Working Party of Senior Budget Officials

REALLOCATION: THE ROLE OF BUDGET INSTITUTIONS

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REALLOCATION: THE ROLE OF BUDGET INSTITUTIONS

1. OVERVIEW OF THE PROJECT

1.1 Background

1. The economic slowdown in a large part of the OECD area has changed the landscape of budgetary policy. After the long, unprecedented period of high economic growth in the nineties, budgetary authorities in many countries are facing again the problems of fiscal stress that were characteristic for previous periods of recession. The present economic situation is also uncertain. Whereas international organisations have estimated that the low point of the recession has passed, they have recently also acknowledged that recovery is unusually slow and that there are many uncertainties as to future developments.

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

3. In the present situation many OECD countries are facing complicating circumstances that were not present, at least not to the same extent, in previous periods of recession. Four of these are mentioned here. First, citizens have become more demanding towards publicly provided services. During the nineties private incomes increased substantially and markets responded by offering a larger 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. Until now, such 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. This deviation between reality and expectations adds to the upward pressure on expenditures.

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

5. Third, increasing international tensions have contributed to the threat of terrorism. This has given rise to new programs of internal security and expansion of the system of law enforcement. In some countries defence expenditure has been increased. The US and the UK have funded the war in Iraq and a part of the reconstruction efforts in that country. Other countries intend to contribute as well. Expenditure for internal and external security is a high growth sector in many national government budgets.
6. Fourth, many OECD countries have ageing populations. Furthermore, 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 facing increasing deficits in their pension funds. Moreover, the prevalence of pay-as-you-go systems tends to coincide with overly generous benefits and early retirement rights. Most of the countries concerned are only in an early stage of pension reform. As far as general public pension (social security) is concerned, all OECD countries have pay-as-you-go systems. Benefits differ substantially between countries. In this area too, reform efforts have been launched, but most are only in a first stage of development. The problem of ageing populations is exacerbated by the simultaneous improvement of medical technology. Health expenditures will start to grow at an unprecedented rate in the near future. This leads to the so-called double ageing: the share in the population of the age group that retires increases and simultaneously this group will live longer. Both effects compound the problems in the health sector as well as the pension sector.

7. The circumstances mentioned will keep a systematic upward pressure on expenditures, even if the recession will recede and growth will resume. 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

8. The study aims to gain insight in the impact of four institutions of the budget process upon reallocation:

(1) multi-year expenditure frameworks;
(2) rules of budgetary discipline;
(3) the authority of the minister of finance;
(4) the role of program review

9. Some attention will also be paid to two other institutions that in some countries have an impact on reallocation: earmarking of revenues for investment expenditures and budgeting for investment expenditures on an accrual basis. The study also looks at what can be said about 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 good by definition: there may also be bad reallocation -- in the sense of welfare reducing.

10. For the purpose of this study reallocation is defined as the readjustment of expenditures compared to the current budgetary or medium term estimates. This definition gives rise to a number of observations. First, reallocation as defined here, regards only expenditures, not revenues (although changes in taxation or public borrowing or retributions/fees do change the existing allocation of resources in the economy). Second, reallocation does not only refer 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 off setting increase is also a form of reallocation. Similarly, a general or specific increase without an off setting decrease. Third, reallocation concerns a change in an existing pattern of expenditures. This pattern of expenditures is conceived as being determined by expenditure estimates. For the current budget year, these estimates are the estimates authorized by appropriations law. For future years these estimates are the latest official estimates for out years based on the principle of "current law".

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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.
11. An expert group has provided guidance to the study. Twelve member countries participated in that group. They 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 UK, and the US. The governments represented in the expert group answered a questionnaire about institutions and provided case studies to the project. The financial support of the Governments of Canada and the Netherlands for this activity is gratefully acknowledged.

2. MOTIVES FOR REALLOCATION

2.1. Demand and supply factors

12. Reallocation is a change of an existing pattern of expenditure. Since expenditures need authorization in appropriation laws, reallocation is always “planned” in the sense of being deliberately approved by legislators. This is not to say however, that every reallocation stems from new ideas of legislators about budgetary priorities. Indeed, changes in political preferences are but one motive for reallocation. Other motives have to do with adjustment to changed circumstances of the demand and supply of publicly funded services.

13. At the demand side, change in tax revenue is an important motive for change in expenditure, next to political preferences. This goes in both directions: if (structural)² tax revenue rises above the level on which existing spending commitments are based, this opens the way for inclusion of new spending priorities (or for tax relief); if structural tax revenue falls below the level on which existing spending commitments are based, this requires retrenchment of expenditures (or tax increase).

14. Another factor at the demand side, is the use of publicly funded services by citizen-consumers. This use is determined in turn by private disposable income and consumer preferences. Private use is important when it is guaranteed in entitlement legislation. Then a change in private use can cause overspending or underspending with respect to current estimates, which may trigger a reallocation initiative.

15. At the supply side change in expenditure is motivated by change in costs. Costs are in turn determined by production technology, prices of inputs (production factors and intermediate products) and cost efficiency. The development of production technology generally makes production less expensive. Whether or not this provides an incentive for reallocation in the direction of the less expensive services depends on the price elasticity of demand. If demand is highly elastic (< -1) expenditures will increase, if demand is not elastic (> -1) expenditures will decrease. Production technology may also have an effect on the size of the market: it may give rise to new products or better quality products and thus attract additional demand (for example, medical technology). Prices of inputs may also make a service less or more expensive. The price elasticity of demand will determine whether this will increase or decrease expenditure for the service. Finally, the cost efficiency of production is an important factor. This includes both the allocative efficiency of production (the optimal combination of inputs) and the technical efficiency of production (the rate of products and 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. The profit motive is lacking. Reorganisation of public production may therefore yield relatively large gains in cost efficiency and, subsequently, through

² Governments that pursue trend oriented budgetary policies tend to discard cyclical changes in tax revenue as a motive for reallocation. More about this in the section 3.2 of this report medium term frameworks).
the price effect, on expenditures. Again, the elasticity of demand will determine the direction of the expenditure change.

16. In the public sector, demand for services is articulated by politicians, while supply is largely in the realm of public executive agencies. In this light, the budget process can be seen as an annual negotiation process first about qualities and quantities of services among the politicians and subsequently about the services and the prices between politicians and public agencies. Budget institutions are the rules that govern this process. They are partially codified in the organic budget law (not to be confused with the annual appropriations laws) and partially based on convention.

2.2. Clustering of motives

17. In order to gain insight in the role of the various motives for reallocation in practice, the case studies provided by the countries represented in the expert group were clustered. In the first cluster there were cases of overspending more or less across the board and/or revenue shortfall. This will typically occur during a period of macro-economic recession when spending on social services increases and revenues fall back behind the trend. This will lead to a higher deficit (or a lower surplus) than foreseen in existing medium-term frameworks or political agreements. In such situations, governments may decide to embark upon an exercise of general retrenchment. Such situations occurred in New Zealand in 1991, in Canada in 1994 and in Sweden in 1995. This can be called reallocation stemming from fiscal stress. However, even if the aim is general retrenchment, such initiatives are typically accompanied by a selective expansion of a few programs. These programs often involve public investments that may contribute to a speedy economic recovery or expenditures that otherwise strengthen economic performance (for instance, education). It is politically difficult if not impossible to reach agreement on initiatives that are aiming exclusively at retrenchment. It seems as if governments must be able to project a positive image by emphasizing the new expenditures even if they are tiny in comparison to the cuts. In situations of fiscal stress, the motives for reallocation may stem from the demand or the supply side and they will have a general impact. We may think of the replacement of a high spending cabinet by a low spending cabinet (demand), or an increase in the use of social services due to recession (demand), or a back fall of tax revenue (demand), or general cost increase due to higher public sector pay (supply).

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3 Of course they happened also elsewhere and at other times but the present report takes it’s examples only from the cases supplied by the expert group.
Box 1

Program Review 1994 in Canada

In mid-1994, the Government of Canada embarked on a government wide reallocation exercise -- known as Program Review – in an effort to restore fiscal discipline by reducing both the annual budget deficit and the debt-to-GDP ratio. A string of deficits began in fiscal year 1970-71, contributing to a steady rise in the debt-to-GDP ratio from its post-war low of 18% in 1974-75. At the end of 1992-93, the annual federal deficit was over $41 billion (5.9% of GDP), and the debt-to-GDP ratio stood at 66.7%. The newly elected Liberal government had committed itself to reduce the deficit-to-GDP ratio to 3% by 1996-97. However, 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.

