Reallocation
THE ROLE OF BUDGET INSTITUTIONS

Reallocation is about major adjustments of public expenditure away from its current patterns. In recent years, reallocation has become increasingly important as a means to finance new needs in the sphere of internal and external security, integration of immigrants, education, health and pensions, especially in countries where economic growth has been weak. This report examines how reallocation is impacted by four institutions of the budget process:

- medium-term expenditure frameworks,
- rules of budgetary discipline,
- the role of the minister of finance,
- programme review.

Reallocation: The Role of Budget Institutions reviews and discusses the record on reallocation in 12 OECD countries: Canada, the Czech Republic, France, Germany, Italy, Mexico, the Netherlands, New Zealand, Spain, Sweden, the United Kingdom and the United States. The report develops a microeconomic classification of public expenditures.

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Reallocation

THE ROLE OF BUDGET INSTITUTIONS
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Also available in French under the title
La réforme des institutions budgétaires

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Foreword

Reallocation is readjustment of expenditures compared to existing estimates. In recent years, reallocation has become increasingly important as a means to finance new needs in the sphere of internal and external security, integration of immigrants, education, health and pensions, especially in countries where economic growth has been weak. The report reviews and discusses the record on reallocation in 12 OECD member countries: Canada, the Czech Republic, France, Germany, Italy, Mexico, the Netherlands, New Zealand, Spain, Sweden, the United Kingdom and the United States. Representatives of those countries participated in the expert group that provided input to the project. The report looks specifically at the institutions that trigger reallocation or define its aims: medium-term expenditure frameworks, rules of budgetary discipline, the role of the minister of finance, and programme review. The report makes clear that when these budget institutions are strong, reallocation tends to be integrated into the regular budget process. When they are weak, countries need to have recourse to one-off retrenchment operations, which are not always successful and which perturb the budget process. The report argues that budget institutions should be strengthened so that one-off operations can be avoided.

The report was produced by the Budgeting and Management Division of the Public Governance and Territorial Development Directorate of the OECD. It was prepared by Dirk-Jan Kraan, Project Manager in the OECD Secretariat, and Joanne Kelly, Senior Lecturer on Government and International Relations at the University of Sydney, Australia. Financial support for the project provided by the Governments of Canada and of the Netherlands is gratefully acknowledged.

The report is published on the responsibility of the Secretary-General of the OECD.
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1. Overview of the project

1.1. Background

The economic slowdown throughout much of the OECD area has changed the landscape of budgetary policy. Following a period of high economic growth in the 1990s unprecedented in length, budgetary authorities in many countries are again facing the problems of fiscal stress encountered in previous periods of recession. The present economic situation is also unclear. Whereas international organisations consider the worst of the recession to be over, they have recently also acknowledged that recovery is unusually slow and that there are many uncertainties as to future developments.

Fiscal stress in a recession is due to upward pressure on expenditure stemming from increasing unemployment benefits and other means-tested entitlement programmes on the one hand and slow growth of tax revenues on the other. Proposals for tax relief or new investment programmes to stimulate the economy may place additional pressure on the budgetary process. These pressures can to a certain extent be mitigated by shifting resources from existing programmes of lower priority to those of higher priority or to tax relief. Such shifts are one of the forms of reallocation explored in this study.

Many OECD member countries are currently facing circumstances that further complicate this stress, which were not present – or at least not to the same extent – in previous periods of recession. Four of these are mentioned here. First, citizens have become more demanding with regard to publicly provided services. During the 1990s, private incomes increased substantially and markets responded by offering greater choice and higher quality products and services to larger groups of people. Citizens have come to expect similar improvement in the provision of public services. These expectations have not been satisfied. On the contrary, many citizens feel that the quality of publicly provided services, such as education and public transport, has declined. The gap between expectations and reality adds to the upward pressure on expenditures.

Second, several OECD member countries face significant problems in respect to failing integration of new immigrants, which has caused
segregation in various domains of social participation. Some urban
neighbourhoods have deteriorated in spite of overall increasing prosperity.
Social tensions between ethnic groups and crime have increased. Schools
have tended to become more segregated. Living conditions have become
more disparate. Participation in social activities (cultural, recreational,
religious, charitable, and political) has increased for the large majority but
decreased for significant minorities.

Third, growing international tensions have increased the threat of
terrorism. This has given rise to new programmes of internal security and an
expanded system of law enforcement. Some countries have increased their
defence expenditure. The United Kingdom and the United States have
funded the war in Iraq and part of the reconstruction efforts in that country.
Other countries intend to contribute as well. Expenditure for internal and
external security is growing rapidly in many national government budgets.

Fourth, many OECD member countries have ageing populations. Some
countries have fully funded pension systems for public sector employees,
but others have systems based on pay-as-you-go principles. The latter will
be faced with increasing deficits in their pension funds. Moreover, countries
with pay-as-you-go systems also tend to have overly generous benefits and
ey early retirement rights. Most of the countries concerned recognise the
problem but are only at an early stage of pension reform. As far as general
public pension (social security) is concerned, all OECD member countries
have pay-as-you-go systems. Benefits differ substantially among countries.
Reform efforts have been launched in this area too, but most are only in a
first stage of development. The problem of ageing populations is further
exacerbated by simultaneous advances in medical technology. Health
expenditures will start to grow at an unprecedented rate in the near future.
This leads to so-called double ageing: the age group that retires represents a
larger proportion of total population, and this group lives longer. Both
effects compound problems in the health sector as well as the pension
sector.

These circumstances will maintain systematic upward pressure on
expenditures, even if the recession recedes and growth resumes. In this light
it seems plausible that the search for funding methods through reallocation
will remain high on the political agenda for the foreseeable future.

1.2. Aims and methods of the study

The study explores the impact of four institutions of the budget process
upon reallocation:

- Medium-term expenditure frameworks.
Some attention will be given to two other institutions that in some countries also have a bearing on reallocation: earmarking of revenues for investment expenditures, and budgeting for investment expenditures on an accrual basis. The study also examines the effect of these budget institutions on reallocation in terms of allocative efficiency. The latter is a normative question. It supposes that reallocation is not necessarily a good thing; there may also be bad reallocation (namely, resulting in reductions in welfare).

Reallocation is defined here as the readjustment of expenditures in relation to the current budgetary or medium-term estimates. This definition gives rise to a number of observations. First, reallocation as defined here concerns only expenditures, not revenues (although changes in taxation, public borrowing or fees do change the existing allocation of resources in the economy). Second, reallocation does not refer only to shifts in the pattern of expenditures that amount to decreases for some purposes and increases of exactly the same size for other purposes. A general or specific decrease without an offsetting increase (or the reverse) is also a form of reallocation. Third, reallocation is a change in an existing pattern of expenditures. This pattern is conceived as being determined by expenditure estimates. For the current budget year, these are the estimates authorised by appropriations law. For future years they are the latest official estimates for the out-years based on the principle of “current law”.

The study was guided by an expert group of representatives from 12 OECD member countries. These included a mix of small and large countries (in terms of population and GDP), of parliamentary and presidential systems, and of relatively old and new members of the OECD. The group consisted of Canada, the Czech Republic, France, Germany, Italy, the Netherlands, New Zealand, Mexico, Spain, Sweden, the United Kingdom and the United States. The countries answered a questionnaire and provided case studies. The financial support of the Governments of Canada and of the Netherlands for this activity is gratefully acknowledged.

2. Motives for reallocation

2.1. Demand and supply factors

Reallocation is a change from an existing pattern of expenditures. The most evident forms of reallocation are motivated by new policy priorities. Yet changes in political preferences are but one demand-driven motive for reallocation; other
motives stem from adjustment to the changed circumstances of the demand and supply of publicly funded services.

Reallocation pressures are likely to be produced by two specific demand-side factors. First, changes in (structural) tax revenue will create pressures for expenditure change in both directions. If tax revenue rises above the level on which existing spending commitments are based, then pressure for new spending priorities (or for tax relief) is likely. Alternatively, if tax revenue falls below the level on which existing spending commitments are based, then expenditure reductions (or a tax increase) will become more likely.

Second, reallocation can be motivated by changes in the demand for publicly funded services by citizen-consumers. When the public services are guaranteed in entitlement legislation, changes in private use can cause either overspending or underspending with respect to current estimates. This change in demand will trigger expenditure reallocation.

The primary supply-side pressures for reallocation are associated with changes in the cost of delivering government services and in the quality of services. Improvements in production technology (medical, for example) are likely to reduce the cost of delivering public services and may give rise to new or better quality products and thus increase demand. Similarly, changes in the price of inputs (including wages) can make a service less or more expensive. In both instances the price elasticity of demand will determine whether this will increase or decrease expenditure on the service. Finally, the cost efficiency of production is an important factor; this includes both allocative efficiency (the optimal combination of inputs) and technical efficiency (the rate of products to inputs sacrificed for their production). The incentives for cost efficiency in the public sector are not as straightforward as in the market sector. Many public agencies are monopolistic suppliers or can apply price discrimination; often the profit motive leads to higher prices. This is why many argue that reorganisation of public production can yield relatively large gains in cost efficiency and subsequently – through the price effect – on expenditures. Again, the elasticity of demand will determine the direction of the expenditure change.

2.2. Clustering of motives

To gain a better understanding of the motives behind some recent reallocation exercises, the case studies provided by the expert group have been clustered according to the dominant economic motive behind them. The five clusters or types that emerged are summarised in Table 1 and explained in the text following. Then boxes extend the discussion by comparing the main features of process and practice in each of the relevant cases. It is acknowledged that this listing is
incomplete and that similar reallocation exercises will be found in most countries. But the objective here is to provide a preliminary description of the forms, causes and practice of reallocation, rather than an exhaustive history.

Table 1. Motives for reallocation initiatives

<table>
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<th>Motives</th>
<th>Case studies</th>
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<td><strong>Main motive:</strong> – Overspending due to increased demand for specific programme (demand)</td>
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<td>– Germany: Restructuring the Bundeswehr 2001</td>
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<td>– Change in cost efficiency of production (supply)</td>
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Source: Kraan and Kelly.
The first type of reallocation exercise stems from fiscal stress and occurs when overspending is more or less across the board and/or there is a structural revenue shortfall. This typically occurs during periods of macroeconomic recession when spending on social services increases and revenues fall below the trend, leading to higher annual deficits (or a lower surplus) than estimated in the medium-term estimates. Reallocation exercises in Canada (1994), New Zealand (1991) and Sweden (1995) all occurred during periods of fiscal stress. In each of these cases, the reallocation exercise was motivated by multiple demand- and supply-side stimuli, including: replacement of a high-spending cabinet with a low-spending cabinet (demand); an increase in the use of social services due to recession (demand); a reduction in tax revenue (demand); and general cost increases due to higher input prices (supply). In each exercise the government sought to deliver a programme of targeted expenditure reductions rather than proportional cuts. Perhaps demonstrating the political difficulty of these exercises, most were accompanied by the selective expansion of a few programmes portrayed as investments to facilitate economic recovery or expenditures that otherwise strengthen economic performance (e.g. in education).

Box 1. Reallocation under conditions of fiscal stress

Type 1 case studies:
- New Zealand: Budget 1991
- Canada: Program Review 1994
- Sweden: Fiscal consolidation 1995

Case studies from New Zealand, Canada and Sweden each describe government-wide reallocation exercises that occurred during a period of high and rising annual deficits. In 1991, the New Zealand annual fiscal deficit was projected to increase from 4.8% to 6.3% of GDP over three years. Canada faced a similar fiscal situation in 1994 with an annual deficit of 5.9% of GDP and rising. During the same period the annual budget balance in Sweden declined from a surplus in 1990 to a deficit equal to 12% of GDP in 1993. All three countries set an initial deficit target of 3% of GDP within three years, aiming for a balanced budget shortly thereafter. In practice, the deficit targets were achieved more quickly than expected in all three countries. Whether this was due to the reallocation exercises conducted by each government, or the impact of economic growth and falling interest rates, remains a moot point.
Box 1. Reallocation under conditions of fiscal stress (continued)

Although a declining fiscal situation was the major impetus for these reallocation exercises, each case study indicated that far-reaching reallocation exercises should be an “instrument of last resort” when dealing with a fiscal crisis, and should only occur when coupled with changes in the political environment. The fiscal situation in New Zealand and Canada had been declining continually throughout the 1980s and governments in both countries implemented a variety of restraint measures during that period: wage freezes, across-the-board cuts, and extensive public sector reform measures, including the State Sector Act 1988 in New Zealand and the Spending Control Act 1990 in Canada. In Sweden the budgetary decline was more rapid and more extreme yet the resultant reallocation exercise did not occur for almost five years from the commencement of these pressures. Extensive reallocation exercises did not commence in any of the three countries until the election of a new government that had focused on the fiscal problems during the election and explicitly rejected the idea of across-the-board cuts in favour of targeted expenditure reviews that “reallocated funding from low-priority areas to continue high-priority spending”. The case study from Canada argues that even with a change of government, political support was only forthcoming after further pressure from the financial markets:

…the Program Review exercise did not commence until the first Liberal budget was widely criticized as fiscally ill-disciplined and when Moody’s downgraded Canada’s risk rating (from A++ to A+). At that point prime ministerial support became unequivocal.

Markedly similar processes underpinned the three reallocation exercises. As mentioned above, they all spanned a broad area of government expenditures, although major tracts of spending were protected in each instance – some even receiving new money. The processes (described below) were initiated and co-ordinated by the centre of government, which set the policy and financial frameworks. The detailed reviews were undertaken and initial plans developed by individual departments and ministers working within the framework articulated by the centre. These plans were then reviewed and decisions taken by a smaller group of senior cabinet ministers working collectively and supported by a group of senior officials. All three cases highlight the importance of “unequivocal” and sustained political involvement in the government-wide reallocation exercises; the extensive exercise of reallocation is often iterative as the difficulties in achieving fiscal targets become more apparent.

It seems plausible that the “physiological impact” of these exercises shaped the subsequent behaviour of both officials and ministers for up to ten years afterwards. All three countries point to budgetary and institutional reforms that resulted. While these reforms were implemented in New Zealand before the reallocation exercise, it is argued that they only took hold after the crisis of reallocation. In Sweden an extensive programme of budgetary reform was implemented after the reallocation exercise in a bid to avoid future crises: “A lax budgetary process with no medium-term fiscal targets was one of the forces behind the crisis, and the big issue was not just to consolidate the financial situation but to improve budgetary institutions.” In Canada a system of prudent budgeting was maintained after the programme review, and the budgetary role of cabinet and spending agencies was significantly diminished. More important was the moral suasion gained by the Department of Finance, as both ministers and public servants vowed they would “never again” engage in such a painful exercise of consolidation.
Box 1. Reallocation under conditions of fiscal stress (continued)

New Zealand: Budget 1991

The New Zealand government sought to reduce total government spending by “channelling resources to high-priority areas” and “seeking greater value for money”. This process commenced in early 1991 when the prime minister met with chief executives and ministers to urge the importance of fiscal restraint, and in February the cabinet agreed to stringent rules for the 1992 budget: no compensation for increases in their input costs; extra funding limited to statutory or demand-based expenditure policies (e.g. welfare benefits); new policy initiatives funded from reallocation within existing budgets and restricted capital injections.

But the extensive reallocation exercise did not really begin until the draft budget produced in April showed that substantial further savings were required to achieve the fiscal targets. At that time chief executives were instructed to identify additional savings options and to produce technically sound and administratively feasible savings options, while leaving political judgements to the government.

The detailed decision making fell to the newly formed Cabinet Expenditure Control Committee, chaired by an associate minister of finance and supported by the Officials’ Committee on Expenditure Control (OCEC). Officials undertook preliminary reviews of departmental submissions to ensure that they identified substantial savings and areas of lower priority expenditure; subsequently they specified three tiers of savings options ranging from those readily achievable to ones requiring more complex or legislative issues. In May-June, the minister held extended meetings with individual ministers and chief executives to discuss proposed initiatives and recommendations. The full cabinet made decisions in late June 1991.

Canada: Program Review 1994

The process in Canada followed a similar pattern, with two major differences. More emphasis was given to establishing the guiding principles for the review: qualitative criteria by which programmes should be assessed and specific departmental savings targets were both stated up front. Second, in accordance with norms of budgeting in Canada, the cabinet committee developed recommendations for the minister of finance and prime minister, rather than the full cabinet.

Program Review focused exclusively on direct government programme spending, excluding transfer payments (38% of total expenditures), and interest payments on the debt (26% of total expenditures). Six Program Review assessment criteria were developed:

1. Does the programme area or activity continue to serve a public interest?
2. Is there a legitimate and necessary role for government in this programme area or activity?
3. Is the current role of the federal government appropriate, or is the programme a candidate for realignment with the provinces?
Box 1. Reallocation under conditions of fiscal stress (continued)

4. What activities or programmes should or could be transferred in whole or in part to the private or voluntary sector?

5. If the programme or activity continues, how could its efficiency be improved?

6. Is the resultant package of programmes and activities affordable within the fiscal restraint? If not, what programmes or activities should be abandoned?

In the fall of 1994, all departments and agencies prepared action plans outlining their strategic priorities and proposals, using the six Program Review assessment criteria and assigned expenditure reduction targets. These plans were reviewed by a special committee of deputy ministers to ensure that the criteria and targets had been respected. Those departments and agencies not respecting the criteria and targets were advised on possible changes, and the departments and agencies then revised and resubmitted their action plans. Final plans were submitted to a special committee of ministers established by the prime minister for the Program Review exercise. The committee of ministers then made specific recommendations on departmental programmes to the minister of finance, who incorporated them into the 1995 budget.

