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**TABLE OF CONTENTS**

1. INTRODUCTION .....3  
2. IMPROVING EXPENDITURE PRIORITIZATION .....5  
3. PROMOTING EFFECTIVENESS AND EFFICIENCY VIA BUDGETING.....10  
4. AGGREGATE FISCAL DISCIPLINE .....18  
5. A PRACTICE-ORIENTED ANALYTIC FRAMEWORK .....27  
6. IMPLICATIONS FOR FUTURE REFORMS .....32  
REFERENCES .....35

**BUDGET REFORM BEFORE AND AFTER THE GLOBAL FINANCIAL CRISIS**  
**BY MARC ROBINSON<sup>1</sup>**

## 1. INTRODUCTION

1. The global financial crisis (GFC) and its aftermath have radically changed the landscape of government budgeting. Fiscal circumstances have deteriorated significantly, and this is forcing a rethinking of the main directions of budgeting reforms which characterised the pre-GFC era. In the majority of OECD countries, public finances are clearly unsustainable. One key reason for this is long-term expenditure pressures: in particular, future age-related spending (e.g. old-age pensions), and potentially large future increases in interest expenditure (arising from the impact of future interest-rate increases on high levels of government debt). The other particularly grave problem is slow post-GFC revenue growth. This is not a purely temporary cyclical phenomenon, but is in all likelihood a long-term problem arising from “secular” slow economic growth. Slow revenue growth makes it not only harder to control deficits in the short run, but also makes it much more difficult to reduce the effective debt burden.

2. Setting aside debates about the appropriateness of fiscal stimulus in the short run, a majority of OECD countries require fiscal consolidation. This will in most cases call for a major emphasis on the expenditure side. Although in a minority of OECD countries (e.g. the USA and UK) a credible argument can be mounted that substantial tax rises should be part of the solution, in the majority of countries the scope for significant tax rises is either limited or non-existent.

3. This is the context in which budgeting reform must be viewed in the post-GFC era. It has major implications both for the mix of objectives which are the focus of budgeting reform, and for the choice and design of public financial management (PFM) instruments and structures.

4. This is best viewed through the lens of the familiar three-level taxonomy of the main objectives of budgeting:

- Aggregate fiscal discipline (in particular, through control of the fiscal balance and aggregate spending);
- Allocative efficiency (through good prioritization of expenditure);
- Effectiveness and efficiency of expenditure – referred to in this paper as value-for-money (VFM).

5. Prior to the GFC, the dominant theme of budgeting reform was VFM, and the reform objective was to transform budgeting into a powerful tool for promoting efficiency and effectiveness. This dovetailed with VFM as a much broader public sector reform movement – often captured in the term *managing-for-results* – influencing everything from human resources management through to organizational structure and the boundaries between government and the private sector. The idea that budgeting should become a key instrument for promoting VFM led not only to a major focus on

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performance budgeting, but to a range of other reforms including carryover flexibility and accruals. It also significantly influenced the design of medium-term budgeting systems in many countries.

6. Expenditure prioritization, on the other hand, received less attention. Although, as discussed below, some countries got better at prioritising the allocation of new fiscal space, little attention was paid to mechanisms to reprioritise (reallocate) baseline expenditure.

7. The contribution of budget reform to improving aggregate fiscal discipline was an important pre-GFC theme, notwithstanding (or perhaps precisely because of) the poor state of public finances in some OECD countries. It was, for example, at this time that top-down budgeting – a particularly important instrument for aggregate expenditure control – was developed.

8. The significantly more difficult fiscal circumstances of the post-GFC world are bringing about major changes in the emphasis placed on the three objectives of budgeting. Overarching everything is the increasingly dominant preoccupation of budgeters with aggregate fiscal discipline. So far, the main emphasis of post-GFC budget reforms to strengthen aggregate fiscal discipline has been on the tougher application of instruments developed in previous decades – including fiscal rules, fiscal transparency, top-down budgeting and aggregate expenditure ceilings. However, there are major issues concerning both the design of these instruments, and their adequacy in the face of fiscal consolidation requirements, which are only gradually being addressed.

9. The need for improved expenditure prioritization mechanisms is the area of budgetary reform in which there is virtual unanimity. In a context where fiscal space for new spending is extremely limited or negative (Marcel, 2013), it is understood that governments have no choice but to be careful and systematic in the way in which they allocate their limited resources. There is a widespread desire to build strong institutions and processes capable of reallocating expenditure, including – but not limited to – spending review. Improved expenditure prioritization is, moreover, generally understood to be important for restraining the growth of aggregate expenditure and, therefore, for aggregate fiscal discipline.

10. It is most of all in the area of VFM-oriented budgeting reform that thinking is in a state of flux. There is a widespread view within Ministries of Finance (MOFs) that VFM reforms including accruals and performance budgeting have been both burdensome and disappointing. Burdensome in the sense that the information and administrative costs of these reforms have often been very large indeed. Disappointing in the sense that the benefits which have been realized – in terms of improved effectiveness and efficiency – are less than VFM budgeting reform advocates promised. This raises the question of whether some of these reforms should be abandoned, or whether a radical change of direction is instead required.

11. This paper aims to contribute to the reconfiguration of the budgeting reform agenda to meet the needs of the challenging post-GFC environment. To this end, it reviews major themes of the reform agenda inherited from the past and assesses their continuing relevance. It also examines some of the emerging responses to the new context in which governments and their MOFs are now operating. Selected key issues and directions for future reforms are identified.