The Program Review exercise operated in two broad stages. First, the broad parameters of the exercise were set. Cabinet decided to focus the reallocation exercise exclusively on direct government program spending. This accounted for $57.1 billion or 36% of total expenditures but excluded the largest categories of budgetary expenditure: transfer payments to individuals and other levels of government ($61.6 billion, or 38% of total expenditures), and interest payments on the debt ($42.0 billion, or 26% of total expenditures). The Department of Finance calculated total savings needed to meet the deficit-to-GDP target and provide funding for new spending priorities. Departments were then allocated notional reduction targets of 25, 15 or five percent. At the same time, the Privy Council Office (PCO) established an ad hoc Program Review Secretariat to co-ordinate the exercise and associated cabinet machinery. This group developed the following six program assessment criteria, designed to help cabinet identify programs to be transformed, reduced or eliminated.

1) Does the program area or activity continue to serve a public interest?
2) Is there a legitimate and necessary role for government in this program area or activity?
3) Is the current role of the federal government appropriate, or is the program a candidate for realignment with the provinces?
4) What activities or programs should or could be transferred in whole or in part to the private or voluntary sector?
5) If the program or activity continues, how could its efficiency be improved?
6) Is the resultant package of programs and activities affordable within the fiscal restraint? If not, what programs or activities should be abandoned?

Spending departments were informed of their reduction targets and instructed to apply the six criteria and prepare implementation plans for necessary changed. At the same time both the Department of Finance and the Treasury Board Secretariat (TBS) prepared analyses to be used as an alternative source of advice in the committees. During the second stage of Program Review, departmental submission were presented to a series of special purpose committees for review. The committee of senior deputy ministers (departmental heads) focused on ensuring that the reduction targets had been met and the six criteria applied. While they suggested changes to departmental plan, these recommendations were not binding. Next, spending ministers presented the finalised plans to the committee of ministers. Several iterations of this process, as well as a broadening of the direct program spending base to include some previously-exempted programs, took place over the fall and winter. The committee of ministers then made specific recommendations on departmental programs to the Minister of Finance who incorporated them into the 1995 budget, which was tabled in February.

The Program Review exercise delivered $18.8 billion in savings above previously-planned reductions (cumulative over three years) announced in the 1995 and 1996 budgets and to that extent certainly contributed to achieving -- and in fact exceeding -- the original deficit-to-GDP target of 3% by 1996-97. Less clear is whether Program Review achieved its parallel objective of "getting government right"—that is, improving allocative efficiency. The government deliberately varied in reduction targets across departments and this asymmetry may have increased government-wide “allocative efficiency”. However, it is difficult to determine whether departments themselves imposed a standard, across-the-board cut to their program base, or if they also opted for cuts of varying percentages for different programs and this frustrates any attempt to determine the impact on micro-level allocative efficiency.
Box 2

New Zealand Budget 1991

Over late 1990 and early 1991, the New Zealand government conducted a government-wide reallocation exercise that resulted in significant changes in expenditure in the 1991 Budget, with positive effects on the fiscal outlook. The reallocation process was explicitly triggered by the worsening fiscal deficit and change in Government. Coming into office on a policy platform of no tax increases, the Government faced a fiscal crisis with projected annual fiscal deficits increasing from 4.8% to 6.3% of GDP over three years. In addition, the incoming Government had a different view of the role of government in society than its predecessor and therefore intended to pursue significant social policy reforms.

The new Government decided to manage the fiscal situation through a three-pronged expenditure reallocation strategy: to reduce government spending, to channel resources to high priority areas and away from low priority areas, and to seek greater value for money. The process was initiated in the New Year when the Prime Minister called chief executives and Ministers together to urge the importance of fiscal restraint. In February 1991, Ministers examined expenditure in 11 more “second-tier” departments and agreed to further expenditure reduction. The next step in the process was for Cabinet to agree in March to ground rules for the preparation of budgets for 1991/92. These required that, without explicit decisions to the contrary Departments were to receive no compensation for increases in their input costs, that extra funding would only be provided in cases were expenditure was determined by statute and demand (e.g. welfare benefits), that new policy initiatives would have to be funded from reallocations within existing budgets and that capital injections would be restricted to levels consistent with these constraints.

A draft Budget prepared in April showed that substantial further savings would be required to secure a favourable fiscal outlook. Chief executives were instructed to identify additional savings options, producing technically sound and administratively feasible options, while leaving political judgements to the Government.

Finally, much of the detailed decision-making fell to the newly formed Cabinet Expenditure Control Committee (ECC), chaired by an Associate Minister of Finance and supported by the Officials Committee on Expenditure Control (OCEC). The officials committee undertook preliminary reviews of departmental submissions to ensure they identified substantial savings and areas of lower priority expenditure. The committee then identified three tiers of savings options ranging from readily achievable to ones requiring more complex or legislative issues. The ECC then considered these recommendations in May and June, holding extended meetings with individual Ministers and chief executives to discuss proposed initiatives. This work was then reviewed by the Cabinet Strategy Committee, which also considered revenue options. The full Cabinet made decisions in late June and early July. The budget was finally released on 30 June 1991, one day before the statutory deadline.

The 1991 Budget reallocation process lead to significant reallocation and greatly improved the projected deficit situation. Net financial expenditure projected for 1991/92 decreased by $2,378 million between October and April, when the first draft budget was prepared, as a result of the first round of policy changes and the review of second tier departments. The following ECC/OCEC reviews led to an additional $1,224 million in reductions between April and Budget. The result was that projected deficits reduced by $2 billion for 1991/92 and $4.7 billion for 1993/94.

A key factor in the success of the 1991 Budget from a reallocation point of view was the strong mandate from the Prime Minister and other senior Ministers to introduce reforms and reduce funding to address the fiscal deficits. While the Government’s policy objectives and the fiscal crisis gave impetus for the reallocation exercise, the previous changes to public sector management gave the Government new tools to implement the necessary expenditure changes. The Public Finance Act gave Ministers improved information about the outputs they were purchasing from departments, allowing Cabinet to make decisions about where to reduce expenditure, while the State Sector Act gave chief executives and their managers discretion about how to reduce expenditure, allowing them to focus on effectiveness.
18. The opposite case of fiscal stress is that of fiscal abundance. Here we observe cases of underspending across the board and/or revenue windfalls. This will typically occur in a situation of high macro-economic 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 policy agreements. This produces upward pressures on expenditure. On the other hand, it also provides an opportunity to reduce a few specific expenditures. Some social benefits are not entitlements and will thus not shrink automatically in accordance with current law estimates. One can think of active labour market policies, or social services for the elderly. If unemployment shrinks and prosperity of the elderly increases, there is good reason to curtail those programs. 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. We may think of the replacement of a high spending cabinet by a low 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 price of oil (supply). Revenue windfalls occurred frequently in OECD countries during the nineties. They gave rise to demands for better quality of public services on the part of citizens, in accordance with the increased prosperity prevailing in the private sector.

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4 This exercise was undertaken as part of a more general planning or review procedure (to be looked at in the next chapter), but represents a typical usage of such a procedure in times of fiscal abundance.
Box 3

**Review of labour market policy in the Netherlands in 2001**

In the year 2000/2001, a study was conducted on Active Labour Market Policies (ALMP). The study was part of the regular procedure of Interdepartmental Policy Review\(^5\). The motivation for the Ministry of Finance to initiate this study was threefold.

First, expenditures on active labor market policies tripled during the last decade, while unemployment fell sharply and vacancies – even those for unskilled workers – became increasingly difficult to fill.

Second, the new organization of social security in the Netherlands – among other things - implies contracting-out of employment services by paying private providers to place the long-term unemployed in regular jobs. Therefore, a next logical step is to abolish at least a part of the ALMP-measures, in order to be able to reallocate the corresponding funds to those new private providers and enable them to carry out this task.

Third, the current system of active labor market policy measures is unnecessarily complex.

The review led to the following conclusions (among others):

- Both the public administrators (preoccupied with administering benefits) and benefit recipients (lacking adequate control and sanctions) lack sufficient financial incentives towards finding a regular job (for their client) as soon as possible.
- By paying private providers a bonus once their clients have found (and have kept) a job, the effectiveness of active policy measures can substantially rise. Separate policy measures can all be abandoned, and make way for a reintegration budget that is spent on services provided by private firms. This will make the system much simpler and will allow private reintegration firms to help their clients to find a regular job in diverse ways, according to their specific needs.
- The future budget needs to be directly linked to the number of beneficiary recipients that are looking for – or are supposed to – look for a job. At the macro-level, the budget needs to fluctuate with these numbers. In this way, the budget instead of the types of policy measures change along with the business cycle. Until now, policy makers have tried to accommodate the business cycle situation by introducing new policy measures (such as ID jobs) which were outdated before they even were implemented.