While Program Review per se focused only on direct programme spending, the federal government’s expenditure reduction exercise in 1995 extended to other programme spending areas such as transfer payments. Major transfer payments to provinces excluding equalisation were targeted for a 15% reduction over three fiscal years ending in 1997-98. Major transfer payments to persons were also scaled back, with the unemployment insurance programme targeted for a minimum 10% cut and the old age security system placed under a review to control its costs.

The measures announced in the 1995 budget were deepened and extended by one year in the 1996 budget. All told, the average department was to be cut by 21.5% over four years.

Sweden: Fiscal consolidation 1995

In Sweden the core processes within the executive follow a similar pattern where the central government sets guidelines, departments undertake the review, and the centre and ministers decide actions at the political level. Two major differences are evident between this and the previous two cases. First, the minority government status of the Social Democrats meant that they had to include opposition parties in setting the guidelines and developing final recommendations. Unlike New Zealand and Canada, Sweden reduced the deficit through a combination of revenue increases (one-third) and expenditure cuts (two-thirds), undertaken in a two-part strategy designed to obtain the support required in parliament to pass the bills. The revenue increases were passed with support from the Left party, and expenditure reallocations were developed in consultation with, and with support from, the Centre party. Second, the guiding principles developed to frame the reallocation exercise highlight important policy differences between Sweden and New Zealand in particular. The exercise in Sweden was designed to limit the extent to which expenditure reductions impacted on the welfare programmes. In particular, “core services” delivered via transfers to local government, health care and education were largely protected, and the burden of the cuts fell on direct transfers to households and businesses.
The opposite case of fiscal stress is that of fiscal abundance. Here there are cases of underspending across the board and/or revenue windfalls. This will typically occur in a situation of high macroeconomic growth when spending on social services decreases and revenues grow faster than the trend. In general, fiscal abundance leads to a lower deficit (or a higher surplus) than foreseen in existing multi-year estimates. This produces upward pressures on expenditure. On the other hand, it provides an opportunity to reduce a few specific expenditures. Some social benefits are not entitlements and so may not shrink automatically in accordance with current law estimates (e.g. active labour market policies, or social services for the elderly). If unemployment shrinks and the prosperity of the elderly increases, there is good reason to curtail those programmes. An example is the review of labour market policy in the Netherlands in 2001. The motives for reallocation may again stem from the demand or the supply side and will be of a general nature: the replacement of a low-spending cabinet by a high-spending cabinet (demand), or a decrease in the use of social services due to economic growth (demand), or a tax revenue windfall (demand), or cost reduction with a general impact, for instance as a consequence of a lower oil price (supply). Revenue windfalls occurred frequently in OECD member countries during the 1990s. They gave rise to citizen demands for better quality of public services, in accordance with the increased prosperity prevailing in the private sector.

Box 2. Reallocation under conditions of fiscal abundance

Type 2 case studies:

- United Kingdom: Spending Reviews 1998
- Netherlands: Interdepartmental policy reviews (adapted from the Reconsideration procedure which commenced in 1981)
- New Zealand: Value for money reviews (VFM) 2001
- Canada: Departmental assessments 2001-02

Motivated by changing policy demands rather than immediate fiscal stress, all four of these reallocation exercises were designed to provide a vehicle for ongoing, targeted expenditure reallocation across government. As with the previous cases, all of these exercises were co-ordinated by the centre of government and involved a cabinet body as decision maker.
Box 2. Reallocation under conditions of fiscal abundance (continued)

The role of line agencies differs between cases: in the Netherlands, detailed reviews were undertaken by a secretariat located in the ministry of finance; in the United Kingdom, reviews were undertaken in line agencies but in consultation with treasury analysts; in Canada and New Zealand, departments were the primary drivers of the exercises operating (in theory at least) with little input from the centre. Despite the objective of permanency, only the systems in the Netherlands (since 1981) and the United Kingdom (since 1998) are presently still in place. In Canada, the departmental assessments process was eventually overtaken by a mandatory and comprehensive spending review process affecting all departments and agencies over a multi-year cycle, as announced in the 2003 budget. As these four cases provide the main examples of ongoing programme review examined in Section 3.5, more details of two of the cases are provided in that section and in Box 7. The discussion here addresses some of the differences between reallocation exercises conducted under conditions of fiscal stress and conditions of fiscal abundance highlighted by these cases.

Whereas the financial objectives of reallocation predominate in an environment of fiscal stress, the primary (but not sole) justification for reallocation under conditions of fiscal abundance is improving public services and allocative efficiency. Experience in the Netherlands provides the best example of these changing priorities. Interdepartmental policy reviews emerged from existing mechanisms – known as the Reconsideration procedure – which were designed in 1981 to achieve reallocation during a period of fiscal stress. The process retains many features of its predecessor, including a selective focus (approximately ten policy reviews are conducted per year) and the use of small interdepartmental working parties supported by the ministry of finance to conduct reviews designed to provide the government with a number of possible alternatives. Under the budget surpluses of the 1990s, two main changes were made to the system. First, the requirement that each review produce at least one alternative that would lead to a 20% reduction of expenditure after four years was abolished. Second, the reviews shifted in focus from budget cuts per se to institutional changes, including options for demand-led programme funding, outsourcing, privatisation, and decentralisation to other levels of government. As a consequence, any financial reallocation must be justified by recommendations for policy change or for institutional redesign. However, during the high-growth late 1990s, the procedure was also used to cut expenditures that are less needed during an economic upswing but that do not shrink automatically (because they are not based on entitlements). The review of labour market policy that proposed cuts amounting to EUR 1.1 billion is an example of such use.

Reallocation under conditions of fiscal abundance does not necessarily entail expenditure cuts. The reallocation can be additive [meaning that additional funds are directed toward new policy priorities (the United Kingdom) or to facilitate programme redesign (the Netherlands and the United Kingdom)], subtractive [meaning that resources are moved from lower to higher priorities (Canada and New Zealand)] or both. The biannual Spending Review exercise conducted in the United Kingdom since 1998 is designed to ensure that departmental spending is allocated to improving performance in areas of government priority. Spending Reviews were developed in 1998 to replace the annual spending round and shift negotiations from the annual increment to medium-term operating budgets. The exercise is co-ordinated by the chancellor, the treasury and the Cabinet Committee on Public Services and Public Expenditure (PSX).
Conducted over one year, the process examines key performance targets and “key strategic challenges” for the coming three years. Departments submit an analysis of resources and public service agreements to the treasury for analysis and discussion, on the basis of which departmental budgets are set and performance delivery targets are negotiated. The system was designed and has operated under benign fiscal conditions and focuses on questions of prioritisation, performance and design rather than expenditure restraint. It is debatable whether this system could support reallocation under conditions of fiscal stress.

The experience of Canada and New Zealand suggests that the absence of hard fiscal constraints makes it much more difficult to couple programme redesign with subtractive reallocation. Canada introduced a concept of departmental assessment (DA) in April 2001 in response to the prime minister’s request that spending ministers find ways of adjusting their programme and budgets through internal reallocation so that their operations would be sustainable within their existing funding levels. Consideration had been given towards making the process mandatory but, in the end, it was made elective at the discretion of departments and agencies. The DA took the form of a submission to the Treasury Board Secretariat (TBS) seeking the necessary authorities to carry out the internal reallocation consistent with programme sustainability. The TBS worked with the participating departments and agencies to ensure that their restructuring and reallocation options were sustainable. The DAs were then submitted to Treasury Board ministers for consideration. The number of departments and agencies choosing to participate over the next two years was understandably low due to a variety of factors: they may have already received “programme integrity” funding in the February 2000 and December 2001 budgets to address certain operating and capital concerns; they were rightfully confident that, in a period of fiscal abundance, their higher priorities would receive the necessary funding in a forthcoming budget because of approvals-in-principle already obtained from the cabinet and cabinet committees; or they already had the necessary authorities to carry out internal reallocation. In light of the programme integrity funding recently provided, the majority of departments and agencies that chose to participate likely did so in the largely mistaken hope of receiving additional funding. The DA process was essentially aborted in 2003, being overtaken by a mandatory and comprehensive spending review process affecting all departments and agencies over a multi-year cycle, as announced in the 2003 budget, which was designed to renew the government’s efforts to reallocate resources from lower to higher priorities and ensure that government programmes continue to be relevant, effective and affordable.

The New Zealand experience with value for money reviews (VFM) provides a vivid example of the difficulties in maintaining political support for reallocation during periods of fiscal abundance. During the 2000 election, ministers had agreed to a self-imposed fiscal cap of NZD 5.9 billion on new operating spending over the three-year term of the government. Spending during the first two years meant that the government entered its third year (2002/03) facing an election with only NZD 815 million available for new spending. The VFM process was conducted during the lead-up to the 2002 budget “to provide ministers with the information they needed to identify reallocation options to fund new programmes” so that they could remain within the fiscal cap. While the cabinet agreed to review 17 specific areas of spending, the only significant instances of reallocation occurred under two ministers who participated in the exercise voluntarily. The lesson of this exercise is summarised as follows:
Box 2. Reallocation under conditions of fiscal abundance (continued)

The key lesson from the process is that an exercise needs strong support from the spending ministers and departments to be successful... While the fiscal cap provided a constraint for 2002/03, the positive fiscal outlook allowed for higher expenditure in out-years.

The third type of reallocation initiative focuses on a single programme or group of programmes that causes overspending (main motive) but may also involve a few other programmes that can contribute to solving the resulting budgetary problem (secondary motive). The main motive may again stem from the supply side or the demand side, but it is limited to a specific programme or group of programmes and does not apply to the public sector as a whole. However, the programme(s) causing the overspending is (are) so large that doing nothing would have a significant impact on the deficit. The reallocation initiative will first aim at curtailment of the programme(s) causing the problem. However, if this is not possible in view of political preferences, the initiative may also involve other programmes that can contribute to the solution because they have dropped in political priority or because they cause underspending due to lower costs or less use of the services. The ageing problem that necessitates pension and health care reform in many countries belongs to this cluster.

Box 3. Reallocation under conditions of programme overspending

Type 3 case studies:

- Mexico: Voluntary retirement
- France: Control of health expenditures

Most countries represented in the expert group provided examples of “unplanned” reallocation due to overspending in one or more spending areas. Dealing with this “expenditure creep” was generally seen to be the type of problem faced by budget analysts within central and line agencies every day. In most countries it appears that this problem was typically managed by reallocation within individual departments. Only cases of systemic overspending require a more sustained or government-wide solution.
Box 3. Reallocation under conditions of programme overspending (continued)

The case of programme overspending presented by Mexico stemmed from increases in salary costs, pensions and administrative costs (supply side) over a sustained period. As a result, current expenditure grew from 37% to 63% of total programmable expenditure over 13 years. Government-wide voluntary retirement programmes had been in place throughout the 1990s; however, these were viewed as largely ineffective. In 2002 the government redesigned the voluntary retirement programme in an effort to reverse this trend. Each department received additional funds in the form of a fully repayable four-year “investment plan” to be used on programmes that stimulated voluntary retirement. Departments retain the savings achieved by reducing posts, as long as the saved funds are allocated in accordance with the overall government strategy of promoting investment and social expenditures.

In France there has been continuous overspending in the health sector. The Law on the Funding of Social Security specifies a national target for health insurance costs which, since the law’s introduction in 1997, has only been met one year (1997). In all years from 1998 to 2002 there has been considerable overspending; the annual average increase has been 4.6%. For 2002 the target increased by 3.8%, actual spending by 7.3%. The rate of growth of actual spending is unsustainable because it exceeds the growth rate of premium revenue, which causes a widening deficit. A recent report of the World Health Organisation has shown that the quality of French healthcare is among the best in the world, but that nevertheless the life expectancy in France is lower than that of countries like Italy and Japan that spend much less on health. The reason is that there are other factors (alcohol, tobacco, and accidents) related to food intake and behaviour that are more important for the health situation of the population than healthcare. The high costs of French healthcare are mainly due to the high consumption of pharmaceuticals and the high number of hospital beds per inhabitant (almost double that of Canada, Denmark, Spain, Sweden, the United Kingdom and the United States). Since 1996 there have been attempts to reform the healthcare system and to control expenditures. Until now these attempts have not been successful, mainly because: it has not been possible to control the salaries of the medical professions; because sanctions against overspending by practitioners have not been effective; and because of the rising costs of hospitals mainly due to the reduction of working time and the increasing cost of pharmaceuticals. The government is now preparing a new approach towards reform of the healthcare system.

The fourth type of reallocation is the complement of the third: it focuses on a single programme or group of programmes that has risen in political priority (main motive) but may also involve a few other programmes that can contribute to solving the resulting budgetary problem (secondary motive). The main motive concerns the demand for the provided services. The programme(s) that have risen in political priority is (are) so large that funding them without offsetting measures would have a significant effect on the deficit. The reallocation initiative will first aim at efficiency gains in the new priority programme(s). However, if this is not possible, the
initiative will also involve a few other programmes that can contribute to the solution because they cause underspending due to lower costs or less use of services or because they have dropped in political priority. The increased concern for the integration of immigrants and the priority for internal and external security that can be observed in many OECD member countries belong to this cluster.

Box 4. Reallocation due to changing political priorities

Type 4 case studies:

- Germany: Investment initiative 2000
- Netherlands: Investment fund 1993
- United Kingdom: Capital investment planning
- Sweden: Defence/health exercise 1998
- United States: Homeland Security

Germany, the Netherlands and the United Kingdom

Of the reallocation exercises motivated by changes in political priorities, three (Germany, the Netherlands and the United Kingdom) stem from a renewed emphasis on capital and investment programmes. Both Germany and the Netherlands effected this reallocation by earmarking specific streams of revenue that can only be accessed for investments. The Netherlands established the Fund for Economic Structure Enhancement in 1993 to ensure that revenues from gas exports were “invested rather than consumed”. The federal German government established a similar fund in 2000 and used windfall revenue of EUR 50 billion from selling third-generation mobile phone licences to repay outstanding debt. This in turn reduced expenditure on interest charges by EUR 2.5 billion per year and the additional funds were earmarked as the “future investment fund”. In both countries the type of project that can be financed through this fund is set out in budgetary regulations and laws but these are relatively broad. In the Netherlands, projects are primarily associated with “enhancing economic infrastructure”, including transport infrastructure, technology and telecommunications but also knowledge infrastructure. In Germany, money from the fund has been allocated across a broader range of projects, including EUR 800 million in additional capital for education, science and research; EUR 1.7 billion for investment in the transport sector; EUR 184 million to modernise universities; EUR 25.6 million for development in the former East Germany; EUR 41 million to modernise computer facilities in trade schools; and EUR 56.2 million annually for national genome research into five categories of disease. Some EUR 250 million is foreseen for renewable energies.
Box 4. Reallocation due to changing political priorities (continued)

The United Kingdom has developed quite different mechanisms in pursuit of the same reallocation objective. The fiscal and budgetary regime introduced in 1998 reformed the allocation system in an effort to remove a perceived bias against capital spending. Two fiscal rules were established which required over the economic cycle that a) the government only borrow to invest and not to fund current expenditure, and b) public sector debt remain around 40% of GDP. Compliance with these rules required departments and the government as a whole to develop separate current and capital budgets, and to ensure limited flexibility to transfer resources between them. As of 2003-04, departments require the authority of the Treasury to shift spending between these categories. In addition, the introduction of accrual accounting principles under the auspices of resource accounting and budgeting (RAB) is intended to “give departments the incentives to manage their capital assets more effectively, by reflecting the economic costs of holding and using assets in budgets”.

All three initiatives appear to have been successful: both Germany and the Netherlands reallocated resources from interest repayments to a range of investment projects, and in the Netherlands the real annual growth of investment (as a percentage of GDP) exceeded the real annual growth GDP throughout the 1990s. In the United Kingdom, capital investment is set to rise to 2.3% of GDP by 2007/08 compared with 0.7% in 1998/99. However, how these reallocations are to be judged from the point of view of allocative efficiency is a different matter (see discussion in Section 3.6).

Sweden: Defence/health exercise 1998

The fourth case study involves the politically difficult task of explicitly transferring funds from a low-priority spending area – in this case defence – to fund increased spending in an area of higher priority (health). In Sweden, the Social Democratic government was re-elected in 1998 following a campaign focused on healthcare, schools and the care of vulnerable groups in the community. While this exercise was not directly motivated by fiscal constraints, the government remained fiscally cautious after the 1994 consolidation exercise and only one year of budget surplus. Consequently it sought to provide a source of additional funding for healthcare spending through reallocating funds from defence spending. After considerable negotiation, the government reached a consensus with the Centre Party that defence appropriations should be reduced by SEK 4 billion (10%) from 2002, and that the defence programmes should be aligned and reorganised. To compensate for the initial costs of restructuring, defence received an additional appropriation of SEK 3 billion in 2002 and SEK 1 billion in 2003 (current prices). The net saving on defence would then be SEK 1 billion in 2002, SEK 3 billion in 2003, and SEK 4 billion in 2004. It was agreed that the full amount of this reduction was to be transferred from the defence appropriation to the appropriation for local government block grants (which deliver health programmes) and to be spent on healthcare. The fact that local governments are funded through a general grant system meant that this money could not be earmarked, but representatives from the local governments were asked to sign a contract to allocate resources towards healthcare.
Box 4. Reallocation due to changing political priorities (continued)

The primary success of this process was not in delivering new funding to the local governments – they were likely to receive higher grants with or without the defence cuts – but in allowing these increases to be delivered as a quid pro quo for reductions in the defence portfolio. Joining these two initiatives actually facilitated the political viability of reallocation because the government had something – increased social spending – to offer its negotiating partner.

