough budget the first priorities should be

- To create a clear legal framework
- To develop good macroeconomic statistics and forecasts
- To implement a top-down budget process starting from fiscal objectives
- To implement reliable accounting and reporting systems

When this has been achieved it is time to continue with additional reforms aiming at further compliance with the OECD and IMF best or good practices for budget transparency. But take one step at the time, and don’t rush it.