The review was finished during the summer of 2001 and elections were due in May 2002. There was no agreement within the coalition government on the conclusions of the review. In august 2002, the new right wing coalition decided to:

- cut the budget for ALMP-measures by almost 1 billion euro (0,85 billion Euro in 2006 to be exact) and revise the system of active labour market policies: separate measures should gradually be abandoned, and make way for a reintegration budget that is spent on services provided by private firms.
- fiscal policy measures that stimulate employers to hire low-paid workers (the “SPAK” and the “VLW”) were to be gradually abolished, resulting in a budgetary cut of 1,1 billion Euro that will be fully realized 2006.

Both changes were directly based on this policy review. However, not all the lessons of the ALMP review were followed by the new coalition. No plans were made to incorporate reintegration measures for disabled (REA) in the reintegration budget. Moreover, no formal link between the required reintegration budget and the number of benefit recipients was made.

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\(^5\) This is a form of program review under the supervision of the ministry of Finance, which will be discussed in section 3.5.
19. The third cluster of reallocation initiatives focuses on a single program or group of programs that causes overspending (main motive) but may also involve a few other programs that can contribute to the solution of 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 program or group of programs and does not apply to the public sector as a whole. However, the program(s) causing the overspending is (are) so large that doing nothing would have a significant impact on the deficit. The reallocation initiative will firstly aim at curtailment of the program(s) causing the problem. However, if this is not possible in view of political preferences, the initiative may also involve other programs 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 problems that necessitates pension and health care reform in many countries belong to this cluster. An example provided by the case studies is the launching of the voluntary retirement program in Mexico in 2002.

Box 4

**Voluntary retirement Program in Mexico 2002**

The present Mexican administration faces a budgetary challenge concerning the development of the Mexican economy. In the past thirteen years, current expenditure has grown from 37% to 63% of programmable expenditure whereas capital expenditure has diminished accordingly (shrinking even in absolute terms). In addition, the Mexican administration wants to redirect the emphasis within current expenditure to social services since poverty is one of the major problems that Mexicans face. However, the growth of current expenditure is almost exclusively due to personnel services, pensions and administrative costs generated by the bureaucracy. In order to reverse this trend, the Mexican government has developed a strategy of reallocation that aims to foster the modernisation of public management and public administration. One of the measures it envisages for that purpose is a voluntary retirement programme.

Although voluntary retirement programmes have been applied in Mexico since 1988, these programmes have not achieved their aims. The unsatisfactory result achieved so far is mainly due to the lack of resources made available for this purpose upfront.

In order to generate more satisfactory results, the present Mexican administration has proposed and the Congress has authorized a new Voluntary Retirement Program that makes possible the use of as much resources as necessary to achieve the required reduction of public employees. The idea of the programme is that each department can use resources available in a four year “investment plan” in order to stimulate voluntary retirement. The savings that become available through the suppression of posts become available to the departments concerned but must fit within the overall government strategy of promoting investment and social expenditures. The departments must also pay back within four years the resources acquired under the investment plan.

20. The fourth cluster is the opposite of the third: it focuses on single program or group of programs that has risen in political priority (main motive) but may also involve a few other programs that can contribute to the solution of the resulting budgetary problem (secondary motive). The main motive concerns the demand for the provided services. The program(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 program(s). However, if this is not possible, the initiative will also involve a few other programs that can contribute to the solution because they cause under-spending 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 countries belong to this cluster. Examples provided by the case studies are: the Investment Initiative 2000 in Germany and the Health/Defence Exercise 1998 in Sweden.
Box 5

**Investment Initiative 2000 in Germany**

In 2000, the Federal German Government received a wind-fall revenue of approx. €50 billion by selling third generation mobile phone licenses by auction. The entire proceeds of this exercise were used to repay outstanding debt and consequently reducing interest charges by €2.5 billion per year. This additional stream of funds was then earmarked and allocated to new investment programs across a range of different policy areas, identified as priorities by the government.

The programme for future investments will provide € 800 million in additional capital for education, science and research and € 1.7 billion for investment in the transport sector.

Education, science and research are high priorities for the Federal Government. Increasing investment in these areas is an important step towards improving the economy’s efficiency, opening up expanding new markets and raising the standards of education of future generations.

€184m has been set aside to help modernise the organisation of universities and an additional €25.6m will be spent on development in the old East Germany. Within the programme for future investments, an amount of €41m will be spent on modernising computer facilities in trade schools. National genome research into five categories of disease is also set to benefit from an additional €56.2m annually; €250m is foreseen for renewable energies.

Investment in transport may be seen as an investment in the economic and social future of Germany. This helps to combat unemployment and positively influences the economic development of the Federal Republic of Germany. Investment in the rail network will be increased by €1b each year while an additional €460m annually will be spent on improving the main roads in the country, the rest of €250m are other investments in the traffic sector.
Box 6

*The Health/Defense exercise 1998 in Sweden*

The Social Democratic government was re-elected 1998 after a campaign focused on health care, schools and care of vulnerable groups in the community. Local governments supply much of these services/activities and the central government can only influence this policy areas by altering the level of block grants to the local government sector. While this reallocation exercise was not directly motivated by the fiscal framework, the government had just completed a far-reaching consolidation exercise and had only delivered one budget surplus. Consequently, a degree of fiscal caution remained within the government. They therefore sought to provide a source of additional funding by reallocating funds away from defense to health care spending.

While some disagreements emerged, the Government was able to reach consensus with the Centre Party that defense appropriations should be reduced by SEK 4 billion (10 per cent) from 2002, and that the defense programs should be aligned and reorganised. To compensate for the initial costs of restructuring, defense received an additional appropriation of SEK 3 billions 2002 and SEK 1 billion 2003 (current prices). The net saving on the defense would then be SEK 1 billion 2002 and SEK 3 billions SEK 4 billion 2003 and 2004.

<table>
<thead>
<tr>
<th>Appropriation changes due to the reallocation (Percentage change, compared to level in 2001)</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense, reductions</td>
<td>–10</td>
<td>–10</td>
<td>–10</td>
</tr>
<tr>
<td>Defense, restructuring</td>
<td>7</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Defense, net</td>
<td>–3</td>
<td>–7</td>
<td>–10</td>
</tr>
<tr>
<td>Block grants to municipalities</td>
<td>1</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

It was agreed that the full amount reduced was to be transferred from the defense appropriation to the appropriation for local government block grants and to be spent on health care. The fact that local governments are funded through a general grant system meant that this money could not be earmarked. As a result, representatives from the local governments were asked to sign a contract to allocate resources towards healthcare.

While local governments were likely to have received higher grants without the defense cuts, joining these two initiatives together seems to have made the defense cuts easier to agree upon from a political point of view as it delivered something – increased social spending – to the negotiating partner.
21. The fifth cluster focuses on substitution of inputs (production factors or intermediate products) within the same program or set of programs in order to make the program(s) more efficient. This is a type of 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. Examples are the “Autonomie de gestion dans les Préfectures Françaises 2004” reforms in France and the Modernisation of the ”Bundeswehr” (Federal Armed Forces) in Germany.
Box 7

The globalisation of budgets and the autonomy of management in the Préfectures in France

An experiment of globalisation of the budgets for procurement and salaries has been introduced since 2000 in a part of the network of French Préfectures. In 2003, this experiment applies to one third of the national territory and its application to the entire territory has been decided for 2004. 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 territorial administration: the activities of the Préfectures

The tasks of the Préfectures is to assure the co-ordination and management of the services of the State at the territorial level in the department or the region. This territorial administration carries out the following missions and functions among others:

- the representation and communication of the State at the territorial level
- the co-ordination of security policy for persons and goods in the department (forces of police and gendarmerie)
- the issue of official papers (identity papers, grey cards, etc.)
- the guidance and control of local communities
- the organisation of elections
- the co-ordination of interdepartmental economic and social policies.

General principles of the globalisation of the budgets

The experiment gives to the Préfectures the 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, independent of its use (with 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(s). This can modify the structure of employment, provided that two ceilings are simultaneously complied with: total employment and the total salary sum.

Benefits expected from the globalisation experiment

The expected benefits from the experiment were among others:

- more responsibility for local managers;
- allow for a better allocation of resources in the management of missions;
- promote 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);
- reducing external preventive financial control.