The United States: Homeland Security

The broad range of policies designed to “secure the United States from terrorist attack” (homeland security) gained immediate priority after the attacks of 11 September 2001. The subsequent reallocation exercise was designed to increase the resources dedicated to homeland security and to consolidate them within a single cabinet department. This involved three major tasks:

- Defining and tracking the “universe of homeland security activities”.
- Implementing institutional reforms that established cabinet and departmental machinery to co-ordinate and take accountability for these programmes.
- Allocating additional resources to this policy area.

The political impetus created by 11 September made the task of legislating institutional reform relatively simple: the Office of Homeland Security (OHS) was established in October 2001, and legislation to establish a Department of Homeland Security was proposed in June 2002 and passed in November 2002. This reorganisation eventually consolidated 22 components from 11 agencies into the DHS and unified more than half of the homeland security resources.

By contrast, the job of articulating the status quo expenditure and programme base for homeland security was particularly complex and often highly contested. Existing resources cut across 30 executive branch agencies, and incorporated aspects of law enforcement, border security and healthcare; activities were often embedded in a range of programmes and were difficult to identify. This meant that the Office of Management and Budget (OMB) had to develop resource and programme data from the bottom up, using historical datasets developed by agencies and the annual report resource estimates. Debates about whether or not specific programmes contributed to homeland security were guided by the strategic framework being established by the OHS, but these debates were finally decided at the political level.
Box 4. Reallocation due to changing political priorities (continued)

The process of allocating additional resources initially relied on an emergency supplemental appropriations act, but once the OHS was established it worked with OMB to develop a budget submission for fiscal year 2003. Based on joint cross-cutting reviews, the budget submission focused on priority areas and sought to: a) focus resources where there were known gaps in capacity; b) ensure that resources could be effectively utilised in the short term; and c) enable agencies to begin long-term prioritisation. OMB sought to maintain a clear and understandable definition of homeland security to facilitate the measurement of real policy change and performance. Nonetheless, the status of homeland security as a “favoured category” has resulted in pressure to include more resources within the definition.

The fifth type of reallocation focuses on substitution of inputs (production factors or intermediate products) within the same programme or set of programmes in order to make the programme(s) more efficient. This is an effort that is motivated exclusively by supply factors. Reallocation is necessary in this case if separate production factors or intermediate products are appropriated on different accounts. Substitution of production factors may be desirable in order to improve the allocative efficiency of the production process in response to changing input prices or to accommodate the production process to technological innovations leading to new products or lower costs. It may also be the case that substitution is desirable in view of preceding reforms directed at improvement of cost efficiency. To the extent that the budget is reformed in the direction of performance accounts, this type of reallocation is less necessary. The reform in the direction of performance accounts can also be seen as a type of reallocation initiative in this cluster since it is aimed at making this type of substitution possible.

Box 5. Reallocation to facilitate the substitution of inputs

Type 5 case studies:
- Germany: Restructuring the Bundeswehr 2001
- France: Autonomie de gestion des préfectures 2000
Box 5. Reallocation to facilitate the substitution of inputs (continued)

The drive to aggregate appropriation structures in most of the countries involved in this study means that exercises designed to reallocate funds from one input area to another within a single programme are largely invisible. In New Zealand and Sweden for example, the centre does not track expenditures at the level of input, and even in countries where this information is collected (e.g. Canada), allocation is decided by line agencies and not the centre or legislature. As a result, the centre often finds it difficult to implement reallocation exercises in the interest of operational efficiency and typically relies on blunt or indirect instruments such as efficiency dividends or administrative reform initiatives.

Germany sought to improve operational efficiency within the defence budget by ensuring that all savings were reinvested in the portfolio, rather than reducing overall spending. Under this programme, the armed forces (Bundeswehr) are being reduced in size: military personnel will be reduced from 340,000 to 255,000 troops and there will also be a reduction in civilian personnel posts. Intensive co-operation with the private sector in the field of information technology, clothing, and fleet and real estate management is intended to cut running expenses. The savings generated will be invested in the modernisation of the armed forces and their equipment. For example, strategic airlift and reconnaissance capabilities will be improved and several initiatives have been designed to improve training and education, thus making military service more attractive. Since 2002, proceeds up to a ceiling of EUR 600 million on the sale of movable and immovable properties may be retained and added to the defence budget.

In contrast to the move to truncate running cost votes in many OECD member countries, the budgetary system of France remains highly disaggregated. In 2000, the budgets for procurement and salaries were consolidated in a part of the network of French préfectures (responsible for the co-ordination and management of the services of the State at the territorial level in the department or the region). This experiment is considered as a pilot for the reform of public management in France and for the implementation of the new organic budget law that was approved in 2001. The experiment gives the préfectures authority over their entire budget for current expenditure (procurement and salaries). The budget is calculated on the basis of real expenditure in the year preceding the start of the experiment. The budget is increased annually, independently of its use (0.3% annually between 2000 and 2002). It is adjusted for general salary measures in the public sector. When a vacancy occurs, the préfet can allocate the resources involved for procurement or the creation of a new post. This can modify the structure of employment, provided that two ceilings are simultaneously complied with: total employment and the total salary sum.

In 2000, about 18% of the appropriation freed up was used for supplementary operations, 17% for bonuses for officials, and 55% for additional procurement. It was therefore seen to facilitate public sector modernisation and improved working conditions. It has allowed the recruitment of new staff and the contracting out of tasks that were previously carried out by public officials. The expected benefits of this experiment include: more responsibility for local managers; a better allocation of resources in the management of missions; the development of human resource management at the local level (reform of the hierarchical structure of the organisation, development of qualifications, contracting out of certain tasks); and a reduction in external preventive financial control.
3. The role of institutions

3.1. Diagnosis and redress

All the institutions that have been studied appear to have a double function. In the first place, they are a diagnostic tool in the sense that they help to establish the need for reallocation. If, for instance, the expenditure targets of a multi-annual framework are exceeded, this might trigger a reallocation initiative. In the second place, they are a tool for redress in that they help formulate the reallocation proposal. Extending the example: a medium-term framework itself contains the quantitative targets determining the size of the cuts that are required to offset the overspending.

The study aims to assess the working of institutions on the basis of the criterion of allocative efficiency. However, this criterion is not directly operational. Allocative efficiency cannot be measured in practice. Therefore, the study makes use of proxies. In particular, attention will be paid to the institutional guarantees that information about the allocative efficiency of alternative policies is available at the right time to those decision makers who have incentives to use this information. In general, these decision makers are to be found in the centre of government. The minister of finance is the traditional “friend” of the taxpayer and as such has a strong interest in allocative efficiency. The prime minister and/or the president are other players with a strong positional interest in allocative efficiency. The same is true for the budget committees and financial (tax) committees of the legislature. The study will look at the competences of these authorities in the budget process as a proxy for the direct measurement of the impact of institutions on allocative efficiency.

3.2. Medium-term expenditure frameworks

All OECD member countries have medium-term expenditure frameworks. They are based on a medium-term forecast of the macroeconomic variables that are important for the budget: economic growth, inflation, the price of oil, exchange rates, etc. They specify medium-term targets for total revenues, total expenditures, the deficit and sometimes a number of major subdivisions of expenditure. Derived from that is an expenditure path starting in the upcoming budget year and finishing in the medium-term target year.

Medium-term expenditure frameworks can be rolling or periodical in nature. Rolling frameworks are drawn up during budget preparation every year or every two years. Each year, or each second year, the target year (the last year of the framework) is passed on to a later year. Periodical frameworks are drawn up at the beginning of the period to which they apply and then stay in place until that period has lapsed. Both rolling and
periodical frameworks may be amenable to revision in the middle of their lifetime. If a medium-term framework is periodical, the upcoming budget year may take any position in the sequence of years to which it applies. Of the countries that provided information to this study, the Netherlands, Sweden and the United States had periodical medium-term frameworks (the United States until 2002); all others had rolling frameworks.

The medium-term framework may cover two, three or four years, including the upcoming budget year. Table 2 shows the length of the framework among the countries participating in the study.

<table>
<thead>
<tr>
<th>Two years</th>
<th>Three years</th>
<th>Four years</th>
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<tbody>
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<td>Italy</td>
<td>Canada</td>
<td>Mexico</td>
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<tr>
<td>United Kingdom</td>
<td>Czech Republic</td>
<td>Netherlands</td>
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<tr>
<td>France</td>
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<td>Germany</td>
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Source: Kraan and Kelly.

The primary aim of a medium-term expenditure framework is to provide intertemporal consistency to budgetary policy. For this purpose, the framework makes clear how in subsequent annual stages the medium-term targets will be realised. In particular, a government that publishes a medium-term expenditure framework will have to make clear that its proposals for the upcoming budget year are consistent with its medium-term targets, and that it will not postpone all necessary painful measures to the out-years of the framework. Secondary aims of a medium-term framework may be to strengthen the stabilisation function of the budget and to bring more tranquillity to the budget process. For these purposes, it is necessary that the time path of total expenditures leading to the medium-term target be considered as a series of fixed caps that cannot be adjusted further during annual budget preparation. In other words, even if the framework is rolling, the caps of last year can no longer be touched, even for the out-years. Only a new out-year (or two years) can be added at the end of the time path. This means that the expenditure total of the upcoming budget year must be consistent with the cap of last year’s corresponding out-year. Indeed, from year to year, the expenditure total of the budget has to be reconciled with the expenditure cap of a medium-term framework that was established in some previous year. A medium-term expenditure framework that has only the primary aim is called a flexible framework because it allows for the adjustment of total expenditures to economic and budgetary circumstances...
from year to year. A framework that also has the secondary aims is called a
**fixed** framework, because it does not allow for such adjustment from year to year. Of the countries that provided information to this study, the Netherlands, Sweden, the United Kingdom and the United States (until 2002) had fixed medium-term frameworks. The others (Canada, the Czech Republic, France, Germany, Italy, Mexico, New Zealand and Spain) had flexible frameworks.

A fixed medium-term framework automatically leads to a fluctuating annual deficit. Since expenditures cannot be adjusted and tax revenue will fluctuate according to the economic business cycle, the deficit will fluctuate accordingly. Sometimes an upper limit is established for the allowed fluctuation of the deficit. If the limit is exceeded, the expenditure cap of the framework has to be adjusted. This is the case, for example, in the Netherlands: in the period 1998-2002, the upper limit was 1% of GDP higher than the structural deficit derived from structural tax revenue and the expenditure cap. A fluctuating deficit contributes to the macroeconomic stabilisation function of the budget. The general budget fund acts in this way as an “automatic stabiliser”. This means that its effect on the economy is cyclical, not that it is countercyclical (for the latter, expenditures would need to be increased if tax revenue fell behind the trend).

A fixed medium-term framework also brings added tranquillity to the budget process because tax revenue fluctuations are no longer a reason for expenditure adjustment. Of course, there remain annual adjustments at the level of spending ministries and budget accounts, but these focus exclusively on the division of the total available under the cap. They are no longer affected by the revenue side of the budget.

Medium-term frameworks, regardless of whether they are flexible or fixed, are directed at a certain balance between expenditures, revenues and the deficit in the medium term. In view of the reasoning behind this balance, the framework can be characterised as (a) debt oriented, (b) supply-side oriented, or (c) demand-side oriented.

In a debt oriented framework, the medium-term structural deficit target is the central aim; this means that the expenditure and structural revenue targets are determined by the deficit. A low deficit is deemed important for reasons of monetary policy. If a country is heavily indebted and runs a high deficit, the market will require a high rate of interest for its loans and this may in turn affect the interest rate levels in global capital markets. In addition, debt repayment is deemed important in countries that face the problem of an ageing population in the near future. An ageing population requires high investment in the private sector in order to pay for future retirement and healthcare costs. Public borrowing, however, crowds out
private borrowing. Examples of debt oriented medium-term frameworks are the ones that aim at a balanced budget over the cycle. These are used in Canada, Mexico, New Zealand and the United Kingdom. Sweden even aims at a surplus over the cycle. The Stability and Growth Pact of the European Union is an example of a supranational medium-term framework that is primarily motivated by monetary and demographic considerations.

In a supply-side oriented framework, tax relief is the central aim; this means that the structural deficit and expenditure targets are determined by tax relief. The latter is thought important because of its effects on incentives in the market sector of the economy. In a strict sense, only marginal tax rates are important for incentives, and in theory the decrease in marginal rates could be compensated by the increase in average rates; total receipts would not be affected. However, this only applies to a progressive tax system (where the rate increases with the base) – not, for instance, to sales or value-added taxes which are typically not progressive. Furthermore, in practice, the decrease in marginal rates sought by supply-side oriented tax reform is often not compensated by the increase in average rates.

In a demand-side oriented framework, the structural deficit is the central aim as in a debt oriented framework. However, in this case the deficit target is not based on monetary and demographic considerations but rather on the supposed “structural savings surplus” in the market sector of the economy. This is a concept from Keynesian macroeconomic theory. At the time when the theory was dominant in the world of academic economics, many OECD member countries adopted this type of medium-term policy. Examples were the Konjunktur Neutrale Haushalt in the former West Germany, the Structureel Begrotingsbeleid in the Netherlands and the full employment surplus in the United States.9 In the 1990s, Japan still followed a medium-term policy that was partially motivated by Keynesian ideas about demand management. At present, most OECD member countries have abandoned these ideas as motivation for their medium-term budgetary policies.

Medium-term expenditure frameworks are based on macroeconomic assumptions and forecasts. The organisation responsible for these assumptions and forecasts is usually the same as the one that makes the short-term assumptions and forecasts for the upcoming budget. This unit may or may not be part of the budget office. The rationale for separating it from the budget office is to provide it with a certain degree of independence. In this way, the tendency of incumbent politicians to base financial planning on assumptions that are too optimistic may be held in check. Of the countries participating in this study, Canada, Germany, the Netherlands and the United States have created some degree of independence for the organisation responsible for the macroeconomic assumptions and forecasts.
In Germany and the United States, this task is given to a committee that is not entirely under the control of the budget office. Furthermore, in the United States, the Congressional Budget Office will develop its own assumptions, which will be compared to those of the administration. In Canada, the forecasts of the Department of Finance are based on a survey of about 20 private sector forecasters, who work independently of one another. In the Netherlands, the task of forecasting is given to an independent bureau. The organisation responsible for the assumptions and forecasts may do the econometric modelling underlying the forecasts by itself or contract it out to a research institute or private firm, or use existing forecasts produced by research institutes and private firms.

Some of the countries participating in the study claim to use deliberately “cautious” macroeconomic assumptions when they draw up medium-term expenditure frameworks (France, the Netherlands and the United Kingdom). This implies that they use assumptions that are somewhat more pessimistic than the average forecasts of other research institutes and private firms, especially as far as economic growth is concerned. The United Kingdom treasury subtracts 0.25% of GDP from its own growth forecasts by way of prudence margin.

Medium-term expenditure frameworks tend to concentrate interdepartmental reallocation packages in the decisions about the (extension of the) framework. After the framework has been established, interdepartmental reallocation becomes more difficult because of the division of the expenditure caps across departments. Furthermore, if frameworks require across-the-board retrenchments or allow across-the-board expansions, these operations tend to be smaller in scale than the reallocation exercises that sometimes occur when medium-term frameworks are established (extended), due to the fact that the development of tax revenue plays a less important role. This effect is even stronger for fixed than for flexible medium-term expenditure frameworks. Therefore, fixed frameworks bring even more tranquillity to the budgetary process than flexible frameworks.

From the point of view of allocative efficiency, medium-term expenditure frameworks are largely neutral. They have a stabilising effect on the expenditure pattern once they are established, but whether this is desirable from an efficiency point of view is entirely dependent on the efficiency of the expenditure pattern that is being stabilised. However, a negative efficiency effect could be that frameworks make it somewhat more difficult to change an existing expenditure to meet new external circumstances. On the other hand, a positive efficiency effect follows from the concentration of interdepartmental reallocation in the periodic design or revision of the framework. The order and tranquillity that expenditure
frameworks typically impose upon the budgetary process lead to savings in
decision-making costs. This effect too is stronger for fixed than for flexible
frameworks and can be a significant source of savings for governments that
are considering moving from a flexible to a fixed framework.

3.3. Rules of budgetary discipline

In order to be effective, medium-term expenditure frameworks must be
accompanied by rules of budgetary discipline. These rules require that all
budgetary estimates, for the current budget year as well as the out-years
(including the upcoming budget year), must comply with the caps of the
medium-term framework and that all overspending with respect to those
caps must be compensated. The compensation requirement applies first to
the current budget year. Of course, there are formal barriers against
overspending in the current budget year to begin with, because this requires
supplementary appropriations bills. In some countries, elaborate control
systems are in place in order to prevent this from happening (the Czech
Republic, France, Italy and the United States). However, overspending can
never be entirely excluded, and in the cases where it occurs, rules of
budgetary discipline require compensation. In order to be effective, the
compensation requirement must then also extend to the out-years of the
medium-term framework. This implies that overspending with a structural
cause must be compensated by measures with structural effects, so that the
amount of overspending is compensated year by year through the effects of
the compensating measures. It also implies that policies that only cause
overspending in later years ("camel noses") must be compensated by
measures that equally take effect in the future. This includes the coming
budget year, to which the caps of the first out-year of the current budget
apply.