Use of the margin of freedom: a reallocation of resource:

In 2000, about 18% of the appropriation freed up was used for supplementary operations, 17% for bonuses for officials, and 55% for additional procurement. The globalisation has thus made possible an additional effort in the area of modernisation and improvement of working conditions. The globalisation has also made possible the modification of the relative weight of the different categories of personnel, the recruitment of lacking competencies and the contracting out of tasks that were carried out by public officials before.
Box 8

*Modernisation of the “Bundeswehr” 2000*

In Germany, the defence budget is being reformed within the framework of the Future Programme 2000 initiating reforms geared towards modernization. Under this programme, the armed forces (“Bundeswehr”) are being reduced in size. The savings generated will be invested in the modernisation of the armed forces and their equipment. The restructuring began in 2001 and should be finished by 2006. Besides provisions for ex-territorial security and the territorial integrity of the Federal Republic of Germany, it will be necessary to participate in NATO peace-keeping activities in other regions (e.g. Kosovo and South East Europe). These new tasks require redefining priorities within the medium-term expenditure framework. Accordingly, in June 2000 the Federal Government passed reforms providing the cornerstones of a new conceptual orientation of the Bundeswehr.

The number of military personnel will be reduced from 340,000 to 255,000 troops. This cut will also be accompanied by a reduction in civilian personnel posts. There will be several initiatives to improve training and education, thus making military service more attractive. The provision of strategic airlift and reconnaissance capabilities will be improved. Since 2002, proceeds up to a ceiling of €600m on the sale of moveable and immovable properties may be retained and added to the defence budget. Intensive co-operation with the private sector in the field of information technology, clothing, and fleet and real estate management will cut running expenses. These savings can then be invested in the modernisation of the armed forces’ equipment and material.
22. The motives for reallocation initiatives are summarized in Table 1.

Table 1 -- Motives for reallocation initiatives

<table>
<thead>
<tr>
<th>Type of initiative</th>
<th>Motives</th>
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<tbody>
<tr>
<td>1. Fiscal stress</td>
<td>Revenue shortfall (demand)</td>
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<tr>
<td></td>
<td>Reprioritization across the board (demand)</td>
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<td></td>
<td>Overspending due to increased use of all social services (demand)</td>
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<tr>
<td></td>
<td>Overspending due to increased costs across the board (supply)</td>
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<tr>
<td>2. Fiscal abundance</td>
<td>Revenue windfall (supply)</td>
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<td></td>
<td>Reprioritisation across the board (demand)</td>
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<td></td>
<td>Underspending due to decreased use of all social services (demand)</td>
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<tr>
<td></td>
<td>Underspending due to decreased costs across the board (supply)</td>
</tr>
<tr>
<td>3. Program overspending</td>
<td>Main motive: [\text{Overspending due to increased use of specific entitlement service (demand)}]</td>
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<tr>
<td></td>
<td>[\text{Overspending due to increased cost of specific program (supply)}]</td>
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<tr>
<td></td>
<td>Secondary motive (applicable to other program): [\text{Drop of political priority (demand)}]</td>
</tr>
<tr>
<td></td>
<td>[\text{Underspending due to decreased cost of specific program (supply)}]</td>
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<tr>
<td></td>
<td>[\text{Underspending due to decreased use of specific entitlement service (demand)}]</td>
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<tr>
<td>4. New political priority</td>
<td>Main motive [\text{Rise of new priority for specific program (demand)}]</td>
</tr>
<tr>
<td></td>
<td>Secondary motive applicable to other program: [\text{Drop of political priority of other program (demand)}]</td>
</tr>
<tr>
<td></td>
<td>[\text{Underspending due to increased cost of specific program (supply)}]</td>
</tr>
<tr>
<td></td>
<td>[\text{Underspending due to decreased use of specific entitlement service (demand)}]</td>
</tr>
<tr>
<td>5. Substitution of inputs</td>
<td>Change in production technology (supply)</td>
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<tr>
<td></td>
<td>Change in input prices (supply)</td>
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<tr>
<td></td>
<td>Change in cost efficiency of production (supply)</td>
</tr>
</tbody>
</table>

3. The role of institutions

3.1. Diagnosis and redress

23. All 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 the sense that they help to formulate the reallocation proposal. Extending the example: a medium term framework contains itself the quantitative targets determining the size of the cuts that are required to offset the overspending.

24. 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 particular decision-makers who experience the incentives to use this information. In general, these authorities are to be found in the centre of government. The Minister of Finance is the traditional “friend” of the tax payer 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 also 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

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

26. Medium-term expenditure frameworks may be rolling or periodical in nature. Rolling frameworks are drawn up during budget preparation every year (or every two years\(^6\)). Each year (every two years) the target year (the last year of the framework) is passed on to a next year. Periodical frameworks are drawn up at the beginning of the period to which they apply and then stay in place until this period has lapsed. Both rolling and periodical frameworks may be amenable to revision in the middle of their life time. 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 have provided information to this study, Sweden, the Netherlands and the US had periodical medium-term frameworks (the US until 2002); all others had rolling frameworks.

27. The medium-term framework may cover 2, 3, 4 or 5 years, including the upcoming budget year. Table 2 shows the length of the framework among the countries that have provided information to this study.

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\(^6\) The UK revises its medium term framework every two years in the procedure of “Spending Review”.

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Table 2 Period covered by medium-term expenditure framework

<table>
<thead>
<tr>
<th></th>
<th>2 years</th>
<th>3 years</th>
<th>4 years</th>
<th>5 years</th>
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</thead>
<tbody>
<tr>
<td>Italy</td>
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<tr>
<td>Czech Republic</td>
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<td>France</td>
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<td>Germany</td>
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<td>Sweden</td>
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<td>United Kingdom</td>
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<td>Canada</td>
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<td>Netherlands</td>
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<td>New Zealand</td>
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<tr>
<td>United Kingdom</td>
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</tr>
</tbody>
</table>

28. 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, the 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 does 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 in the budget process. For these purposes, 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 anymore during annual budget preparation. In other words, even if the framework is rolling, the caps of last year cannot be touched anymore, 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 only has 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 has also 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 UK and the US (until 2002) had fixed medium term frameworks. The others: Canada, Czech Republic, France, Germany, Italy, Mexico and New Zealand had flexible frameworks.

29. A fixed medium term framework leads automatically 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% GDP higher than the structural deficit derived from structural tax revenue and the expenditure cap). A fluctuating deficit contributes to the macro-economic 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 it would be required that expenditures were increased if tax revenue fell behind the trend).

30. A fixed medium 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

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7 The out-years are the years after the upcoming budget year.
division of the total available under the cap. They are not affected anymore by the revenue side of the budget.

31. Medium term frameworks, regardless of whether they are flexible or periodical, 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 characterized as (a) debt oriented, (b) supply side oriented, or (c) demand side oriented.

32. In a debt oriented framework, the medium-term structural deficit target is the central aim and the expenditure and structural revenue targets are determined by it. 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. It is possible that part of that problem has to be solved by public borrowing and this can only be done, without severe repercussions on the private sector, if public debt is low at the start. 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 UK. The Growth and Stability Pact of the EU is an example of supranational medium term framework that is primarily motivated by monetary and demographic considerations.

33. In a supply side oriented framework, tax relief is the central aim and the structural deficit and expenditure targets are determined by it. Tax relief 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 of average rates. This would not affect total receipts. However, this only applies to 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 of average rates.

34. In a demand side oriented framework, the structural deficit is the central aim, similarly 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 macro-economic theory. At the time this theory was dominant in the world of academic economics, many OECD countries adopted this type of medium term policy. Examples were the “Konjunktur Neutrale Haushalt” in West-Germany, the “Structureel Begrotingsbeleid” in the Netherlands and the “Full Employment Surplus” in the US. In the nineties, Japan still followed a medium term policy that was partially motivated by Keynesian ideas about demand management. At present, most OECD governments have abandoned these ideas as motivation for their medium term budgetary policies.

35. Medium term expenditure frameworks are based on macro-economic assumptions and forecasts. The organisation that is responsible for these assumptions 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 that have provided information for this study, Canada, Germany, the Netherlands and the US have created some form of independence for the organisation responsible for the macro-economic assumptions and forecasts. In Germany and the US,

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8 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).
this task is given to a committee that is not entirely under the control of the Budget Office. In Canada and
the Netherlands, this task is given to an independent bureau. The organisation that is 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.

36. Some of the governments that have provided information to this study claim to use deliberately
“cautious” macro-economic assumptions, while drawing up medium term expenditure frameworks
(Canada, France, Netherlands, Sweden, UK). This implies that they use assumptions that are somewhat
more pessimistic than the average forecasts of other research institutes and firms, especially as far as
economic growth is concerned. The UK Treasury subtracts 0.25% GDP from its own growth forecasts by
way of prudence margin.

37. 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 the 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, periodical frameworks bring
even more tranquillity in the budgetary process than flexible frameworks.

38. 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 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 leads 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

39. 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 in the first place 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 there are quite elaborate control systems in place in order to prevent this from
happening (Czech Republic, France, Italy). In the US, the Congress supervises the adherence to
appropriations laws once they are established. 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 also extend to the out years of the medium term framework. This
implies that overspending with a structural cause must be compensated with 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 with measures that equally take effect in the future. This includes the upcoming budget year, to which the caps of the first out year of the current budget apply.

40. 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 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 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 US, mandatory spending (mostly on the basis of entitlement legislation) was exempted from the compensation requirement under the Budget Enforcement Act of 1992 (expired in 2002). The UK 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.

41. 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 regularize those reallocations after the fact and supervision of those bills on the part of the minister of finance and cabinet or president can be marginal, namely limited to compliance with the rules of discipline and of compatibility with general cabinet/presidential policies. This supposes that the reallocations do not involve shifts of political priorities, but rather substitution of inputs (type 5 reallocations in the sense of section 2.2), or, if they do change political priorities, for instance in cases of overspending or the rise of a new priority (types 3 and 4 reallocations in the sense of section 2.2), that this does not effect major directions of government policy, but rather shifts of emphasis within broad policy areas that can be considered to belong to 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, then 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 US, where Congress is the dominant authority with respect to appropriations. The upshot is then that, apart from the US, the introduction of rules of budgetary discipline tends to facilitate reallocation on the initiative of spending ministers, while it strengthens at the same time the control of the departmental totals, not only in the budget year, but also in the out-years.

42. Rules of budgetary discipline 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 shortfall or windfall (types 1 and 2 reallocation in the sense of section 2.2), and in cases of overspending for a specific program or rise of a new priority (types 3 and 4 reallocation in the sense of section 2.2). 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 nineties in many OECD countries. Revenue shortfalls or windfalls can only trigger reallocation if the framework is flexible and leaves some room at all 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 that are 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 program (type 3) or the rise of a new political priority (type 4) requires compensation on a smaller scale, usually in one or only a few programs. 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. An example is the Compensation of the salary adjustment of teachers in the Czech Republic in 2002. The cabinet or the President will only be involved if the programs involved are of major political significance or if the spending ministers seeks to share the burden of compensation with other colleagues. The Voluntary Retirement Program in Mexico, the Investment Initiative 2000 in Germany and the Health/Defense Exercise 1998 in Sweden, mentioned in section 2.2 are examples of the latter case.
The compensation of the salary adjustment of teachers 2002 in the Czech Republic

The Czech Republic does not have a fixed medium term expenditure framework, but it does have a medium term outlook and the Policy Statement of the present Government contains medium term targets for the year 2006. This can be considered as a flexible medium term framework. There are also rules of budgetary discipline which stipulate that in the case of necessity, it is possible to increase expenditure above the approved limit but that these supplementary resources must be compensated by savings on other budgetary items. However, these rules do no apply to the multi-year estimates for the out-years, since there is no fixed multi-year framework.

The Czech Republic will accede to the EU on 1 May 2004. Before this accession many years passed when the society and economy underwent fundamental changes to satisfy the EU convergence criteria. One of them stated that accession countries should pursue the same goals as the EU, even though not all goals apply immediately, since the process of integration is gradual and will be long.

At the Lisbon summit in 2000, the EU set some important goals: by 2010 the EU should become the most dynamic and competitive knowledge-based economy and society in the world and it should have sustainable economic growth generating high employment and social cohesion. Furthermore, at the Barcelona summit, the European Council established a specific spending target for research and development, namely 3% of GDP invested by the EU as a whole by 2010, while 2/3 of this amount should be spent by business sector and 1/3 by the public sector. This target is already achieved by some Scandinavian countries. The Czech Republic spends only roughly 1.25% of GDP (business and public sector together).

In response to the Barcelona agreement, the Czech Cabinet adopted the Provision No.1144/2000, which expressed its commitment that the state budget would allocate 0.7% of GDP to research and development in 2002. However, the Ministry of Finance insisted on an escape clause, stating that implementation would depend also on the economic and fiscal situation.

In 2001, the State Budget Act authorised a growth rate of total state expenditures of 9.8% in 2002. The appropriation for research and development surprisingly (from the point of view of the above mentioned commitment) showed a decrease by 1.3%. And in November 2002, the Ministry of Education submitted to the Ministry of Finance the request for budget reallocation (required by Czech rules of budgetary discipline) from research and development to wages of teachers. The Ministry of Education at the end of 2002 faced the situation of lack of resources for wages of teachers. This reflected a pragmatic way of thinking on the side of the spending ministry. The teachers are permanently dissatisfied with their wages, which may be low compared to salaries in the private sector or in the banking sector and the ministry deemed it necessary to make some concessions in this respect. In the end the state budget for research and development was lowered by 0.15%-point of GDP in 2002.

This reallocation was driven by the changing short-term preferences of the Government, not by changing priorities. It was triggered by one minister’s decision to solve the most burning problem in her area of responsibility. The Cabinet approved the reallocation because it had to choose among competing spending proposals while it was under pressure from the electorate. It also had to pay attention to the sense of the Chamber of Deputies of the Parliament, which is under the pressure of lobbies. Finally, the whole budgetary system is constrained by lack of revenue. It can be concluded that the Government, although it is not yet bound by the Stability and Growth Pact (concerning the deficit and debt limits), or by some domestic expenditure framework setting such a deficit limit, applied its rules of budgetary discipline in recognition of the fact that sound macroeconomic development cannot be founded on continuously repeated deficit financing.
3.4 The role of the Minister of Finance

43. The rules and conventions delimiting the authority of the minister who is responsible for the budget differ from country to country. In most OECD countries, the Minister of Finance (or Secretary of the Treasury or Chancellor of the Exchequer) is responsible for the budget as well as for monetary and fiscal affairs. 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, monetary, fiscal and macro-budgetary 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 taken care of 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. Monetary and fiscal affairs are the responsibility of the Treasury Department. 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.  

44. 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 cabinet with alternative options. Once the budget is formulated, the Minister of Finance typically develops and tables the budget documentation in parliament. Many countries that provided information to 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 that occur during the budget year.

45. Ministers of Finance will have an interest in reallocation for the purposes of enforcing (1) medium term frameworks, (2) current appropriations laws, (3) rules of budgetary discipline and (4) to improve cost efficiency. All five types of reallocation in the sense of section 2.2 may be required for these purposes. However, this does not mean that the Minister of Finance, can on his own, order the commencement of a reallocation operation of any of those types.

46. There are few areas in which a Ministry of Finance can act autonomously, and this applies in particular to the domain of reallocation. Whilst 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 is based on compromise and accommodation among relative equals, is a more directive principal-agent style relationship as far as budgetary matters are concerned, or operates within clearly defined spheres of responsibility (often legal distinctions).

47. Reallocation operations of type 1 and 2 in the sense of section 2.4 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

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9 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 their official title. In Canada, for example, this can either be the Minister of Finance or the President of the Treasury Board.
the case in practice. These exercises only succeed with the support of the Prime Minister/President and this 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. In Canada, for example, this co-ordinating role was in fact given to the Privy Council Office (essentially the Prime Minister’s Department); in New Zealand the task was shared across a number of central agencies.

48. 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 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 Sweden, New Zealand, the Netherlands and the United Kingdom are characterized by strong devolution; countries with a more legalistic tradition, such as Germany, France, Italy and the United States, are characterized by a stronger authority of the centre over the detail of reallocation.

49. While devolution of authority over departmental budgets may facilitate some types of reallocation exercises (types 3-5 in the sense of section 2.2), 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 (types 1 and 2) or 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 2001 in New Zealand and the Departmental Assessment process in Canada. In both instances, the Minister of Finance sought cabinet approval for the objectives and the content of the 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.
Box 10

Value for Money Reviews in New Zealand 2001

The New Zealand government conducted a Value for Money (VFM) exercise in July-November 2001 in the lead up to the 2002 Budget initiatives process. Two objectives underpinned the process: improve outcomes through better prioritisation of resources and ensure the government was able to respect the self-imposed cap on new spending. This exercise was intended to provide ministers with the information they needed to identify reallocation options to fund new programs but the main drivers of the VFM process were the Minister of Finance and the Treasury. While the exercise had limited success in terms of reallocation at the total expenditure level, results in the specific area of social services were more positive. This was largely because the spending Minister used the exercise to find his own reprioritisation opportunities.