Rules of budgetary discipline typically attribute the first responsibility
for the compensation of overspending to the spending minister. This
requires that the spending caps of the framework are divided among the
departments. The spending minister can always try to share the burden with
other ministers, but this requires the agreement of those ministers and the
cabinet or president. The rules may differ on the treatment of overspending
on entitlement legislation. Sometimes the spending minister is made
responsible for timely change of the legislation in order to halt the
overspending (the Netherlands, Sweden). If this is not explicitly stated, the
cabinet or the president is responsible. In the United States, mandatory
spending (mostly on the basis of entitlement legislation) was exempted from
the compensation requirement under the Budget Enforcement Act of 1990
(expired in 2002). However, the United States had rules of budgetary
discipline for congressional action to change entitlement or tax legislation
(the so-called pay-as-you-go principle, or PAYGO). The United Kingdom makes a distinction between spending that is subject to departmental expenditure limits (DEL) and annually managed expenditure (AME). AME covers social benefits and other volatile or non-discretionary items and is exempted from compensation requirements. In contrast, AME programmes are subject to biannual scrutiny and forecast to ensure that spending in these areas does not threaten fiscal stability.

There seems to be a certain inverse relation between the effectiveness of rules of budgetary discipline and the strictness of control systems that aim to prevent overspending of separate accounts in the budget year. If rules of discipline are effective, spending ministers can be allowed to reallocate relatively easily between accounts. There is then no need for heavy preventive control systems. Supplementary appropriations bills can be used to regularise those reallocations after the fact, and supervision of those bills on the part of the minister of finance and the cabinet or president can be marginal, namely limited to compliance with the rules of discipline and of compatibility with general cabinet/presidential policies. The assumption is that the reallocations do not involve shifts of political priorities, but rather substitution of inputs (Type 5 reallocation); or, if they do change political priorities – for instance in cases of overspending or the rise of a new priority (Types 3 and 4) – that this does not affect major directions of government policy, but rather shifts of emphasis in broad policy areas within the sphere of discretion of individual spending ministers. In this respect, it is also relevant that rules of budgetary discipline are usually executive rules that bind ministers only; they do not apply to the legislature. Even if spending control within the executive branch has largely shifted from appropriations laws to rules of budgetary discipline, the legislature will still focus on appropriations. To a certain extent this will be the case in every country because spending ministers are responsible for appropriations to parliament, but it is particularly true in the United States where the Congress is the dominant authority with respect to appropriations. The upshot then is that, apart from the United States, introducing rules of budgetary discipline tends to facilitate reallocation on the initiative of spending ministers, while it also strengthens the control of the departmental totals, not only in the budget year but also in the out-years.

Rules of budgetary discipline not only facilitate but also trigger reallocation and even point to the form it should take. They trigger reallocation in cases of overspending or underspending across the board or revenue shortfall or windfall (Types 1 and 2 reallocation), and in cases of overspending for a specific programme or the rise of a new priority (Types 3 and 4). Overspending across the board in times of fiscal stress requires reallocation in the sense of retrenchment across the board. Underspending
across the board in times of fiscal abundance makes it possible to fund new priorities across the board or to provide tax relief. This was the prevailing type of reallocation during much of the 1990s in many OECD member countries. Revenue shortfalls or windfalls can only trigger reallocation if the framework is flexible and leaves at least some room for effects of revenues on expenditures. Apart from that, revenues can of course have an effect on expenditures when the framework is first made up or extended (in a rolling system). Reallocations motivated by fiscal stress (Type 1) and fiscal abundance (Type 2) are typically government-wide operations of great political significance undertaken under the supervision of the cabinet or the president. The minister of finance will play an advisory and supportive role, but will usually not lead the operation. Overspending for a particular programme (Type 3) or the rise of a new political priority (Type 4) require compensation on a smaller scale, usually in one or only a few programmes. According to rules of budgetary discipline, the spending minister is responsible for compensation and the minister of finance will usually play a strong supervisory role. The cabinet or the president will only be involved if the programmes are of major political significance or if the spending minister seeks to share the burden of compensation with other colleagues. The voluntary retirement programme in Mexico, the investment initiative 2000 in Germany and the defence/health exercise 1998 in Sweden, mentioned in Section 2.2, are examples of the latter case.

3.4. The role of the minister of finance

The rules and conventions delimiting the authority of the minister who is responsible for the budget differ from country to country. In most OECD member countries, the minister of finance (or secretary of the treasury or chancellor of the exchequer) is responsible for the budget as well as for domestic and international finance. In some countries, the minister of finance is also responsible for economic affairs. However, in a few cases the responsibilities for financial affairs are split up in a different way. In Canada, domestic and international finance as well as macrobudgetary affairs are the responsibility of the minister of finance, and departmental spending and estimates are the responsibilities of the Treasury Board Secretariat. In the United States, budgetary affairs are handled by the Office of Management of Budget, which is part of the Executive Office of the President. It is headed by a budget director who has cabinet rank. Domestic and international finance are the responsibility of the Department of the Treasury. The degree to which authority for the budget and fiscal affairs are separated may limit how other budgetary institutions can be used by a minister of finance to facilitate reallocation.11
Ministers of finance share a common set of functional roles and authorities. These include the development of the medium-term expenditure framework and enforcement of the rules of budgetary discipline. During the budget formulation process, ministries of finance are responsible for setting the procedural rules, reviewing the budget documentation submitted by spending ministries (typically but not always within the guidelines and expenditure ceilings established by the ministry) and providing the cabinet with alternative options. Once the budget is formulated, the minister of finance typically develops the budget documentation and submits it to parliament. Many countries that provided information for this study also mentioned the authority to set executive-level expenditure controls in addition to those set in appropriations laws, including the authority to approve reallocations between expenditure items during the budget year.

Ministers of finance will have an interest in reallocation for the purposes of enforcing (1) medium-term frameworks, (2) current appropriations laws, and (3) rules of budgetary discipline, as well as (4) improving cost efficiency. All five types of reallocation mentioned in Section 2.2 may be required for these purposes. However, this does not mean that the minister of finance can, on his or her own, order a reallocation operation of any of those types.

There are few areas in which a ministry of finance can act autonomously, and this applies in particular to the domain of reallocation. While the minister of finance can diagnose the need for reallocation, this does not necessarily translate into a leading role in the subsequent reallocation effort. The support of other ministers, the cabinet, the prime minister or the president is likely to be necessary. Even if reallocation is considered to be an appropriate course of action, the degree to which ministries of finance can identify the scope, target and details of policy change required differs significantly between countries. This study highlights that this capacity will be affected by the degree to which the relationship between the minister of finance and other ministers: a) is based on compromise and accommodation among relative equals; b) is a more directive principal-agent style relationship as far as budgetary matters are concerned; or c) operates within clearly defined spheres of responsibility (often legal distinctions).

Reallocation operations of Type 1 and 2 are the least likely to be initiated by the minister of finance unilaterally. Whereas in theory authority over the budgetary framework could enable the minister of finance to instigate government-wide reallocation, this does not appear to be the case in practice. These exercises only succeed with the support of the prime minister/president which is translated into acceptance, if not support, of the cabinet more broadly. Once this support is garnered, the ministry of finance...
will typically work with the prime minister/president to establish the broad framework of the reallocation exercise. This will include setting a budgetary balance target and identifying the distribution of expenditure cuts either by setting reduction targets for each department, or by recommending new departmental spending caps. While individual ministries are asked to develop the specific cutting options, the ministry of finance will typically review the options developed by departments and provide the cabinet with possible alternatives.

Tight rules of budgetary discipline enable devolution but also reduce the authority of the centre of government (minister of finance, prime minister/president) over the detail of reallocation. While this may be a necessary trade-off, it does limit the extent to which the centre can ensure that reallocation decisions improve allocative efficiency. The countries in this study are differentiated by the extent to which spending ministries bear responsibility for their departmental budgets. Countries with effective rules of budgetary discipline, such as the Netherlands, New Zealand, Sweden and the United Kingdom, are characterised by strong devolution; countries with a more legalistic tradition, such as France, Germany, Italy and the United States, are characterised by a stronger authority of the centre over the detail of reallocation.

While devolution of authority over departmental budgets may facilitate some types of reallocation exercises (Types 3-5), the pervasiveness of this culture seems to build an expectation of budgetary autonomy that both diminishes the authority of the minister of finance and builds a non-negotiable expenditure base. In doing so, it hampers cross-government reallocation (Types 1 and 2) and even those versions of Types 3 and 4 reallocation that cut across departmental boundaries. Some recent attempts to increase the authority of the minister of finance to conduct cross-departmental reallocation can be seen in the value for money reviews in New Zealand and the departmental assessment process in Canada (see Box 2). In both instances, the minister of finance sought cabinet approval for the objectives and the content of the reallocation process and provided departments with impetus and resources. But successful reallocation depended almost entirely on the degree of buy-in from individual ministers. There were only a few instances where the exercise led to identifiable reallocation across departments (only in New Zealand).

Ministries of finance also differ with respect to the impact of their decisions in the annual cycle of budget formulation. Usually there are two stages when the minister of finance takes decisions on actual expenditure estimates. The first occurs at the beginning of the cycle as the minister sends out target numbers or guidelines to the spending departments. These numbers may already incorporate interdepartmental reallocations that the
The role of budget institutions in reallocation

Minister considers necessary in order to maintain the medium-term framework. Here the authority of the minister determines how much importance the spending departments will attach to these numbers. The second occurs at the end of the cycle as the minister puts forward the final proposal. A “weak” minister of finance will not be able to impose that final proposal on spending ministers unilaterally. In the case of a difference of opinion, the decision will be taken over by the cabinet or a cabinet committee. A “strong” minister of finance is able to impose a final proposal on spending ministers unilaterally, with at best an appeal procedure to the prime minister or the president. France, the United Kingdom and the United States are examples of countries with strong ministers of finance in this sense.

The finance ministries in the Netherlands, New Zealand and Sweden use their authority to set procedural rules and targets for the annual cycle of budget formulation, to ensure that spending ministries reallocate as a routine part of the budget management. In establishing a system of fixed nominal baselines, New Zealand has separated out the management of funding for existing programmes from management of the funding for new programmes. In the former area, departmental budgets are supposed to remain largely unchanged from year to year and spending ministers must manage any cost pressures through reallocations within accounts or specific output areas. Importantly, this occurs without recourse to or approval from the minister of finance, leaving departments with sole authority to assess the allocative efficiency of these decisions. Departments are also prompted to undertake priority-driven reallocation (Type 4) by the requirement that the cost of new policy initiatives is fully offset by commensurate cuts within the existing budget. It should be noted that while the latter mechanisms provide the information required to fund new policy development through reallocation, it may still be the cabinet, and not the minister of finance, that decides to fund new programmes through reallocation. In an effort to provide an impetus for the cabinet to pursue this objective, the governing coalition in New Zealand established a cap on total new expenditures over the life of the government. There are three reasons why this proved difficult to enforce in practice: (1) there was a budgetary surplus; (2) the fiscal squeeze occurred at the end of a government’s mandate, *i.e.* just before an election; and (3) the minister of finance could only provide ministers and the cabinet with information to facilitate reallocation decisions (see the VFM process mentioned above), but the spending ministers bore the ultimate responsibility. In this instance, ministers collectively decided not to adhere to the rules of budgetary discipline; the minister of finance had little recourse.
Most of the countries represented in this study have implemented reforms in the direction of results oriented budgeting. These reforms involved: (1) efforts to assess the outputs and outcomes of spending programmes through quantitative indicators or policy evaluation; (2) relaxation or elimination of rules that restrict the discretion of managers to decide about inputs; and (3) the use of output or outcome information in the budgetary process. The second type of reform has meant among other things the revision of the account structure of budgets in the direction of output oriented items. In view of expected gains in technical and allocative efficiency, these reforms have often been initiated or supported by ministries of finance. Examples are the 1990 reforms in New Zealand and, more recently, the Program Assessment Rating Tool (PART) in the United States (see below and Box 6).

PART was developed by the Office of Management and Budget (OMB) in order to further the integration of performance information in the budget process. PART is in essence a questionnaire that requires spending departments and other agencies to provide information about performance as part of the regular budgetary process. The questionnaire consists of a relatively limited number of questions and focuses on key aspects of performance. For the presidential budget 2004, PART has been used for a fifth of all spending programmes by way of experiment. OMB intends to expand it to all programmes in the coming years. The position of OMB as part of the Executive Office of the President both constrains and enhances its capacity to promote reallocation. The diagnostic role of OMB is enhanced by a direct line to the president but operating within a highly competitive environment that includes actors from both the public and private sectors. As the PART initiative in the United States suggests, an interested president can provide both mandate and authority to undertake review exercises designed to identify programmes ripe for reallocation. That being said, the strategic role of the legislature means that any recommendations developed by OMB on the basis of these reviews remain advice to the president and proposals to the Congress and to the public more broadly. The authority of OMB to conduct reallocation exercises is highly constrained.
Box 6. The Program Assessment Rating Tool (PART) in the United States

The Program Assessment Rating Tool (PART) was introduced to assess government programmes in an ongoing, systematic and transparent manner in the lead-up to fiscal year 2004. Development of this tool was primarily driven by a change in leadership and priorities in 2001. The new president articulated the integration of budget and performance as one of the five priorities on the President’s Management Agenda, and PART was developed on the premise that both the allocation of resources and accountability for the management of those resources are critical to optimising results. While fiscal pressures did not drive the development of PART, they made it more widely relevant. PART was developed by a task team in OMB, in consultation with a range of experts and stakeholders. Essentially, the system requires programme managers, with oversight from OMB, to assess and produce ratings of 20% of the programmes in a department each year. OMB programme examiners, in consultation with the agencies, have the discretion to select which programmes are to be assessed.

A series of approximately 30 common questions evaluate four critical areas of a programme. Each area has a different weight in the overall score: programme design and purpose count for 20%; strategic planning, 10%; programme management, including financial oversight and programme improvement efforts, 20%; and accountability for programme results, 50%. PART also includes additional questions in each section that have been tailored for a particular type of programme. Seven programme types were identified:

1. Competitive grant: Programmes that distribute funds through a competitive process.
2. Block/formula grant: Programmes that distribute funds by formula or block grant.
3. Regulatory-based: Programmes that employ or issue regulations to achieve goals.
4. Capital assets and service acquisition: Programmes that achieve goals through development and acquisition of capital assets or the purchase of services from a commercial source.
5. Credit: Programmes that provide support through loans, loan guarantees and direct credit.
6. Direct federal: Programmes that provide support and services by federal employees.
7. Research and development: Programmes that focus on creating knowledge or applying it toward the creating of systems, devices, methods, materials or technologies.
Box 6. The Program Assessment Rating Tool (PART) in the United States
(continued)

The responses to each question determine the scores for the sections. The section scores are combined to produce a numerical score of 0 to 100 for the programme as a whole and an overall qualitative rating of effective, adequate, or ineffective.

The process of completing the PARTs generally involves one OMB programme examiner and several relevant programme managers and staff within a department. The programme staff provides the evidence to support positive responses; this evidence is discussed and evaluated for sufficiency with the OMB examiner. When responses are negative, the budget examiner works with the programme managers to identify the cause of the weaknesses and to propose recommendations for correcting them. Overall recommendations for future performance and funding are also jointly developed. Departments can appeal their PART ratings in the same way they can appeal their budget allocations.

In the first year it was employed (FY 2004 budget), PART led to the incorporation of performance information in the budget and the results influenced some budget allocations. However, the impact was not on a scale that was reflected in the budget numbers. It is reasonable to expect that, as a larger percentage of programmes are assessed and multiple years of data demonstrate persistent problems, the PART data will support greater reallocations. The wide variation across departments in the number, funding level and definition of programmes can be confusing to the users of the PART data and adds to the difficulty of comparing programme funding levels to budget data, particularly because the account structures are also not uniform across departments. Efforts are under way to better trace budget accounts to programmes for aggregate use in future budgets.

3.5. Programme review

Programme review is defined in this study as a specific form of policy evaluation characterised by the fact that it is initiated and supervised from the centre of government, namely the budget office or the office of the prime minister/president. Most countries participating in this study reported that they had standard procedures for policy evaluation, but only a few reported standard procedures for programme review in this particular sense. Other countries reported that they had used programme review procedures on an ad hoc basis in order to support large retrenchment operations in the past (Type 1 reallocation).

At present in many OECD member countries, it is common practice for policy evaluation to be supervised by spending departments. This type of evaluation is closely connected with the move towards performance
management. Policy evaluation is commonly seen as the best alternative to performance indicators as an informational device for the steering and control of expenditures. Since the goals and outputs of many programmes cannot be measured in a reliable way, evaluation is widely used by programme managers to acquire feedback information about their activities, in terms of effectiveness and cost efficiency. However, programme review in fact fulfils different functions: it looks at the allocative efficiency of programmes for the government and the citizen/consumer; and it looks at the consequences of alternative funding levels. The first function requires answering questions such as: (1) Is this programme justified by a valid motive for government intervention, or should the programme be left to the market or the private non-profit sector? (2) Should this programme be organised at the level of national government or should it be left, for instance, to the municipalities? (3) Does this programme use the appropriate instrument or should it, for instance, use regulation or a tax instead of a subsidy? (4) Is this programme designed appropriately from the point of view of allocative efficiency for the government and the citizen/consumer – for instance the right subsidy base, regulatory object, criteria for eligibility, etc.? The second function requires answering questions such as: What would be the consequences for the quality of services, the level of provision, the private funding contribution and the demand for substitute services, if public funding were reduced by, for instance, 5%, 10% or 20%? These two functions are typically not fulfilled by policy evaluation under the supervision of spending departments. Of the countries that provided information to this study, the Netherlands and the United Kingdom have standard procedures of programme review.

Programme review can be used for all types of reallocation in which the minister of finance or the prime minister has to play an important role. This applies first to across-the-board reallocation exercises of Types 1 and 2 (fiscal stress and fiscal abundance). In the case of Type 2 reallocation, programme review will particularly be applied to the programmes that have to be curtailed; programme review is less suitable to the design of programme expansion. Spending departments see this as part of their core task and do not need help from the centre of government to produce such proposals. Programme review can also be useful for Types 3 and 4 reallocation (programme overspending and new priority), again only with regard to programmes that have to be curtailed. In these cases it will particularly be applied if the reallocation is so politically significant that it cannot be left to the spending minister or if a spending minister wants to transfer a (part of a) retrenchment commitment to one or more colleagues.

Programme review tends to be a controversial institution. Spending departments resist being subjected to it. The review exercises themselves do
not often run smoothly and sometimes turn into interdepartmental battlefields. Special rules such as those used in the Dutch procedure may alleviate these problems (external chairman, no right to veto, secretariat provided by the ministry of finance, a supervisory committee in which the spending departments are not represented). Nevertheless, in the years of high economic growth during the 1990s, the Dutch minister of finance had to give up the obligatory 20% retrenchment variant in order to save the procedure. Also, there were years when the procedure barely survived. The British procedure exists only since 1998 and has a relatively mild obligatory retrenchment alternative of 5%. Nevertheless, these procedures are important. They provide for opportunities to build reallocation into the regular budgetary process. If they are combined with multi-year expenditure frameworks, it becomes somewhat easier to find compensatory measures. They thus provide for some additional flexibility to adjust the budget to changing external circumstances. Programme review yields information on the allocative efficiency of programmes and alternative scenarios. Furthermore, programme review tends to strengthen the position of the minister of finance and the prime minister/president in the decision-making process. These are exactly the ministers that have a positional interest in allocative efficiency because they are judged by the electorate on the costs and benefits of government as a whole. Although it is a difficult reform to introduce, governments that do not have it may well find programme review worthwhile. Especially in the changed budgetary landscape of the 21st century, it may prove to be a preferable alternative to big periodical retrenchment exercises that are applied in spasmodic fashion and for which the procedures have to be hammered out anew every time.

Box 7. **Designing successful programme review mechanisms**

Relevant cases:

- United Kingdom: Spending Reviews 1998
- Netherlands: Interdepartmental policy reviews

Of the numerous efforts to establish ongoing programme review exercises that facilitate targeted expenditure reallocation, only those of the Netherlands and the United Kingdom appear to have been successful. Box 1 discussed attempts made in New Zealand and Canada to establish a similar system but neither of these processes was sustainable, although both countries continue to move toward this objective. In addition, the PART system introduced in the United States may prove successful, although it is still too early to judge. Given the interest
Box 7. Designing successful programme review mechanisms (continued)

in establishing programme review mechanisms, the processes of spending review and interdepartmental policy reviews are described below.

Spending review process

The government of the United Kingdom introduced a new biannual Spending Review process to set departmental spending plans for the three years following, as part of broader budget reforms in 1998. The reforms were intended to address criticism of the previous control regime – that is, that it did not distinguish between capital and current spending, that it was focused on cash inputs instead of outcomes, and that the annual spending round was too short a planning horizon. The Spending Reviews cover discretionary spending (with the exceptions of transport and health) and set new spending and performance plans (public service agreements, PSAs) for two additional years beyond the existing plans. Non-discretionary, so-called annually managed expenditure (AME) is also excluded from the process.

While the review process has been adapted each year since implementation, the basic steps remain unchanged. The process lasts about one year and includes the following key milestones (based on the 2002 Spending Review):

- The chief secretary (budget minister) writes to departments setting out the framework for the review.
- The Cabinet Committee on Public Services and Public Expenditure (PSX) (chaired by the chancellor) meets with secretaries of State of spending departments to discuss progress against targets and objectives, and considers papers from each department setting out key strategic challenges.
- Departments submit an analysis of resources and a draft public service agreement to the treasury. The latter sets out what the department proposes to achieve with its resources over the Spending Review period.
- The budget in March forecasts revenues over the period covered by the Spending Review, and an envelope for total public spending for the period is derived from that forecast, split into current and capital spending.
- Analysis of resources and draft PSAs are scrutinised by treasury spending teams and treasury ministers; negotiations take place at official and ministerial level between the treasury and spending departments.
- Departmental spending plans and PSAs are discussed and agreed between the chancellor, the prime minister and the relevant departmental minister. The outcome of the review is published; spending plans decided on in the Spending Review are fixed and not subsequently reopened.
Box 7. Designing successful programme review mechanisms (continued)

Interdepartmental policy review

The Reconsideration procedure introduced in the Netherlands in 1981 forms the basis of the current system of programme review. Under this system, policy reviews are conducted with the purpose of developing alternatives that would yield savings preferably based on efficiency measures but, if necessary, based on reduction of service levels. Only alternatives costing the same or less can be considered. Each review has to produce at least one alternative that would lead to a 20% reduction of expenditure after four years compared to the current estimate of the last out-year. In the 1990s, the Reconsideration procedure was gradually adapted to changing economic circumstances. The mandatory 20% savings alternative has been abolished and reviews have become focused on institutional changes.

Nonetheless, the procedural and organisational aspects have remained unaltered since 1981, and include the following stages:

- Policy areas are proposed for review by the minister of finance, and the cabinet approves approximately ten reviews each year.

- The reviews are conducted by small working parties in which the spending ministry, the ministry of finance and the ministry of general affairs (the prime minister) are represented (often there are interdepartmental subjects so that more spending ministries are represented). The ministry of finance provides the secretariat for all reviews.

- External experts can also be invited to participate and at present the working parties conducting the review are mostly chaired by independent persons (university professors, officials who do not bear responsibility for the policy to be reviewed). In the working parties there is no right to veto against proposals for policy alternatives or against inclusion of factual information in the report.

- The whole procedure is supervised by a small interdepartmental committee of senior officials chaired by the director-general of the budget and a ministerial committee consisting of a few ministers chaired by the prime minister.

- All reports are made public and submitted to parliament. Reviews have to be finished in the spring so that their results can be used by the spending minister as well as by the minister of finance during budget preparation. The spending minister can use them, for instance, to comply with compensation requirements under rules of budgetary discipline. The minister of finance can use them in negotiations with spending ministers or while preparing general retrenchment operations. Apart from use in the budgetary process, the spending minister has to produce a cabinet statement on each review which, after approval in the cabinet, is submitted to parliament. A summary report of all reviews is submitted to parliament as part of the annual budget memorandum.
In summary, both processes are intended to provide budget decision makers with advice on resource allocation and possible reallocations; however, differences in budgetary procedures and political systems have produced quite different models of programme review. The United Kingdom system is biennial and incorporated into the broader system of resource allocation and performance management. The reviews cover all areas of departmental programme spending, and are undertaken by line agencies (albeit in consultation with the treasury). While the final report is published, the alternative recommendations constitute advice to the minister and the cabinet. In contrast, the process in the Netherlands focuses on relatively few policies (approximately ten) every year and is designed to focus exclusively on undertaking those reviews and developing recommendations. Reviews are conducted by cross-departmental working groups that include and are often chaired by external participants. The recommendations developed in the reviews are made public and can be used by line or central agencies, the cabinet, or opposition parties.

Finally, recent experience in the Netherlands highlights the fact that in both countries, reviews undertaken by the bureaucracy constitute advice to politicians and it is they who must then decide whether and how to implement those recommendations. During 2000 and 2001, active labour market policies were reviewed in an effort to make them more cost-effective, less complex, and more aligned with the shift toward private sector delivery agents. Completed during the summer of 2001, the review recommended a range of policy redesign measures that would enable substantial budgetary reductions. The political sensitivity of these reforms made implementation difficult and it was not until a right-wing coalition government was elected in May 2002 that any changes were implemented.

### 3.6. Other institutions

Earmarking of revenues for specific expenditures is a method sometimes used to facilitate reallocation (see Box 4). In general, earmarking is used to protect certain expenditures that are funded from the special fund in which the earmarked revenues flow. The expectation is usually that the revenue from the earmarked tax is more stable or will grow faster than general tax revenue, so that the stability or the growth of the expenditures concerned is guaranteed. Since earmarking will in general have an effect on allocation, it is a relevant budgetary institution for this study.

Earmarking of revenues is a common practice in all OECD member countries. It is applied in the areas of social security, public health, education, road construction and many others. In general, earmarking is problematic from the point of view of allocative efficiency. If an increase (or decrease) of the earmarked revenues does not exactly match the political priority or the changes in use or cost of the services that are funded, then the special fund in which the earmarked revenues flow must be supplemented.
with revenues from the general tax fund or the special fund will swell over time. This can easily harm the transparency of the budget, especially if there are many special funds. Special funds may also be exempted from the caps of a medium-term expenditure framework. New priorities or overspending may then be approved if they are funded from the special fund, more readily than if they are funded from the general fund. The expenditures concerned are then also protected against compensation requirements stemming from rules of budgetary discipline. This may harm allocative efficiency. Nevertheless, there may be some purposes for which earmarking can be sensible.

Public investment is a kind of expenditure that is sometimes believed to merit special protection through earmarking of revenues. Three arguments play a role in this view. First, investments are expenditures for the production or purchase of commodities that last longer than a year. It is sometimes thought that in government, unlike in private firms, the prevailing incentives work against expenditures for the long term. Therefore, investment expenditures would always be cut first and increased last. Second, in some policy areas, investment has a fluctuating character. If this is the case, budgeting is usually troublesome, requiring periodic fluctuations in appropriations. Third, investments are notoriously difficult to plan in time. If they are on-budget, appropriations often have to be transferred from year to year – which may also be difficult, depending on the prevailing regime of appropriations transfer. Each of these arguments is controversial. For the first: it is not clear why expenditures for the long term should merit special protection if these expenditures are not productive. Not all durable commodities can be considered as productive. This holds for the public sector as well as the market sector. Much public investment can be considered as production of durable consumption goods. This could be said for the purchase of wilderness land for conservation purposes, but also for war planes or office construction. In fact, it could be said for every publicly funded capital good that does not yield monetary proceeds, including roads (apart from toll roads), waterways and railways – that is to say, for almost all government investment. From this perspective, it is not obvious why such durable consumption goods should merit special protection, for instance vis-à-vis goods that do contribute to production in the short term. For the second argument: in many policy areas investments do not lead to fluctuating appropriations. Often the flow of investments is so large that the pattern is flattened out by the law of large numbers. In the few areas where this is not the case (government office construction is a notorious example), other methods are possible in order to avoid fluctuating appropriations (for instance renting from the private sector, borrowing from a central investment department, or renting from a central on-budget investment fund). For the third argument: this only holds for policy areas where
investments would lead to fluctuating appropriations, and this problem is automatically solved if the fluctuating appropriations problem is solved. It thus seems as if public “investment” (in the broad sense of durable commodities) is not a sensible criterion to distinguish expenditures that might merit special protection through earmarking. A different matter is whether there may be reasons to set apart certain special revenues, which can be characterised as capital revenues (for instance from exploitation of national resources or sale of capital assets) for special purposes.

This report is not the place to treat the wider question of the purposes for which earmarking and special funds might be a sensible solution, or how the relevant spending areas or revenues ought to be delimited. Earmarking has been raised here because of its effects on allocation. However, in general, earmarking has disadvantages from the point of view of allocative efficiency. It should be considered only when there are reasons to assume that these disadvantages are not important or are exceeded by advantages stemming from the special character of the spending areas or revenues concerned.

The United Kingdom has put budgeting for capital investment on an accruals basis (see Box 4). This institutional reform too was motivated by the wish to reallocate in favour of investment. For this purpose, separate current and capital budgets have been introduced with the department’s overall expenditure limit (DEL). The current (or resource) budget includes a charge for depreciation of capital assets and a cost of capital charge. This reform too has an (intended) effect on allocation and is therefore relevant to this study.

The reasoning is different here than in the Dutch case. Investment is not exempted from the expenditure caps of the medium-term framework but, as far as the current expenditure sub-caps are concerned, is only taken into account in so far as its burden is supposed to fall in the budget year. This is not to say that capital expenditure is free from budgetary pressure. Indeed, allocation of the capital budget forms an important part of the spending review negotiations with the departments. Nevertheless, the separate treatment of investments weakens the allocative function of the budget. For this reason, the government of the United States continues to stand by the principle that investments should be budgeted up front for the entire amount of the expenditure, in competition with current expenditure. This principle reflects the fact that the allocation of economic resources is changed at the time the investment is made and not during the lifetime of the capital good. This would be different if the government decided to rent a capital good from a firm in the market sector. Then the allocation of economic resources would be changed by the full amount of the investment in the private sector and it would not be changed in the public sector. This is a case where the
allocative function of the budget requires a different kind of budgetary information than the administrative function. Given the nature of the government “household”, in which the productive branch can best be conceived as a subsector, there is also much to say for the United States view that the allocative function ought to be decisive for the institutional set-up of the budget and the appropriations laws, and that accruals information on production in executive agencies should be collected and published in extra-budgetary account records. The practical advantages of the United States approach are that the definition of (productive) investment and depreciation rates will not lead to allocative consequences and that these rates will not be contested in the context of the budgetary process. This leaves open the question of how to solve the problems of fluctuating capital expenditures and of the timing of appropriations for such expenditures. There are, however, other solutions for these problems, as mentioned before.

4. An empirical perspective

It is well known that patterns of allocation in public finance vary substantially among OECD member countries. They also change over time – not always in the same direction, nor always in the direction of convergence between countries. The explanation of change in the pattern of allocation in the budgets of central governments has been a research theme since the end of the 19th century. Each of the demand and supply factors mentioned in Section 2 has received attention and many particular theories have been put forward about their long-term impact. Lately there has been a particular interest in political factors. In particular, much empirical research has been conducted about the effects of the electoral cycle (expansionary budgetary policy before elections, restrictive budgetary policy after elections) and partisan effects (more redistributive policies under left-wing governments, more conservative policies under right-wing governments). These factors can be subsumed under the demand factor of “political preferences” (Section 2) but they are interesting in their own right. Budget institutions are not demand or supply factors, but rather constraints on the decision-making process that determine how demand and supply factors will impact upon outcomes. In general it turns out to be very hard to identify and ascertain the effects of any particular factor or budget institution on outcomes. Those of any one factor or institution tend to be overwhelmed by the effects of other factors or institutions, working in different directions. Against this background it is not to be expected that the impact of any particular institution can be identified by looking at empirical data.

Nonetheless, it is worthwhile to look at empirical data in the context of a study on budget institutions and reallocation, for two reasons. The first is
that it is useful to have insight into patterns of allocation, even if it is not possible to identify the role of separate institutions. One sees the picture as it evolves under the impact of all relevant circumstances, budget institutions included. This enables one to say at least what outcomes prevailing institutions have not prevented from occurring or what outcomes institutions have not been able to safeguard. The second reason is that patterns of allocation or the development in time of such patterns can be judged against the normative criterion of allocative efficiency. Although it is not possible to ascertain the role of institutions in the emergence of such patterns, it is still possible to evaluate the patterns, once emerged. Since institutions aim to contribute to allocative efficiency, it is at least possible to conclude that they do not function effectively or have to be strengthened if the emerging patterns are unsatisfactory from a normative point of view.

For both reasons above it is necessary to have quantitative data about public expenditure that are relevant from an allocative point of view. Existing expenditure classifications such as the budget classification, the economic classification and the functional classification do not serve that purpose. The budget classification is often based on type of input and organisational structure, the economic classification is based on macroeconomic impact, and the functional classification is based on purpose of expenditure. What is needed is a classification based on economic motive, which allows the evaluation of allocative efficiency. Such a classification can be called a microeconomic classification. It should be especially helpful to budgeters, as opposed to macroeconomists.

A microeconomic classification was developed as part of the reallocation project of the OECD. The classification is based on four criteria:

- Public goods versus private goods (publicly provided).
- Monetary transfers versus services in kind.
- Services in kind aimed at income support (social services) versus services in kind generating external effects.
- Purpose of expenditure.

The first three criteria are the essential ones. Their relevance follows from the fact that the conditions for optimal allocation of public goods (characterised by non-rivalry) are different from those of private goods, that the conditions for optimal distribution of transfers are different from those of the optimal allocation of services in kind, and that the conditions for the optimal distribution of social services are different from those of the optimal allocation of services with external effects. The fourth criterion is added for
recognisability of the expenditure groups. The microeconomic classification concerns the net expenditure (gross minus non-tax revenue) of central consolidated government (including the health and social security sectors). The microeconomic classification is added in Annex A. A database was formed on the basis of the microeconomic classification for 11 countries participating in the expert group. For this purpose, data from existing databases were used, especially data from the Government Finance Statistics (GFS) of the International Monetary Fund (IMF) and from four separate databases of the OECD. Annex A describes the microeconomic classification and its construction in detail. Annex B presents the database in tabular form and illustrates it graphically.

The database thus constituted is a rich source of information allowing many kinds of observations and quantitative analysis. It can be used for those purposes, but here only some elementary observations shall be made, mainly in the factual (as opposed to the normative) sphere.

The present study confirms what is known from many earlier ones concerning the large disparity in the size of central government among OECD member countries (Graph B.1 in Annex B). The countries included in the database can be divided into three groups on the basis of the size of the central government sector since 1995:

- Total net expenditure of central government less than 30% of GDP: Canada, Mexico, the United States.
- Total net expenditure of central government between 30 and 40% of GDP: Germany, New Zealand, Spain, Sweden (since 1999), the United Kingdom.
- Total net expenditure of central government higher than 40% of GDP: France, Italy, the Netherlands, Sweden (before 1999).

The disparity is mainly due to private goods. These are the services and transfers that are characteristic of the welfare state: social transfers, education, health and subsidies/public contributions.