While the VFM process occurred in the context of fiscal constraints, it was not explicitly triggered by a gap between the expenditure framework and estimates. The 2002 Budget was the third and final Budget of the first term of the current Government. During the election campaign the government had committed to a “fiscal cap” of $6.1 billion on new operating spending over the term of the government. New spending in the first two budgets meant that the government was left facing an election with a relatively tight $815 million available for new spending in 2002/03. While this produced pressure on the government to fund new spending through reallocation, some was negated by the fact that the government budget was in surplus.

The process began in August 2001 when Cabinet agreed to review seventeen specific areas of spending, and invited all other Ministers to review their activities against the objectives of the VFM review. In practice, one additional Minister (Housing) volunteered be part of the VFM exercise, while the Minister of Social Services and Employment extended the VFM focus from the one vote identified by Cabinet to all of his votes.

Initial meetings between spending ministers and the minister of finance were intended to gain ministerial support and participation. These were to be an open discussion about the issues related to each Vote, e.g. trends in baseline changes, Ministers’ objectives, upcoming risks, and any ideas about ways to achieve these objectives more efficiently and effectively. Each session was based on written information about trends in the vote’s baselines, developed by the Treasury in consultation with the relevant departments. In practice, the discussions covered a range of topics depending on the nature of the vote. Spending Ministers showed varying interest in examining their votes for reprioritisation opportunities. The general outcomes of the discussions were that Ministers agreed to areas for further development/evaluation and sought an indication of progress by the end of September to lead into Budget 2002 strategy planning. Following the initial VFM discussions, the Minister of Finance indicated that there would be an opportunity for further bilaterals in October/November, if required. Bilaterals were only required for two votes as other follow-up work could be handled at a departmental level. By the end of 2001, the VFM process led into the initiatives process and any VFM proposals were turned into Budget initiatives to be submitted to the Minister of Finance at the end of January 2002.

The VFM process had mixed results and did not lead to substantial reallocation. Some reprioritisation opportunities were identified in the social services and employment area (in the order of $30-$40 million per annum), largely reflecting the interest of that Minister. A small number of other initiatives were partially or fully offset by savings within the individual votes, but no significant cross-vote reallocation occurred. It is possible that the process led to some reallocation within appropriations, but these cannot be easily identified. Despite the lack of resulting reallocation, the VFM process was successful in its other goals of considering value for money issues within votes and managing risks. The Treasury was able to work with departments over several months to refine upcoming initiatives, so the resulting proposals were better developed and some low-value spending could be avoided.

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10 $815 million was 0.7% of GDP at the 2002 Budget.
50. 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 in which 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 Minister of Finance 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 of Finance puts forward a final proposal after all negotiations have ended. 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 cabinet or a cabinet committee. A “strong” Minister of Finance is able to impose a final proposal on spending ministers unilaterally, with at most an appeal procedure to the Prime Minister or the President. France, Canada, the UK, and the US are examples of countries with strong Ministers of Finance in this sense.

51. The Ministry of Finance in New Zealand, Sweden and the Netherlands use 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 programs from management of the funding for new programs. 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 reallocation decisions. Departments are also prompted to undertake priority driven reallocation (type 4 in the sense of section 2.2) by the requirement that the cost of new policy initiatives is fully off-set 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 cabinet, and not the Minister of Finance that decides to fund new programs through reallocation. In an effort to provide an impetus for 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 is a budgetary surplus, (2) the fiscal squeeze occurred at the end of a government’s mandate i.e. just before and election, and (3) the Minister of Finance could only provide ministers and cabinet with information to facilitate reallocation decisions (see the VFM process mentioned above), 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 has little recourse.

52. In most of the countries that provided information for this study there have been reforms in the direction of results oriented budgeting. This has involved: (1) efforts to assess the outputs and outcomes of spending programs 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.

53. In the United States the PART has been 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 part of all spending programs by way of experiment. OMB intends to expand it to all programs 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 including actors from both the public and private sectors. Also, the extent to which OMB is able to use its authority over the budgetary process to build incentives for reallocation is constrained by legislation setting out how the estimates must be calculated. As the PART initiative in the US suggests, an interested President can provide both mandate and authority to undertake review exercises designed to identify programs 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 the public more broadly. The authority of OMB to initiate reallocation exercises is highly constrained.
Box 11

**The programme assessment rating tool (PART) in the USA**

The United States government introduced the Program Assessment Rating Tool (PART) to assess government programs in an on-going, 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 the PART was developed on the premise that both the allocation of resources and accountability for the management of those resources are critical to optimizing results. While fiscal pressures did not drive the development of the 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 departmental managers to assess twenty percent of their programs each year, and report the results back to OMB who then provide an overall rating of the department. OMB program examiners in consultation with the agencies have the discretion to select which programs are to be assessed.

A series of approximately 30 questions evaluate four critical areas of a program: program design and purpose (20%); strategic planning (10%); program management, including financial oversight and program improvement efforts (20%), and accountability for programs results (50%). PART also includes in each section questions that have been tailored for a particular type of program in addition to the questions which apply to all programs. Seven program types were identified:

1) Competitive grant: Programs that distribute funds through a competitive process.
2) Block/formula grant: Programs that distribute funds by formula or block grant.
3) Regulatory-based: Programs that employs or issues regulations to achieve goals.
4) Capital assets and service acquisition: Programs that achieve goals through development and acquisition of capital assets or the purchase of services from a commercial source.
5) Credit: Programs that provide support through loans, loan guarantees and direct credit.
6) Direct federal: Programs that provide support and services by federal employees.
7) Research and development: Programs that focus on creating knowledge or applying it toward the creating of systems, devices, methods, materials or technologies.

Upon receipt of agency responses, OMB assesses each section and allocates a numeric score of 0 to 100 to each agency. Section scores are combined to produce overall qualitative ratings of Effective, Moderately Effective, Adequate, or Ineffective. Programs that do not have acceptable performance measures or have not yet collected performance data generally receive a rating of Results Not Demonstrated.

The process of completing the PARTs is highly collaborative generally involving one OMB program examiner and several relevant program managers and staff within an agency. Program staff provide evidence to support positive responses which is discussed and evaluated for sufficiency with the OMB examiner. Where negative responses are necessary, the examiner works with the program managers to identify the cause of the weaknesses and recommendations for correcting it. Overall recommendations for future performance and funding are also jointly developed. Agencies can appeal their PART ratings ultimately to the President, however, appeals were reduced by the establishment of an internal interagency panel that was considered independent and balanced enough to resolve further appeals in a way that was considered fair and consistent.

In the first year of its use (FY 2004 Budget), PART led to the incorporation of performance information in the budget and results influenced some budget allocations between programs with similar goals. However, the impact was not at a scale so as to be demonstrated in the budget numbers. It is reasonable to expect that, as a larger percentage of programs are assessed, and multiple years of data demonstrate persistent problems, the PART data will support greater reallocations.

The wide variation across agencies in the number, funding level and definition of programs can be confusing to audiences of the PART data and adds to the difficult of comparing program funding levels to budget data, particularly because the account structures are also not uniform across agencies. Efforts are underway to better trace budget accounts to programs for aggregate use in future budgets.
3.5 Program Review

54. Program review is defined in this study as a specific form of policy evaluation. It is characterized 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 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 program review in this sense. Some other countries reported that they had used program review procedures on an ad hoc basis in order to support large retrenchment operations in the past (type 1 reallocations).

55. At present, policy evaluation supervised by spending departments is common practice in many OECD countries. This type of evaluation is closely connected with the move towards performance management. Policy evaluation is commonly seen as the best alternative for performance indicators as informational device for the steering and control of expenditures. Since the goals and outputs of many programs can not be measured in a reliable way, evaluation is widely used by program managers to acquire feed-back information about their activities, in terms of effectiveness and cost efficiency. However, program review fulfils different functions: (1) it looks at the allocative efficiency of programs for the government and the citizen/consumer, and (2) it looks at the consequences of alternative funding levels. The first function requires the answering of questions such as: (1) is this program motivated by a valid motive for government intervention or should it be left to the market or the private non-profit sector? (2) should this program be organized at the level of national government or should it be left, for instance, to the municipalities (3) does this program use the appropriate instrument or should it, for instance, use regulation or a tax instead of a subsidy? (4) is this program designed appropriately from the point of view of allocative efficiency for the government/consumer, for instance the right subsidy base, regulatory object, criteria of eligibility, etc.? The second function requires the answering of questions such as: (1) 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 governments that provided information to this study, the UK and the Netherlands have standard procedures of program review.

56. Program 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 in the first place to across the board reallocation exercises of types 1 and 2 (fiscal stress and fiscal abundance). In the case of type 2 reallocation, program review will particularly be applied to the programs that have to be curtailed. Program review is less suitable to the design of program 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. Program review can also be useful for type 3 and type 4 reallocations (program overspending and new priority), again only with regard to the programs that have to be curtailed. In these cases it will particularly be applied if the reallocation is so politically significant that it can not be left to the spending minister or in the case that a spending minister wants to transfer a (part of a) retrenchment commitment to one or more colleagues.

57. Program review tends to be a controversial institution. Spending departments resist being subjected to it. The review exercises themselves often do not run smoothly and sometimes turn into interdepartmental battle fields. Special rules such as used in the Dutch procedure may alleviate these problems (external chairman, no veto-right, secretariat provided by the Ministry of Finance, supervisory committee wherein the spending departments are not represented). Nevertheless, in the years of high economic growth during the nineties, the Dutch Minister of Finance had to give up the obligatory 20% retrenchment variant in order to save the procedure. Also, there were years that the procedure hardly 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. Program review yields information on the allocative efficiency of programs and alternative scenarios. Furthermore, program 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 introduction of program review is a difficult reform, it might therefore be worthwhile for governments that do not have it to start with it. Especially in the changed budgetary landscape of the 21st century, program review may 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 at every new occasion.
**Spending Review in the United Kingdom**

The UK Government introduced a new process for planning public spending in 1998. The previous control regime was criticised because it did not distinguish between capital and current spending, it was focused on cash inputs instead of outcomes and because the annual spending round was too short a planning horizon. The 1998 reforms attempted to tackle some of these deficiencies by introducing a new biannual Spending Review process to set departmental spending plans for the following three years. Each Review sets new spending plans for two additional years beyond the existing plans. This means that departments have budgetary certainty for at least two years ahead. The Spending Reviews cover discretionary spending with the exception of transport and health spending which plans longer than the 3-year time horizon of the Spending Reviews. Non-discretionary, so-called Annually Managed (AME) spending, that Departments can not reasonably be expected to plan and control on a three year basis, is also excluded from the Spending Review process, and is instead subjected to rigorous scrutiny and forecasting on a biannual basis as part of the regular budgetary process. A key innovation and a crucial feature of the Government’s spending plans since 1998 has been a new focus on the outcomes from public expenditure, embodied in Public Service Agreements (PSAs).

**The process**

The allocation process from start to finish lasts about one year. By way of example key milestones in the 2002 Spending Review process were:

- The Chief Secretary (Budget Minister) wrote to Departments in Summer 2001 setting out the framework for the Review.
- Over the Summer and Autumn, the Cabinet Committee on Public Services and Public Expenditure (PSX), chaired by the Chancellor, met with Secretaries of State of spending Departments to discuss Departments’ progress against targets and objectives. In the late Autumn the Committee considered papers from each department that set out the key strategic challenges they faced.
- In February 2002 Departments submitted an Analysis of Resources to the Treasury for the years covered by the Spending Review. At the same time Departments were required to submit draft Public Service Agreements which set out in the form of measurable targets what the Department proposed to achieve with its resources over the Spending Review period.
- As part of their Analysis of Resources Departments were required to identify 5 per cent of their baseline expenditure which could be wound down and reallocated to other, higher priority programmes. This encouraged Departments to think about how they could prioritize their spending more effectively.
- The Budget in March forecasts revenues over the period covered by the Spending Review. On the basis of this forecast an ‘envelope’ for total public spending for the period is derived, split into current and capital spending.
- Over the following months the departments’ Analysis of Resources and draft PSAs are scrutinized by Treasury Spending Teams and Treasury Ministers and negotiations take place at official and Ministerial level between Treasury and spending Departments.
- The Spending Review concludes in July 2002. Allocations and PSA’s are discussed and agreed between the Chancellor, the Prime Minister and the relevant departmental Minister. The outcome of the Review is published. The spending plans decided on in the Spending Review are fixed and are not subsequently reopened.

**Outcomes**

Broadly budgetary outcomes show increased public spending primarily benefiting key public services, such as health and education rather than being directed towards transfer payments. Of course, much of the changes in the growth rates over these two periods can be attributed to exogenous factors rather than the impact of budgetary institutions, for example the cyclical position of the economy, and changes to fiscal policy and the fiscal stance. There is no simple way of separating out the impact of the budgetary institutions from these exogenous factors.
**Box 13**

**Interdepartmental Policy Review in the Netherlands**

**The Reconsideration Procedure**

The Netherlands started with program review under the supervision of the Minister of Finance in the early 1980’s. The first instrument of program review was the so called Reconsideration Procedure which was introduced in 1981. This procedure aimed at policy review with the purpose of developing alternatives that would yield savings. Preferably, savings would be based on efficiency measures but if necessary on reduction of service levels. Only alternatives costing the same or less could be considered. Each review had to produce at least one alternative that would lead to a 20% reduction of expenditure after 4 years compared to the current estimate of the last out-year.

**Reconsideration becomes Interdepartmental Policy Review**

In the nineties, the Reconsideration procedure has gradually been adapted to changing economic circumstances. The mandatory 20% savings alternative has been abolished. Reviews have become more focussed on institutional changes, rather than on budget cuts per se. Institutional changes include demand-led programme funding, outsourcing, privatisation, decentralisation to other levels of government etc.

The procedural and organisational aspects have remained unaltered. Subjects for Reconsideration reviews are proposed by the Minister of Finance and approved by the cabinet. 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). External experts can also be invited to participate. The Ministry of Finance provides the Secretariat for all reviews. In the working parties there is no veto-right 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 top 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. Presently, 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). The number of studies per year has increase a little since the 1980’s to more than 10 a year (each department is supposed to participate each year).

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 it, 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, to be submitted after approval in cabinet to parliament. A summary report of all reviews is submitted to Parliament as part of the annual Budget Memorandum.

**Results**

During the years that the procedure primarily aimed at savings, the procedure has been reasonably effective. Until 1994 one third of the savings proposals has on average been implemented. This has led to cumulatively €7,7 billion of savings since 1981. Since 1994, the results have mainly consisted of policy reform. These results can not be characterised quantitatively but various evaluations have shown that many reforms of major policy areas have been achieved and that the results are very satisfactory.
3.6 Other institutions

58. Earmarking of revenues for specific expenditures is a method that is sometimes used to reallocate in favour of those expenditures. In general, earmarking is used to protect certain expenditures that are funded from the special fund in which the earmarked revenues flows. 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.

59. Earmarking of revenues is a common practice in all OECD 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, the use or the cost changes 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.

60. Public investment is a kind of expenditure that is sometimes thought 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 have a fluctuating character. If this is the case, budgeting is usually troublesome because it requires periodic fluctuations in appropriations. Third, investments are notoriously difficult to plan in time. If they are on budget, appropriations have often to be transferred from year to year, which, too, may be difficult, depending on the prevailing regime of appropriations transfer. Each of these arguments is controversial. As for the first: it is not clear why expenditures for the long run should merit special protection if these expenditures are not productive. Not all durable commodities can be considered as productive. This holds for the public as well as for 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 run. As 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 constructions are possible in order to avoid fluctuating appropriations (for instance renting from the private sector, or borrowing from a central investment department or renting from a central on-budget investment fund). As for the third argument: this argument 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.

61. This report is not the place to treat the wider subject for which purposes earmarking and special funds might be a sensible solution or how the according 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. Earmarking should only be considered if there are reasons to assume that in special cases these disadvantages are not important or exceeded by advantages stemming from the special character of the spending areas or revenues concerned.
Box 14

**Investment and the Fund for Economic Structure Enhancement in the Netherlands**

After the Second World War, Europe had to be rebuilt, and so too the Netherlands. In the two decades after 1950, government investment rose from about 3% of GDP to about 5% of GDP in 1970, after which year the investment quite steadily declined to about 2.6% of GDP in 1998. The decline in investment (in the public as well as the market sector) was partly due to high inflation and thus high nominal interest rates, which made investment expensive. At the same time, the government’s fiscal balance sharply deteriorated in the second half of the 1970’s. This urged subsequent coalitions to cut back on government spending and in particular on investment. Investments are easier to spread in time or to postpone than other expenditures.