It should be emphasised, however, that the disparity in spending patterns of central governments is not due solely to different policies. The patterns are also strongly influenced by: the division of responsibilities over the different levels of government; the role of tax expenditures; mandatory spending on private insurance schemes; and practices concerning guaranties on private loans and public-private partnerships. As far as the first factor is concerned, it may be relevant that all the countries in the first group in the dot points above are federal countries (although Germany – also a federal country – is in the second group).
Since 1993 there has been a uniform tendency for the central government sector to decrease as a share of GDP, except in France, Germany, Italy and Mexico where it has remained roughly constant or has increased slightly. The decrease has almost exclusively taken place in the sector of private goods, in particular subsidies and public contributions and social transfers (see Graph B.4 in Annex B). This observation is not surprising considering the high economic growth in those years and the connection between high growth and low social transfers, social services and aid to industry. The whole period from 1993 to 2000 shows the typical pattern of Type 2 reallocation (fiscal abundance). There has also been a denominator effect, resulting in the central government sector shrinking as a share of GDP even if it has been growing in absolute terms. In view of the high economic growth numbers of those years, it may even cause surprise that the public goods sector has remained more or less stable as a share of GDP. That means that this sector has grown at the same high rate as GDP in those years. Since multi-year estimates for public goods usually do not grow at a high rate, it seems plausible that substantial reallocation has taken place in those years in favour of expenditure groups, such as General Transfers to Subnational Governments, Infrastructure, Public Safety and Order and General Public Services (for this supposition, see also Graphs B.5, B.6 and B.7 in Annex B). These are Type 4 reallocations (new political priorities) made possible by abundant revenue.

The graphs on public goods (Graph B.2 in Annex B) make clear that there is also diversity in the expenditure patterns of central governments concerning public goods, but not as wide as with respect to private goods. These graphs include, inter alia, the traditional government tasks of Defence, Public Safety and Order, and Infrastructure. If the countries are again divided into three groups on the basis of their expenditures since 1995, the following picture arises (France is not included, due to lacking data):

- Total net expenditure of central government lower than 8% of GDP: Mexico, New Zealand.
- Total net expenditure of central government between 8 and 12% of GDP: Canada, Germany, the United States.
- Total net expenditure of central government higher than 12% of GDP: Italy (since 1998), the Netherlands, Spain, Sweden, the United Kingdom.

These differences are due to both goods in kind and transfers. Expenditures for goods in kind are very high (more than 5% of GDP) in Italy, the Netherlands, Sweden, the United Kingdom and the United States.
This is mainly due to high expenditures in these countries for PUBLIC SAFETY AND ORDER and, in the United Kingdom and the United States, for DEFENCE. Expenditures for GENERAL PURPOSE TRANSFERS are very high (more than 5% of GDP) in Canada, Germany, the Netherlands, Spain, Sweden and the United Kingdom. This is due to a combination of high INTEREST expenditure (Germany, the Netherlands, Spain and Sweden), high GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS (Canada, Germany, the Netherlands and Sweden) and high DEVELOPMENT ASSISTANCE (the Netherlands and Sweden).

There is no clear pattern in the development of expenditures for public goods in recent years. In Canada, Germany, the Netherlands, Spain and Sweden the level of such expenditures is more or less stable since the mid-1990s. In Italy and Mexico there is a weak upward tendency. In New Zealand, the United Kingdom and the United States there is a weak downward tendency. Underlying these aggregate changes, however, are somewhat more volatile movements of component expenditure groups (see Graphs B.5, B.6 and B.7 in Annex B).

Long-term developments are more interesting in this respect. Since 1980 the growth of DEFENCE has substantially stayed behind the development of GDP in almost all countries, including the United Kingdom and the United States (Graph B.5). PUBLIC SAFETY AND ORDER has in most countries grown substantially faster than GDP, but not in Canada where it has stayed behind, and not in the Netherlands and Sweden where it has roughly grown in proportion to GDP (Graph B.5). INFRASTRUCTURE is very volatile (Graph B.6): in the long term (since 1980) it has on average stayed behind GDP in some countries (Canada, France, Germany, the Netherlands, the United Kingdom and the United States), grew faster in some countries (Mexico and Sweden) and kept more or less equal pace with GDP in some countries (Italy, New Zealand and Spain). BASIC RESEARCH has on average stayed behind GDP in the long term (since 1980) in most countries except Italy, New Zealand, the United States where it grew faster, and the United Kingdom where it grew on average at an equal rate (Graph B.6). INTEREST is of course a function of the accumulation of public debt. In many countries (Graph B.7) the pattern is that INTEREST has grown at a higher rate than GDP in the 1980s and at a lower rate in the 1990s (Canada, Italy, Mexico, the Netherlands, New Zealand and Spain – but not in Germany where growth rates of INTEREST and GDP have diverged at an accelerating pace in the 1990s, and only partially in Sweden where there was a temporary upswing in the mid-1990s). GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS (Graph B.7) has in a number of countries grown at an equal rate with GDP in the 1980s and started to grow faster than GDP from the early or mid-1990s (Canada, Germany, Mexico, Spain and Sweden). This is
probably due to reallocation initiatives aimed at decentralisation, which in many cases originate in fiscal stress (Type 1 reallocation). In the Netherlands and the United Kingdom, General Transfers to Subnational Governments has on average kept equal pace with GDP, whereas in Italy and the United States it has stayed substantially behind GDP. Development Assistance (Graph B.7) has in a number of countries grown on average at a rate equal to GDP (Germany, the Netherlands, New Zealand and Spain), whereas in others it has stayed behind GDP, especially since the beginning of the 1990s (Canada, France, Italy, Sweden, the United Kingdom and the United States). Since Development Assistance is often expressed as a percentage of GDP in multi-year estimates, deviations from GDP growth percentages will often be the consequence of deliberate policy decisions (Type 1, 3 or 4 reallocation: fiscal stress, compensation for overspending or compensation for new political priorities in other areas).

As far as expenditures on private goods are concerned, the classification leads to the same results as the classification of total expenditure, which causes no surprise because (as has been seen) the divergence of total expenditure is mainly due to the divergence of expenditure on private goods. Specifically, the period since 1995 shows:

- Total net expenditure on private goods less than 15% of GDP: Canada, Mexico, the United States.
- Total net expenditure on private goods more than 15% but less than 30% of GDP: Germany, Italy, New Zealand, Spain, Sweden (since 1996), the United Kingdom.
- Total net expenditure on private goods more than 30% of GDP: France, the Netherlands, Sweden (before 1996).

The composition of the expenditures on private goods shows a wide variety as well. Much depends on the organisation of education and public health. In some countries these tasks are mainly assigned to the subnational level, so that central government expenditures are small or not significant. This applies to Canada (both Education and Health), Germany (Education), Sweden (Health), the United Kingdom (Education) and the United States (Education). Subsidies and public contributions have been smaller than 5% since 1995 in almost all countries except France, the Netherlands, Sweden and the United Kingdom. In the latter two countries they have, however, come down since 1998. It appears (Graph B.4 in Annex B) that within this sector, Subsidies to Market Sector for Goods Other Than Social Services is by far the largest component in some countries (Canada, France, Italy, Mexico, Spain and the United States). In other countries, Social Services is of similar size (Germany and the
Netherlands), and in still others SOCIAL SERVICES is larger (New Zealand, Sweden and the United Kingdom). The main component of expenditures on private goods is SOCIAL TRANSFERS. This component is much larger than EDUCATION and HEALTH, also in those countries where the latter tasks are fully financed at the central level.

The reductions that have taken place since 1995 in the sector of subsidies and public contributions (except in France, Germany and Mexico) have exclusively focused on SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES (not on PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES nor on SOCIAL SERVICES). This focus of retrenchments on subsidies to the market sector reflects a general tendency to reduce intervention in the private sector of the economy. It seems plausible that reallocation of this kind was mainly realised in connection with the funding of new priorities (Type 4 reallocation).

In the long term (since 1980), the private goods sector shows the following picture. SOCIAL TRANSFERS (Graph B.9) has on average grown faster than GDP in almost all countries except the Netherlands (roughly at the same rate, but slower since 1993), New Zealand (faster in the 1980s, slower in the 1990s, on average equal) and the United States (slower throughout). In Canada it has kept equal pace until the reform of 1995, when it was for a large part replaced by a block grant known as the Canada Health and Social Transfer (CHST), which is formally a general purpose transfer. EDUCATION (Graph B.9) has on average grown slower than GDP in almost all countries, except Mexico and the United Kingdom where it has grown faster (in the United Kingdom especially since 1991). HEALTH (Graph B.9) grew faster than GDP in almost all countries except Canada (where it kept pace until the reform of 1995), Italy, New Zealand, Spain, and the United Kingdom (all at roughly equal rates except in Italy where it has gone down). All of these expenditures are based on entitlements, so that their movements are mainly reflected in the multi-year estimates and do not constitute reallocation. Nevertheless, it seems plausible that expansion of SOCIAL TRANSFERS and EDUCATION in the 1990s and the reduction of HEALTH throughout the period under consideration implies reallocation (of Type 4, new political priorities, in the case of expansions; of Type 1, fiscal stress, in the case of reductions).

As far as subsidies and public contributions are concerned, the long-term picture shows that the reduction of SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES (Graph B.8) has occurred mainly in the 1990s. In the 1980s, most countries kept these subsidies stable or even increased them (the Netherlands and Sweden). In some countries, SOCIAL SERVICES (Graph B.8) has on average kept pace with GDP in the 1980s and
then started to grow faster in the early 1990s (Germany, the Netherlands and New Zealand). In Spain, it started growing faster in the mid-1980s. In France, Italy, Mexico and the United Kingdom, it has grown much faster throughout the period (except in Mexico during the period 1994-97, when it was temporarily reduced). In Sweden, it grew roughly in proportion. In Canada, it grew in proportion until 1996, when it dropped as a consequence of the reform. In the United States, its growth stayed behind GDP throughout the period under consideration. PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES (Graph B.8) is a relatively small expenditure group in all countries (recreation, culture and religion). On average it has grown faster than GDP in Canada, France, Italy, New Zealand, Sweden and Mexico, it has grown roughly in proportion in Germany, Spain and the United Kingdom, and it has lagged behind GDP in the Netherlands and the United States.

5. Conclusions

Reallocation is motivated by changes in demand or supply conditions. Demand conditions are political preferences, use of services by citizen/consumers and tax revenue. Supply conditions are production technology in the public sector, input prices and the cost efficiency of production. In order to gain insight into the role of the various motives for reallocation in practice, the case studies provided by the countries represented in the expert group for this study were clustered. This led to five types of reallocation:

- Fiscal stress.
- Fiscal abundance.
- Programme overspending.
- New political priority.
- Substitution of inputs.

All institutions that were studied have a double function. First, they are a diagnostic tool in the sense that they help to establish the need for reallocation. Second, they are a tool for redress in the sense that they help to formulate the reallocation proposal.

5.1. Medium-term expenditure frameworks

All OECD member countries have medium-term expenditure frameworks. They specify medium-term targets for total revenues, total expenditures, the deficit and sometimes a number of major subdivisions of
expenditure. Derived from that is an expenditure path starting in the coming budget year and finishing in the medium-term target year.

Medium-term expenditure frameworks may be rolling or periodical. The may cover two, three, four or five years including the coming budget year. Most countries that provided information to the study have frameworks that cover three years. Periodical frameworks may be subject to revision during their lifetime.

The primary aim of medium-term expenditure frameworks is to provide intertemporal consistency to budgetary policy. For this purpose, the framework makes clear how in subsequent annual stages the medium-term targets will be realised. Secondary aims of a medium-term framework may be to strengthen the stabilisation function of the budget and to bring added tranquillity to the budget process. For the latter purpose, it is necessary that the time path of total expenditures leading to the medium-term target is considered as a series of fixed caps that cannot be adjusted any further during the annual budget preparation. This means that from year to year the expenditure total of the budget has to be reconciled with the expenditure cap of the framework that was established in some previous year. A medium-term expenditure framework that has only the primary aim is called a flexible framework, while one that also has the secondary aims is called a fixed framework.

Medium-term frameworks, whether flexible or fixed, are directed at a certain balance between expenditures, revenues and the deficit in the medium term. In view of the reasoning behind this balance, the framework can be characterised as (a) debt oriented, (b) supply-side oriented, or (c) demand-side oriented. In a debt oriented framework, the structural deficit is the central aim and the expenditure and structural revenue targets are determined by it. The structural deficit is specified in the light of monetary and demographic considerations. In a supply-side oriented framework, tax relief is the central aim and the structural deficit and the expenditure targets are derived from it. Tax relief is thought important because of its effects on incentives in the market sector of the economy. In a demand-side oriented framework, the structural deficit is the central aim as it is in a debt oriented framework. However, in this case the structural deficit is based on a supposed “structural savings surplus” in the market sector of the economy. At present, demand-side oriented frameworks have largely been abandoned in OECD member countries.

Medium-term frameworks not only facilitate but also trigger reallocations and, moreover, they point at the form they should take. They trigger reallocation in cases of overspending or underspending across the board or revenue shortfalls or windfalls (Types 1 and 2 reallocation), and in
cases of overspending for a specific programme or rise of a new political priority (Types 3 and 4 reallocation).

Medium-term frameworks tend to concentrate interdepartmental reallocation packages in the decisions about the (extension of the) framework. Furthermore, if frameworks require across-the-board retrenchments or allow across-the-board expansions, these operations tend to be smaller in scale than the reallocation exercises that sometimes occur when medium-term frameworks are established (extended), due to the fact that the development of tax revenue plays a less important role. Therefore medium-term frameworks bring tranquillity to the budgetary process.

From the point of view of allocative efficiency, medium-term expenditure frameworks are largely neutral. On the other hand, a positive efficiency effect follows from the concentration of interdepartmental reallocation in the periodic design or revision of the framework. The order and tranquillity that expenditure frameworks typically impose on the budgetary process leads to savings in decision-making costs.

5.2. Rules of budgetary discipline

In order to be effective, medium-term frameworks must be accompanied by rules of budgetary discipline. These rules require that all budgetary estimates, for the current budget year as well as for the out-years (including the upcoming budget year), must comply with the caps of the medium-term framework and that all overspending with respect to those caps must be compensated. This implies among other things that overspending with a structural cause must be compensated by measures with structural effects, so that the amount of overspending is compensated year by year through the effects of the compensating measures. It also implies that policies that cause overspending in later years (“camel noses”) must be compensated by measures that equally take effect in the future.

Rules of budgetary discipline typically attribute the first responsibility for the compensation of overspending to the spending minister. This requires that the spending caps of the medium-term framework are divided over the departments. The spending minister can always try to share the burden with other ministers, but this requires the agreement of those ministers and the cabinet or president. The rules may differ on the treatment of entitlement legislation. Sometimes the spending minister is made responsible for timely change of the legislation in order to halt the overspending; sometimes entitlement legislation is (in whole or in part) exempted from the compensation requirements.

There seems to be a certain inverse relation between the effectiveness of rules of budgetary discipline and the strictness of control systems that aim to
prevent overspending on separate accounts during the budget year. If rules of discipline are effective, spending ministers can be allowed to reallocate relatively easily between accounts. Supplementary appropriations bills can be used to regularise these reallocations after the fact and supervision of those bills on the part of the minister of finance and the cabinet or president can be marginal, i.e. limited to the control of compliance with the rules of discipline and of compatibility with general cabinet/presidential policy.

5.3. The role of the minister of finance

Ministers of finance will have an interest in reallocation for the purposes of enforcing: (1) medium-term frameworks, (2) current appropriations laws, and (3) rules of budgetary discipline, as well as (4) improving cost efficiency. All five types of reallocation may be required for these purposes. However, this does not mean that the minister of finance can, on his or her own, order a reallocation operation of any of those types.

There are few areas in which a ministry of finance can act autonomously, and this applies in particular to the domain of reallocation. While the minister of finance can diagnose the need for reallocation, this does not necessarily translate into a leading role in the subsequent reallocation effort. Support of other ministers, the cabinet or the president may be necessary. Reallocation operations of Type 1 and 2 especially cannot in general be initiated by the minister of finance unilaterally. Whereas in theory authority over the budgetary framework could enable the minister of finance to instigate government-wide reallocation, this does not appear to be the case in practice. These exercises only succeed with the support of the prime minister/president which is translated into acceptance, if not support, of the cabinet more broadly.

Tight rules of budgetary discipline enable devolution but also mean a loss of authority of the centre of government (minister of finance, prime minister/president) over the details of reallocation. This seems to be a necessary trade-off. While devolution of authority over departmental budgets may facilitate some types of reallocation exercises (Types 3-5), the pervasiveness of this culture seems to build an expectation of budgetary autonomy that both diminishes the authority of the minister of finance and builds a non-negotiable expenditure base. In doing so, it hampers cross-government reallocations or even those versions of Types 3 and 4 reallocation that cut across departmental boundaries.

The roles of ministers of finance are also differentiated with respect to the impact of their decisions during the annual cycle of budget formulation. A “weak” minister of finance will not be able to impose such a final proposal on spending ministers unilaterally. In case of difference of opinion,
the decision will be taken over by the cabinet or a cabinet committee. A “strong” minister of finance is able to impose a final proposal on spending ministers unilaterally, with at best an appeal procedure to the prime minister/president.