**The fund**

The main objective of the Fund for Natural Gas, or the Fund for Economic Structure Enhancement (FES) as it was renamed later, was to use the revenues from gas exports to invest rather than to consume: to transform underground wealth into above-ground wealth. The law that created the fund states, among other things, which revenues will go into the fund and which types of projects will be financed through the fund. The following revenues would be put into the fund:

- non-tax revenue from natural gas export sales above what was planned in the so-called Plan of Gas sales 1990;
- the gas revenues from the so-called Common Area (shared with Germany);
- the revenues from sales of government property;
- other revenues from the sale of certain government wealth.

The fund could be used for the following purposes:

- Investment projects of national interest with the objective of enhancing the economic structure as far as related to:
  1. Traffic and transport infrastructure including environmental aspects;
  2. Technology, telecommunications and knowledge infrastructure;
  3. Soil sanitation as far as related to 1;
  4. Urban main structure, as far as related to 1.
- Projects concerning the so-called investment impulse 1993.

In the coalition agreement after the elections in 1998, changes were made in the means of funding. Because of the fact that in the end total gas revenue would flow into the fund, the law was changed so that in the future only a fixed percentage of gas revenue would flow into the fund. This percentage was set at 41.5% of total revenue (net of taxes). Furthermore, changes were made concerning the treatment of revenues from sales of government property. The revenues no longer would flow into the fund. The revenues were going to be used to repay government debt. The reduction in interest payments that resulted form the reduction in government debt would flow into the fund. The same mechanism applies to the revenue from the auctioning of wave frequencies for telecommunication.

**Results**

From 1980 to 1990 the real growth of public investment was less than the real growth of the GDP. From the beginning of the 1990’s the real annual growth of investment (as a percentage of GDP) exceeded the real annual growth GDP. So, it appears the introduction of the fund led to an increase in government expenditures on investment projects. We can therefore say that the introduction led to a successful reallocation of government means.
62. The United Kingdom has put budgeting for capital investment on an accruals basis. This institutional reform too, was motivated by the wish to reallocate in favour of investment. For this purpose, a clear separation of current and capital spending has been introduced. Capital investment has been removed from the expenditure caps of the departments (DEL’s: Departmental Expenditure Limits) but depreciation of capital assets and a cost of capital charge has been included. This reform too, has an (intended) effect on allocation and is therefore relevant to this study.

63. The reasoning is different here than in the Dutch case. 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. However, 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. For this reason, the US government has recently decided to stand by the principle that investments should be budgeted up-front for the entire amount of the 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 life time 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 not 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\(^\text{11}\). 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 US 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 records of extra-budgetary accounts. Practical advantages of the US 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. This leaves open how the problems of fluctuating capital expenditures and timing of appropriations for such expenditures should be solved. However, for these problems exist other solutions, as mentioned before.

\[^{11}\text{Note that not all steps in the direction of accruals principles weakens the allocative function of the budget. For instance, the new proposal in the US aimed at charging the employer’s share of the full accruing costs of retirement benefits of public officials to the agencies concerned, can be seen as a strengthening of the allocative function of the budget. Indeed, in this case the allocation is changed at the same time as the costs are made, and the former budgetary practice of appropriating the budgetary benefits only in the year in which they were paid did neither reflect when the costs were made nor when the allocation was changed.}\]
Box 15

Capital investment planning in the United Kingdom

Historically, capital investment in the United Kingdom public sector has lagged behind both growth in current spending and capital spending in many other comparable OECD countries.

Until 1998, the UK public spending control framework made no distinction between capital and current spending in budgets. The practical effect of this was that at the margin, departments and agencies tended to divert capital spending to deal with short-term pressures. Over the long-term, the result was that the UK public sector significantly under-invested compared to its published plans.

The new fiscal and budgeting regime introduced in 1998 significantly reformed the allocation system to remove this bias against capital spending.

Two fiscal rules underpin the new regime:

- the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

Compliance with these rules requires a clear separation of current and capital spending, so departments are set separate current and capital budgets with very limited flexibility to transfer resources between them. From 2003-4 departments will be unable to move any spending between categories without the specific permission of the Treasury.

To improve departmental management of assets and their balance sheet the new budgeting regime has also introduced of Resource Accounting and Budgeting (RAB), bringing private sector financial management best practice into public sector budgeting and accounting. Resource accounting and budgeting gives Departments the incentives to manage their capital assets more effectively, by reflecting the economic costs of holding and using assets in budgets. This is particularly important in an era of rapidly increasing public sector investment. Examples of the many changes introduced by full resource budgeting include:

- depreciation of a Department’s capital assets scores in the Department’s resource DEL;
- a cost of capital charge hits Departments’ resource DELs;
- the setting up of provisions scores in Departmental resource DELs.

Together, the introduction of a capital/current split reflected in both the fiscal rules and the budgeting framework, and RAB have allowed the Government to prioritise public investment in order to tackle historic under investment without damaging the credibility of the overall fiscal framework. The rapid increase in Public Sector Net Investment from 2000-01 is driven at least in part by separate capital and resource budgeting. Public sector net investment is set to rise to 2.3% of GDP by 2007-08, compared with 0.7% of GDP in 1998-99.
4. Conclusions

64. Reallocation is motivated by changes of 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. Budget institutions determine the impact of these changes on budgetary outcomes.

65. In order to gain insight to the role of the various motives for reallocation in practice, the case studies that were provided by the governments represented in the expert group for this study, were clustered. This led to five types of reallocation:

   (1) fiscal stress
   (2) fiscal abundance
   (3) program overspending
   (4) new political priority
   (5) substitution of inputs

66. All institutions that have been 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.

Medium term expenditure frameworks

67. All OECD 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 upcoming budget year and finishing in the medium term target year.

68. Medium term expenditure frameworks may be rolling or periodical. The may cover 2, 3, 4 or 5 years including the upcoming 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 life time.

69. 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 in 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 can not be adjusted anymore during 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 exclusively the primary aim is called a flexible framework, one that has also the secondary aims is called a fixed framework.

70. 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 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, similarly as 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 countries.

71. 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 reallocations in the sense of section 2.2), and in cases of overspending for a specific program or rise of a new political priority (types 3 and 4 reallocations).

72. 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 in the in the budgetary process.

73. 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 upon the budgetary process leads to savings in decision-making costs.

**Rules of budgetary discipline**

74. 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 with measures with structural effects, so that the amount of overspending is compensated year by year though the effects of the compensating measures. It also implies that policies that cause overspending in later years (“camel noses”) must be compensated with measures that equally take effect in the future.

75. 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 time 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 holly or in part), exempted from the compensation requirements.

76. 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 cabinet or president can be marginal, namely limited to the control of compliance with the rules of discipline and of compatibility with general cabinet/presidential policy.
The role of the Minister of Finance

77. Ministers of Finance will have an interest in reallocation for the purposes of enforcement of: (1) medium term frameworks, (2) current appropriations laws, (3) rules of budgetary discipline and (4) to improve cost efficiency. All five types of reallocation in the sense of section 2.2 may be required for these purposes. However, this does not mean that the Minister of Finance can, on his own, order the commence a reallocation operation of any of those types.

78. There are few areas in which a Ministry of Finance can act autonomously and this applies in particular to the domain of reallocation. Whilst 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, cabinet or President may be necessary. Especially reallocation operations of type 1 and 2 in the sense of section 2.2. can in general not 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 and this is translated into acceptance, if not support, of the cabinet more broadly.

79. 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 in the sense of section 2.2), 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.

80. The roles of Ministers of Finance are also differentiated with respect to the impact of their decisions in 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 cabinet or a cabinet committee. A “strong” Minister of Finance is able to impose a final proposal on spending ministers unilaterally, with at most an appeal procedure to the Prime Minister/President.

81. In many OECD countries there have been reforms in the direction of results oriented budgeting. This has involved: (1) efforts to assess the outputs and outcomes of spending programs 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 thing 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. These reforms have contributed to reallocation of type 3,4 and 5 in the sense of section 2.2 but there were only a few instances where this has resulted in identifiable reallocation across departments.

Program review

82. Program review in the sense of this study is 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 program review in this sense.
83. Program review fulfils different functions than policy evaluation: (1) it looks at the allocative efficiency, as opposed to only the cost efficiency, of programs for the government and the citizen/consumer, and (2) it looks at the consequences of alternative funding levels.

84. Program 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. Program review is particularly useful when programs have to be curtailed. It is less suitable to the design of program expansion.

85. Program 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, program 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.

Other institutions

86. 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.

87. 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.

87. These are examples of budgeting for capital investment being put on accruals basis. This institutional reform has also been motivated in parts 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. 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.