In many OECD member countries there have been reforms in the direction of results oriented budgeting. These reforms have involved: (1) efforts to assess the outputs and outcomes of spending programmes through quantitative indicators or policy evaluation; (2) relaxation or elimination of rules that restrict the discretionary competence of managers to decide about inputs; and (3) the use of output or outcome information in the budgetary process. The second type of reform has meant, among other things, the revision of the account structure of budgets in the direction of output oriented items. In view of expected gains in technical and allocative efficiency, these reforms have often been initiated or supported by ministries of finance. They have contributed to reallocation of Types 3, 4 and 5 but there were only a few instances where this has resulted in identifiable reallocation across departments.

5.4. Programme review

Programme review is here characterised by the fact that it is initiated and supervised from the centre of government, namely the budget office or the prime minister/president. Most countries that provided information for this study reported that they had standard procedures for policy evaluation, but only a few reported that they had standard procedures for programme review in this particular sense.

Programme review fulfils functions different from those of policy evaluation: it looks at the allocative efficiency, as opposed to only the cost efficiency, of programmes for the government and the citizen/consumer; and it looks at the consequences of alternative funding levels.

Programme review can be used for all types of reallocation in which the minister of finance or the prime minister/president has to play an important role. This applies to every reallocation that is so politically significant that it cannot be left to the spending minister. It also applies to cases in which a spending minister wants to transfer a part of a retrenchment commitment to one or more colleagues. Programme review is particularly useful when programmes have to be curtailed. It is less suitable to the design of programme expansion.

Programme review tends to be a controversial institution. Nevertheless, these procedures are important. They provide for opportunities to build reallocation into the regular budgetary process. They facilitate adherence to rules of budgetary discipline. They thus provide for some additional
flexibility to adjust the budget to changing external circumstances. This is an advantage from the point of view of allocative efficiency. Moreover, programme review generally yields information about allocative efficiency and strengthens the position of those ministers who have a positional interest in allocative efficiency, namely the minister of finance and the prime minister/president.

5.5. Other institutions

Earmarking of revenues is sometimes used to protect certain expenditures against retrenchment or to ensure their increase. Earmarking harms the transparency of the budget, especially if there are many different special funds in which these revenues flow. Special funds may also be exempted from the caps of a medium-term expenditure framework. This may harm allocative efficiency. Nevertheless, there may be some purposes for which earmarking can be sensible.

One purpose for which earmarking is used is the funding of capital investment. The arguments underlying earmarking for this purpose are controversial. A different matter is whether there may be reasons to set apart certain special revenues, which can be characterised as capital revenues (for instance from exploitation of national resources or sale of capital assets) for special purposes.

These are examples of budgeting for capital investment being put on accruals basis. This institutional reform has also been motivated in part by the wish to reallocate in favour of investment. The reasoning is different here than in case of earmarking. Investment is not exempted from the expenditure caps of the medium-term framework, but it is only taken into account in so far as its burden is supposed to fall in the budget year. Although the attribution of the burden of capital goods to the years in which they contribute to public production may be good practice for the purpose of gaining insight in the productive activities of the public sector, this treatment of investments weakens the allocative function of the budget. Given the nature of the government “household”, in which the productive branch can best be conceived as a subsector, there is also much to say for the view that investments should be budgeted up front and that accruals information on production in executive agencies should be collected and published in records of extrabudgetary accounts. The practical advantages of this approach are that the definition of (productive) investment and depreciation rates will not lead to allocative consequences and will not be contested in the context of the budgetary process.
5.6. An empirical perspective

Effects of budget institutions on expenditure patterns tend to be overwhelmed by the effects of other factors and institutions working in different directions, so that it is not to be expected that they can be identified by looking at empirical data. Nevertheless, it is worthwhile to consult such data, because the development of expenditure patterns may show what outcome prevailing institutions have not prevented from occurring or have not been able to safeguard. Moreover, empirical data may allow evaluation from the point of view of allocative efficiency. For both purposes it is necessary to have data that are relevant from an allocative point of view. For that purpose a microeconomic classification of public expenditure was developed and a database was formed on the basis of this classification.

Patterns of central government expenditure show a large variety. This is partially due to different divisions of responsibility between levels of government, different roles of tax expenditure and mandatory private insurance schemes, different taxation of social benefits and different practices concerning loan guaranties and public-private partnerships. Apart from these factors, it seems plausible that there are large differences based on policy.

Patterns of expenditure differ both in the area of public goods and in that of private goods (publicly provided). The differences in the latter are much larger than in the former, but also more determined by the roles of tax expenditure and mandatory private insurance schemes and the taxation of social benefits.

Since the mid-1990s there has been a general tendency for the central government to decrease as a share of GDP. This decrease has almost exclusively taken place in the sector of private goods, in particular subsidies to the market sector, public contributions to the non-profit sector and social transfers. Expenditures for public goods have remained stable as share of GDP or have even increased, but there is no general international trend discernible in the nature of these reallocations.

In the long term (since 1980) the expenditure groups that have grown faster than GDP in most countries are public safety and order, social transfers, and health. Groups that have grown slower in most countries are defence, basic research, and education. For all other groups, no common long-term international trend is discernable.
Notes

1 Current law estimates take into account the changes in the number of eligible users of publicly funded services on the basis of entitlement legislation as well as cost changes due to input prices, but assume that discretionary expenditures remain constant in real terms. The out-years are the years after the coming budget year.

2 Governments that pursue trend-oriented budgetary policies tend not to consider cyclical changes in tax revenue as a motive for reallocation. This is discussed further in Section 3.2.

3 If demand is highly elastic (<-1), expenditures will increase; if demand is not elastic (> -1), expenditures will decrease.

4 This exercise was undertaken as part of a more general planning or review procedure (see Section 3.5), but represents a typical use of such a procedure in times of fiscal abundance.

5 The reason for the change of (multi-year) estimates in this case is not citizen demand or supply conditions as in Type 3 reallocation, but a rise in political priority. Note that the opposite of the third and fourth cases, namely underspending or drop in political priority, is usually not a cause of reallocation, if it concerns only a single programme. In contrast, underspending or a rise of priorities across the board (the opposite of general overspending or general downturn of priorities) does trigger reallocation (Type 2). Cuts in single programmes (not across the board) are only made in connection with proposals to spend the freed money (Type 3 or Type 4 as described above). This is an example of the phenomenon of universalism (a single programme can be expanded but not cut) known from the public choice literature.

6 For the role and effects of medium-term frameworks, see also OECD (2003b).

7 The United Kingdom revises its medium-term framework every two years as part of its procedure of Spending Reviews.

8 Again, the out-years are the years after the coming budget year.

9 The “surplus” in this expression referred to the government budget. This was a euphemism for saying that the budget should be in deficit as long as there was no full employment (as was usually the case).
See Blöndal et al. (2003).

For brevity this report refers to the minister responsible for the budget as the “minister of finance”, regardless of the other responsibilities of this minister and regardless of the official title. In Canada, for example, this can either be the minister of finance or the president of the Treasury Board.

Note that not all steps in the direction of accruals principles weaken the allocative function of the budget. For instance, the new proposal in the United States aimed at charging the employer’s share of the full accruing costs of retirement benefits of civil servants to the departments concerned can be seen as a strengthening of the allocative function of the budget. Indeed, in this case the full allocation is charged to the employee’s department at the same time that the costs are incurred. The present budgetary practice of appropriating part of the costs in later years and charging that portion to the general fund reflects neither when the costs were incurred nor which activities generated the costs. Under both the present system and the proposal, outlays to the public are recorded when budgetary benefits are paid.

For an overview of the older literature, see Tarschys (1975).

For surveys of electoral cycle theory, see Frey and Schneider (1982) and Alesina et al. (1992).

In the sphere of institutions, theories abound, especially as regards organisational process theory [for a survey, see Wildavsky (1988)] and public choice. An early example was the well-known displacement effect theory of Peacock and Wiseman (1961). A new strand of literature emerged in the 1990s on the basis of the common resource pool paradigm [for surveys, see De Haan and Sturm (1994) and Hallerberg and von Hagen (1999)].

The database does not include the Czech Republic.
Bibliography


Annex A.
The Microeconomic Classification

A. Public goods
   I. In kind
      1. DEFENCE
      2. PUBLIC SAFETY AND ORDER
      3. INFRASTRUCTURE
      4. BASIC RESEARCH
      5. GENERAL PUBLIC SERVICES
         II. Monetary transfers
         6. DEVELOPMENT ASSISTANCE
         7. GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS
         8. INTEREST

B. Private goods
   I. In kind
      9. SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES
      10. PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES
      11. SOCIAL SERVICES
      12. EDUCATION
      13. HEALTH
         II. Monetary transfers
         14. SOCIAL TRANSFERS
A.1. Purpose

The microeconomic classification was developed during the reallocation project of the OECD, but serves a wider purpose: it aims to classify government expenditures on the basis of economic motive.

The new database refers to net expenditure (gross minus non-tax revenue) of central consolidated government (including the health and social security sectors). Expenditures by off-budget funds, fed by public levies such as social security and public health insurance funds, are included. Conditional and unconditional grants to subnational governments are included. Tax expenditure and obligatory private expenditure are excluded.

Existing classifications of expenditures are based on type of input and organisational structure (budget classification), macroeconomic type of expenditure (economic classification) or purpose of expenditure (functional classification). The microeconomic classification is different from these classifications although there are also some similarities, especially with the functional classification. The microeconomic classification is especially suitable for studying the allocative impact of the budget, as opposed to the macroeconomic impact. As such the classification should be especially helpful to budgeters as opposed to macroeconomists.

In view of its purpose, the classification is only applicable to separate governments or separate levels of government. Consolidation across levels of government is not possible. In this study the classification is applied to consolidated central government (including the health and social security sectors).

A.2. Criteria

The three basic criteria of the microeconomic classification are:

- Public goods versus private goods (publicly provided).
- Monetary transfers versus services in kind.
- Services in kind aimed at income support (social services) versus services in kind generating external effects.

The requirements for the optimal allocation of private goods are essentially different from those for public goods. Similarly, the requirements for the optimal distribution of transfers are essentially different from those for the optimal allocation of services in kind. Finally, the requirements for the optimal allocation of services with external effects are essentially different from those for the optimal distribution of social services.
For recognisability some categories are subdivided according to purpose of expenditure.

Education and health expenditures are treated as separate groups because they are motivated by considerations of income support as well as external effects.

A.3. Nature and use of the database

The data that are used were not provided by countries for the specific purpose of building this database. Rather, the data are taken from existing databases that have been developed for other purposes. Each of these databases makes use of questionnaires to member countries that are accompanied by substantial explanation and documentation; this material will not be reproduced here.

In some cases the data in existing databases do not exactly fit the requirements of the microeconomic classification. This will result in errors or “rough and ready” estimates. Furthermore, there are some “jumps” in the data (usually already existing in the sources used) for which no good explanations could be given by the members of the expert group. For the reallocation project, this is not a problem. The general picture provided by the database is illuminating. However, other purposes may require more exact data. For such purposes the new database is not suitable.

After the initial use of existing sources, it turned out that data were lacking. These have partially been estimated, and partially been provided by members of the expert group for the reallocation project from national data sources. The estimations and additions were made specifically for this database. The database will not be used to fill gaps in the existing data sources that were initially used.

A.4. Sources

The database consists of time series from 1980 to 2001 of all groups of the microeconomic classification. The time series were constructed by using three main data sources: the Government Finance Statistics (GFS) maintained by the International Monetary Fund (IMF); the Economy and Finance Statistics of the Statistical Office of the European Union (EUROSTAT); and four different special databases maintained by various directorates of the OECD or associated with the OECD.

As far as the GFS is concerned, the database makes use of the old functional classification – the so-called old COFOG (Classification of Functions of Government) – and the economic classification. With respect
to the old COFOG, the database makes use in particular of Table B: Consolidated Central Government. The old COFOG was revised in 2000 by the United Nations. However, the GFS database based on the old COFOG has not (yet) been revised in terms of the new COFOG. Therefore, long time series are only available in the old COFOG. On the other hand, some countries have stopped providing data on the basis of the old COFOG to the IMF. Since the COFOG data are an essential source for the database, for those countries the data for recent years are based on the new COFOG. Data in the new COFOG are obtained from EUROSTAT or from national statistics bureaus.

As far as the special OECD sources are concerned, the database makes use of: 1) the Research and Development database (Directorate for Science, Technology and Industry); 2) the Transport Infrastructure database (Secretariat of the European Conference of Ministers of Transport); 3) the Development Assistance Committee database (Development Co-operation Directorate); and (4) the Social Expenditure database (Directorate for Employment, Labour and Social Affairs). As regards the last source (www.oecd.org/els/social/expenditure), the data from 1999 onwards are provisional.

The old and the new COFOG were used not only for the retrieval of data for specific expenditure groups, but also for the special purpose of providing consistency at the national level.

A.5. Construction

A.5.1. Old COFOG

The time series for a) Defence, b) Public Safety and Order, c) Public Contributions to Non-Profit Sector for Goods Other Than Social Services, d) Education, and e) Health are taken directly from the old COFOG (Public Contributions to Non-Profit Sector for Goods Other Than Social Services = Recreational, Cultural and Religious Affairs).

The time series for Interest is taken directly from the economic classification of the GFS.

The time series for a) Basic Research, b) Development Assistance, and c) Infrastructure are taken directly from the special OECD databases (respectively the Research and Development database, the Transport Infrastructure database and the Development Assistance Committee database). Since the last database only covers European OECD member countries, the data for the non-European countries were requested
from and provided by the members of the OECD expert group on reallocation. The Transport Infrastructure database only provides data for general government. It is therefore assumed that in all non-federal European countries, public transport infrastructure is funded by central government. This is a rough assumption that in some countries may lead to an overestimation. On the other hand, the omission of maintenance costs and expenditure on communication infrastructure may lead to an underestimation (see below). In Germany, the infrastructure data from the Transport Infrastructure database have been split into shares for central government and subnational governments (Länder and other) in accordance with the average expenditures of these levels of government for transport and communication in general.

GENERAL PUBLIC SERVICES is estimated as the remainder of GENERAL PUBLIC SERVICES (old COFOG) after BASIC RESEARCH (from the Research and Development database) and DEVELOPMENT ASSISTANCE (from the Development Assistance Committee database) have been subtracted.

GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS is estimated as the remainder of OTHER EXPENDITURES (old COFOG) after INTEREST (from the economic classification of the GFS) is subtracted. This is based on the consideration that GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS and INTEREST are the main components of OTHER EXPENDITURES. However, this group also contains EXPENDITURES NOT CLASSIFIED BY MAJOR GROUPS and OTHER EXPENDITURES NOT CLASSIFIED BY MAJOR GROUPS, which may cause error.

SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES is estimated as the sum of:

a) AGRICULTURE, FORESTRY, FISHING, HUNTING AFFAIRS AND SERVICES (old COFOG);

b) MINING AND MINERAL RESOURCE AFFAIRS AND SERVICES, OTHER THAN FUELS; MANUFACTURING AFFAIRS AND SERVICES; CONSTRUCTION AFFAIRS AND SERVICES (old COFOG);

c) ECONOMIC AFFAIRS AND SERVICES (old COFOG);

d) the remainder of TRANSPORT AND COMMUNICATION (old COFOG) after INFRASTRUCTURE (from the Transport Infrastructure database) has been subtracted; and

e) the remainder of HOUSING AND COMMUNITY AMENITIES (old COFOG) after HOUSING SUBSIDIES (from the Social Expenditure database) has been subtracted.
ECONOMIC AFFAIRS AND SERVICES contains labour market subsidies. The remainder of TRANSPORT AND COMMUNICATION contains all public funding for communication as well as all current expenditure for transport (especially maintenance and exploitation subsidies). The remainder of HOUSING AND COMMUNITY AMENITIES (old COFOG) contains all public funding of environmental policy, water supply and street lighting.

SOCIAL SERVICES is estimated as the sum of: all social services in kind, except LABOUR MARKET SUBSIDIES and HOUSING SUBSIDIES (from the Social Expenditure database); and HOUSING SUBSIDIES (from the Social Expenditure database).

SOCIAL TRANSFERS is estimated as the remainder of SOCIAL SECURITY AND WELFARE (old COFOG) after SOCIAL SERVICES (from the Social Expenditure database) has been subtracted.

A.5.2. New COFOG

The time series for a) DEFENCE, b) PUBLIC SAFETY AND ORDER, c) PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES, d) EDUCATION, and e) HEALTH are taken directly from the new COFOG (PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES = RECREATION, CULTURE AND RELIGION).

The time series for INTEREST is taken directly from the economic classification of the GFS.

The time series for a) BASIC RESEARCH, b) DEVELOPMENT ASSISTANCE, and c) INFRASTRUCTURE are taken directly from the special OECD databases (respectively the Research and Development database, the Transport Infrastructure database and the Development Assistance Committee database). Since the last database only covers European OECD member countries, the data for the non-European countries were requested from and provided by the members of the OECD expert group on reallocation. The Transport Infrastructure database only provides data for general government. It is therefore assumed that in all non-federal European countries, public transport infrastructure is funded by central government. This is a rough assumption that in some countries may lead to an overestimation. On the other hand, the omission of maintenance costs and expenditure on communication infrastructure may lead to an underestimation (see below). In Germany, the infrastructure data from the Transport Infrastructure database have been split into shares for central government and subnational governments (Länder and other) in accordance with the average expenditures of these levels of government for transport and communication in general.
GENERAL PUBLIC SERVICES is estimated as the remainder of GENERAL PUBLIC SERVICES (new COFOG) after BASIC RESEARCH (from the Research and Development database), DEVELOPMENT ASSISTANCE (from the Development Assistance Committee database), INTEREST (from the economic classification of the GFS) and GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS have been subtracted.

GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS is obtained from national data sources through the members of the expert group.

SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES is estimated as the sum of: the remainder of ECONOMIC AFFAIRS (new COFOG) after INFRASTRUCTURE (from the Transport Infrastructure database) has been subtracted; ENVIRONMENTAL PROTECTION (new COFOG); and HOUSING AND COMMUNITY AMENITIES (new COFOG). HOUSING AND COMMUNITY AMENITIES (new COFOG) contains all public funding of water supply, street lighting and housing development (including zoning), but not housing subsidies.

SOCIAL SERVICES is estimated as the sum of: all social services in kind, except LABOUR MARKET SUBSIDIES and HOUSING SUBSIDIES (from the Social Expenditure database); and HOUSING SUBSIDIES (from the Social Expenditure database).

SOCIAL TRANSFERS is estimated as the remainder of SOCIAL PROTECTION (new COFOG) after SOCIAL SERVICES (from the Social Expenditure database) has been subtracted.

A.5.3. Consistency
Tables A.1 through A.4 summarise the construction of the microeconomic classification. Furthermore, the tables show that, in spite of the use of the seven different data sources, the total of all expenditures must necessarily be identical to the total of expenditures in (old or new) COFOG. This is the case because COFOG groups that are split up have “remainders” that guarantee that the total of the shares is equal to the total of the COFOG group. The sum of the third column of Tables A.3 and A.4 (total expenditures in the microeconomic classification) is therefore necessarily equal to the sum of the first column of those tables (total expenditures according to COFOG).

A.6. Definitions of groups
DEFENCE is defined according to the old COFOG. This coincides approximately with DEFENCE according to the new COFOG.
PUBLIC SAFETY AND ORDER is defined according to the old COFOG. This coincides approximately with PUBLIC SAFETY AND ORDER according to the new COFOG.

INFRASTRUCTURE contains all investment expenditure for the construction of roads, railways, urban and suburban railways, metros and tramways, inland waterways and ports, oil pipelines, maritime ports and airports. Infrastructure is treated in the database as a public good. This may not be self-evident. Owners of railway networks are starting to charge railway companies for the use of the network. Airports are being privatised and are starting to charge carriers for infrastructural facilities. Harbours are increasing port charges. Finally, toll roads are spreading. In spite of these developments, it is probably fair to say that the bulk of transport infrastructure is still being financed from the general tax fund. Furthermore, even if pricing became common, it may be argued that transport infrastructure still remains a public good (characterised by non-rivalry). It is also for this reason that optimal pricing, if applied, remains different from pricing in the market sector (public goods funded by pricing are known in regulatory economics as goods with diminishing marginal costs and have always been known to require special pricing arrangements). In view of these considerations, infrastructure is treated as a public good rather than as a subsidised private good. On the basis of this reasoning, it would have been logical to include public expenditure on communication infrastructure in the INFRASTRUCTURE group. However, these data are not available in an existing database, so they have been left out for a pragmatic reason. By leaving them out, these expenditures end up in the SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES group in view of the estimation procedures employed. It would also have been logical to include maintenance of infrastructure in the INFRASTRUCTURE group since these expenditures too are public goods (characterised by non-rivalry). However, these data are not available either, and these expenditures are thus treated as subsidies as well.

BASIC RESEARCH is experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts, without any particular application or use in view. In the social sciences and humanities, basic research is usually recognisable by the fact that it is not undertaken for the purpose of developing or evaluating public policy or business practice or strategy. Basic research is performed in business enterprises, government, institutions of higher education and private non-profit institutions. The definition is in accordance with the Frascati Manual (the basis of the Research and Development database).
GENERAL PUBLIC SERVICES is defined according to the old COFOG. BASIC RESEARCH and DEVELOPMENT ASSISTANCE are subtracted. The old COFOG definition includes:

- EXECUTIVE AND LEGISLATIVE ORGANS, FINANCIAL AND FISCAL AFFAIRS, EXTERNAL AFFAIRS OTHER THAN FOREIGN AID;
- FOREIGN ECONOMIC AID (differences with the subtracted DEVELOPMENT ASSISTANCE from the Development Assistance Committee database are possible);
- FUNDAMENTAL RESEARCH AFFAIRS AND SERVICES (differences with the subtracted BASIC RESEARCH from the Research and Development database are possible);
- GENERAL SERVICES (general personnel services, statistical services, central purchasing services, archives, operation of public buildings, central motor vehicle pools, printing offices, centralised computer and data processing services, etc.); and
- GENERAL PUBLIC SERVICES NOT ELSEWHERE CLASSIFIED.

This coincides approximately with GENERAL PUBLIC SERVICES according to the new COFOG except that, in the new COFOG, GENERAL PUBLIC SERVICES also includes the subgroups PUBLIC DEBT TRANSACTIONS and TRANSFERS OF A GENERAL CHARACTER BETWEEN DIFFERENT LEVELS OF GOVERNMENT (in this case, differences with the subtracted INTEREST from the economic classification of the GFS and GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS from national data sources are possible).

DEVELOPMENT ASSISTANCE comprises: official development aid (ODA) and other official flows (OOF). ODA is defined as those flows to countries on Part I of the Development Assistance Committee list (DAC) of the OECD and to multilateral institutions for flows to Part I aid recipients, which are: (1) provided by official agencies, including state and local governments, or by their executive agencies, and (2) transaction of which (a) is administered with the promotion of economic development and welfare of developing countries as its main objective, and (b) is concessional in character and conveys a grant element of at least 25%. OOF is defined as development assistance that does not meet the ODA criteria, namely: grants for representative or essentially commercial purposes; transactions to promote development but having a grant element of less than 25%; transactions, whatever their grant element, that are primarily export-facilitating in character; or the net acquisition by governments and central monetary institutions of securities issued by development banks at market
terms. Although the definitions of ODA and OOF refer to both central and subnational governments, only the central government data are used.

GENERAL TRANSFERS TO SUBNATIONAL GOVERNMENTS is defined according to the subgroup TRANSFERS OF A GENERAL CHARACTER BETWEEN DIFFERENT LEVELS OF GOVERNMENT (transfers not allocated to a particular function) of the old COFOG (subgroup of OTHER EXPENDITURES in the old COFOG). This coincides approximately with the subgroup TRANSFERS OF A GENERAL CHARACTER BETWEEN DIFFERENT LEVELS OF GOVERNMENT of the new COFOG (subgroup of GENERAL PUBLIC SERVICES in the new COFOG).

INTEREST is defined according to the economic classification of the GFS.3

SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES is defined according to the old COFOG groups:

a) AGRICULTURE, FORESTRY, FISHING, HUNTING AFFAIRS AND SERVICES;
b) MINING AND MINERAL RESOURCE AFFAIRS AND SERVICES, OTHER THAN FUELS; MANUFACTURING AFFAIRS AND SERVICES; CONSTRUCTION AFFAIRS AND SERVICES;
c) OTHER ECONOMIC AFFAIRS AND SERVICES;
d) HOUSING AND COMMUNITY AMENITIES; and
e) TRANSPORTATION AND COMMUNICATION AFFAIRS AND SERVICES.

HOUSING SUBSIDIES (from the Social Expenditure database) and INFRASTRUCTURE (from the Transport Infrastructure database) are subtracted [differences with the housing expenditures included in (d) and the infrastructure expenditures included in (e) are possible]. This coincides approximately with ECONOMIC AFFAIRS in the new COFOG, except that ECONOMIC AFFAIRS does not include housing subsidies (so that HOUSING SUBSIDIES from the Social Expenditure database need not be subtracted).

PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES is defined according to the old COFOG group RECREATIONAL, CULTURAL AND RELIGIOUS AFFAIRS. This coincides approximately with RECREATION, CULTURE AND RELIGION according to the new COFOG.

SOCIAL SERVICES is defined as all social benefits in kind (not in cash) provided to individuals and families apart from education and health. The social services may be supplied by the profit sector or the non-profit sector (including central government itself). Social services are services that the government sees as necessary for the individuals and families concerned but that they might not be able or willing to buy for themselves if they had to
pay the cost price. This comprises: services for the elderly (residential care, home-help services), services for the handicapped (residential care, day-care and rehabilitation services) and services for families (housing, day-care, children’s homes and social work). Labour market subsidies have been excluded; they are included in OTHER ECONOMIC AFFAIRS AND SERVICES of the old COFOG and ECONOMIC AFFAIRS of the new COFOG and thus in SUBSIDIES TO MARKET SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES.

EDUCATION has been defined according to the old COFOG. This coincides approximately with EDUCATION according to the new COFOG.

HEALTH has been defined according to the old COFOG. This coincides approximately with HEALTH according to the new COFOG.

SOCIAL TRANSFERS is defined according to the old COFOG group SOCIAL SECURITY AND WELFARE. This includes all social benefits (in kind and monetary) as well as pensions for public employees.

SOCIAL SERVICES (from the Social Expenditure database) is subtracted (differences with the social services included in SOCIAL SECURITY AND WELFARE are possible). This coincides approximately with SOCIAL PROTECTION according to the new COFOG, except that SOCIAL PROTECTION also includes housing subsidies (in this case, differences with the subtracted HOUSING SUBSIDIES from the Social Expenditure database are possible).

A.7. Lacking data

Lacking data in one or two subsequent years, not at the beginning or the end of a time series, were estimated by interpolation in the deflated series (a single lacking number being estimated as the average of the deflated numbers in the years after and before, and two subsequent lacking numbers being estimated at one-third and two-thirds of the difference between the deflated numbers of the years before and after the lacking numbers).

Lacking data in one or two subsequent years at the beginning or the end of a time series were estimated by assuming constant annual real growth equal to the average growth in the five subsequent or preceding years.

In case of lacking data for more than three subsequent years (including the absence of an entire time series), the members of the expert group on reallocation were asked to provide the data from national sources. In cases where this could affect the total of expenditures in a given year, the members of the expert group were also asked to check the totals.
Notes


### Table A.1. From microeconomic classification to old COFOG

<table>
<thead>
<tr>
<th>Microeconomic classification</th>
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<th>Old COFOG</th>
<th>Sources</th>
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<td>3. PUBLIC SAFETY AND ORDER</td>
<td>Old COFOG</td>
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<td>1.2 DEVELOPMENT ASSISTANCE</td>
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<td>10. PUBLIC CONTRIBUTIONS TO NON-PROFIT SECTOR FOR GOODS OTHER THAN SOCIAL SERVICES</td>
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<td>4. EDUCATION</td>
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Source: Kraan and Kelly.
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Source: Kraan and Kelly.
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Source: Kraan and Kelly.
**Table A.4. From new COFOG to microeconomic classification**

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Source: Kraan and Kelly.
Annex B.
Country Tables and Graphs
### Table B.1. Canada microeconomic classification

Millions of Canadian dollars, at current prices

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
### Table B.2. France microeconomic classification

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1. The data for 1980 to 1984 were lacking in COFOG and have been estimated by backward extrapolation.
2. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
## Table B.3. Germany microeconomic classification

Millions of euros, at current prices

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
### Table B.5. Mexico microeconomic classification

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
Table B.6. Netherlands microeconomic classification

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
### Table B.7. New Zealand microeconomic classification

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
### Table B.8. Spain microeconomic classification

Millions of euros, at current prices

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1. Social services data from 1999 onwards are provisional.

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
Table B.11. United States microeconomic classification

Millions of United States dollars, at current prices

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1. Social services data from 1999 onwards are provisional.

Source: Compiled from seven databases as explained in Annex A, section A.4.
Graph B.1. Expenditures on public and private goods as share of GDP

Canada

France
Graph B.1. Expenditures on public and private goods as share of GDP (continued)

Germany

Italy
Graph B.1. Expenditures on public and private goods as share of GDP (continued)
Graph B.1. Expenditures on public and private goods as share of GDP (continued)

New Zealand

Spain
Graph B.1. Expenditures on public and private goods as share of GDP (continued)

Sweden

United Kingdom
Graph B.1. Expenditures on public and private goods as share of GDP (continued)
Graph B.2. Expenditures on public goods as share of GDP

Canada

France*

* Since data for General public services and for General transfers to subnational governments are lacking from 1993 onwards, this graph has been cut off at 1992.
Graph B.2. Expenditures on public goods as share of GDP (continued)

Germany

Italy
Graph B.2. Expenditures on public goods as share of GDP (continued)

Mexico

Netherlands
Graph B.2. Expenditures on public goods as share of GDP (continued)

New Zealand

Spain
Graph B.2. Expenditures on public goods as share of GDP (continued)

Sweden

United Kingdom
Graph B.2. Expenditures on public goods as share of GDP (continued)

United States

- General purpose transfers
- Public goods in kind
Graph B.3. Expenditures on private goods as share of GDP

Canada*

* Health and Education expenditures at the federal level are very small in Canada.

France
Graph B.3. Expenditures on private goods as share of GDP (continued)

Germany*

* Education expenditures at the federal level are very small in Germany.

Italy
Graph B.3. Expenditures on private goods as share of GDP (continued)

Mexico

Netherlands
Graph B.3. Expenditures on private goods as share of GDP (continued)

New Zealand

Spain
Graph B.3. Expenditures on private goods as share of GDP *(continued)*

**Sweden**

![Graph showing expenditures on private goods as share of GDP for Sweden](image)

**United Kingdom**

![Graph showing expenditures on private goods as share of GDP for the United Kingdom](image)
Graph B.3. Expenditures on private goods as share of GDP (continued)

United States*

* Education expenditures at the federal level are very small in the United States.
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP (continued)

Germany*

* Public contributions to non-profit sector at the federal level are very small in Germany.

Italy
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP (continued)

Mexico*

*N Public contributions to non-profit sector at the federal level are very small in Mexico.

Netherlands
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP (continued)

New Zealand

Spain
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP (continued)

Sweden*

United Kingdom*

* Public contributions to non-profit sector at the central government level are very small in Sweden.

* Public contributions to non-profit sector at the central government level are very small in the United Kingdom.
Graph B.4. Expenditures on Subsidies, Public contributions and Social services as share of GDP (continued)

United States*

* Public contributions to non-profit sector at the federal level are very small in the United States.
Graph B.5. Real expenditures on Defence, Public safety and order and General public services

Canada

France*

* Data for General public services are lacking from 1993 onwards.
Graph B.5. Real expenditures on Defence, Public safety and order and General public services (continued)

Germany

Index 1980 = 100

Italy

Index 1980 = 100
Graph B.5. Real expenditures on Defence, Public safety and order and General public services (continued)

Mexico

Netherlands
Graph B.5. Real expenditures on Defence, Public safety and order and General public services (continued)

New Zealand

Spain
Graph B.5. Real expenditures on Defence, Public safety and order and General public services (continued)

Sweden

United Kingdom
Graph B.5. Real expenditures on Defence, Public safety and order and General public services (continued)

United States

Index 1980 = 100

- Blue line: General public services
- Dashed blue line: Public safety and order
- Blue dotted line: Real GDP
- Blue dotted line: Defence
Graph B.6. Real expenditures on Infrastructure and Basic research

Canada

Index 1980 = 100

France

Index 1980 = 100
Graph B.6. Real expenditures on Infrastructure and Basic research (continued)

Germany

Italy

Index 1980 = 100

Index 1980 = 100
Graph B.6. Real expenditures on Infrastructure and Basic research (continued)

Mexico

Netherlands
Graph B.6. Real expenditures on Infrastructure and Basic research (continued)
Graph B.6. Real expenditures on Infrastructure and Basic research (continued)

Sweden

Index 1980 = 100

United Kingdom

Index 1980 = 100
Graph B.6. Real expenditures on Infrastructure and Basic research *(continued)*

United States

Index 1980 = 100

- Real GDP
- Infrastructure
- Basic research
Graph B.7. Real expenditures on General purpose transfers

Canada

Index 1980 = 100

France*

Index 1980 = 100

* Data for General transfers to subnational governments are lacking from 1993 onwards.
Graph B.7. Real expenditures on General purpose transfers (continued)

Germany

Italy

Index 1980 = 100

0 100 200 300 400


Index 1980 = 100

0 100 200 300 400 500 600

Graph B.7. Real expenditures on General purpose transfers (continued)

Mexico*

Netherlands

* There is no Development assistance in Mexico.
Graph B.7. Real expenditures on General purpose transfers *(continued)*

New Zealand

Spain
Graph B.7. Real expenditures on General purpose transfers (continued)

Sweden

United Kingdom
Graph B.7. Real expenditures on General purpose transfers (continued)

United States

Index 1980 = 100
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services

Canada

![Graph showing real expenditures on Subsidies, Public contributions and Social services for Canada over time.](image)

France

![Graph showing real expenditures on Subsidies, Public contributions and Social services for France over time.](image)
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services
(continued)

Germany

[Graph showing real expenditures on subsidies, public contributions, and social services over time for Germany.]

Italy

[Graph showing real expenditures on subsidies, public contributions, and social services over time for Italy.]
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services

(continued)

Mexico

Netherlands
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services (continued)

New Zealand

Spain
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services (continued)

Sweden

United Kingdom
Graph B.8. Real expenditures on Subsidies, Public contributions and Social services (continued)

United States

Index 1980 = 100
Graph B.9. Real expenditures on Social transfers, Education and Health

Canada

France
Graph B.9. Real expenditures on Social transfers, Education and Health (continued)
Graph B.9. Real expenditures on Social transfers, Education and Health (continued)

Mexico

Netherlands
Graph B.9. Real expenditures on Social transfers, Education and Health (continued)

New Zealand

Spain
Graph B.9. Real expenditures on Social transfers, Education and Health (continued)

Sweden

United Kingdom
Graph B.9. Real expenditures on Social transfers, Education and Health (continued)

United States

Index 1980 = 100

- Social transfers
- Health
- Real GDP
- Education