12. The structure of the paper is as follows: the first three sections examine budget reform sequentially from the perspective of each of the three objectives of budgeting reform identified above. This analysis commences with a discussion of expenditure prioritization (Section 2), then turns to VFM-oriented budgeting reforms (Section 3), before finally considering the role of budgeting reforms in achieving aggregate fiscal discipline (Section 4). Following this, the paper turns to future directions. This discussion is prefaced by a discussion of the appropriate analytic framework for consideration in future reforms (Section 5), before concluding with a discussion of key issues and directions for the future (Section 6).

## 2. IMPROVING EXPENDITURE PRIORITIZATION

13. As OECD governments reflect on the adequacy of their budgeting instruments and structures to handle the changed circumstances of the post-GFC world, one of their greatest preoccupations is the adequacy of inherited expenditure prioritization processes. Many have formed the view that their expenditure prioritization processes are weak (e.g. NAO, 2012: 9; NCA, 2014), and require urgent strengthening.

14. However, while it is true that prioritization processes require extensive reform, it is important not to be blind to the progress which was made in many OECD countries prior to the GFC in one important dimension of expenditure prioritization – namely, whole-of-government prioritization of *new spending*. In a number of leading countries, MOFs, often in partnership with other key central agencies (e.g. prime ministers' and cabinet offices), became very good at systematically injecting government-wide priorities into the allocation of new fiscal space which became available to government. The periodic "Spending Reviews" which took place in the UK from 1997 were a classic example of this. Despite their name, the UK Spending Reviews of the pre-GFC era were not spending reviews in the sense in which the term is generally used today (i.e. reviews of *baseline* spending to identify savings options)<sup>2</sup>. Rather, they were a process which was designed primarily as a means for government to think strategically every three years about how and where to allocate additional spending.

15. Similarly, in Canada, budgeting changed during the decades preceding the GFC from a process in which each agency received its "fair share" of incremental funds" to one in which priority setting in respect to new fiscal space took on "greater importance" (Good, 2008: 32). In these and certain other OECD countries, the pre-GFC period was one in which the central institutions of government – political and bureaucratic – increasingly and successfully claimed new fiscal space is the property of government as a whole, to be allocated according to government-wide priorities.

16. The weakness in this, however, was that even in these leading countries, the prioritization effort was focused on new fiscal space, and not on baseline expenditure. Little attention was given to reviewing expenditure on existing programs and identifying opportunities to reduce spending on ineffective or low priority programs in order to *reallocate* the money to better uses. So long as revenue growth was buoyant, as was the case in most OECD countries in the financial bubble years immediately preceding the GFC, strategic allocation of new fiscal space appeared sufficient to give budgetary effect to government priorities.

17. Not only was reallocation<sup>3</sup> off the agenda in most OECD countries during the pre-GFC years, but some of the major budgeting reforms of the era had the effect of weakening the capacity of budgeting processes to reallocate resources across government. This happened in several ways.

18. Firstly, the magnitude of the effort and resources devoted by MOFs in some countries to VFM-oriented budgeting reforms distracted from, and undermined, MOF capacity in expenditure prioritization. In Australia, for example, the Department of Finance (in partnership with the Department of Prime

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<sup>2</sup> As the UK Treasury itself acknowledges, the pre-GFC Spending Reviews "focused on allocating incremental increases in expenditure", giving little attention to savings measures (HM Treasury, 2006: 24)

<sup>3</sup> Note that the term "reallocation" is used here in the standard sense of taking money away from something or somebody to give it to someone else. This differs from the much broader meaning assigned to the term (which included even the allocation of new resources) in the OECD's 2005 study *Reallocation: the Role of Budget Institutions*.

Minister and Cabinet) had from the 1970s into the 1980s focused much attention on spending review and expenditure prioritization, and had developed first-rate expenditure policy analysis capacity. In the mid-1990s, however, much of this disappeared when the main focus of reform shifted to the resource-intensive (but ultimately ineffective) development of so-called *accrual output budgeting* (see below).

19. In a number of countries, a second – and related – factor was at work: the notion that the best way to maximize VFM was to pursue a private sector corporate model of public sector reform, in which ministries would operate as largely autonomous entities devoted to maximizing performance. This vision left little room for attention to government-wide priorities. Instead, it encouraged so-called “silo” behaviour. One (of many) manifestations of this model was a set of reforms designed to motivate ministries to improve the management of capital assets by, in effect, treating these assets as the property of individual ministries rather than of the government as a whole. (These reforms are described below.)

20. A third factor at play was that top-down budgeting processes were in a number of countries developed in a way which gave spending ministries unprecedented allocative discretion – particularly in internally reallocating baseline expenditure, but in some cases even over the allocation of new fiscal space – as a *quid pro quo* for strengthened central control over aggregate expenditure. Certain countries implemented a specific version of top-down budgeting in which, early in the budget preparation process, the aggregate expenditure ceiling was split into spending ministry ceilings, and spending ministries were then given a large measure of discretion over the allocation of their ceilings.

21. Other countries (starting with New Zealand in the 1980s) sought to implement the principle that new spending initiatives should in most cases be funded by spending ministries by reallocation within their ceilings, avoiding requests to the government for increased total funding for the ministry.

22. It is these and related initiatives which were captured in the familiar pre-GFC slogan “every spending ministry its own ministry of finance”.

23. The effect of these approaches was to treat the baseline component of government expenditure – and sometimes also new fiscal space – as the property of spending ministries, rather than belonging to the government as a whole. The model of fixed ministry ceilings being set early in the budget process may have been unproblematic if those ceilings had been set to fully reflect government-wide expenditure priorities and if, in particular, they were informed by serious review of baseline expenditure as to incorporate expenditure reallocation across government. In practice, however, this was not the case. The baseline expenditure of spending ministries tended instead to be treated as the starting point, with additional funds provided on top of that, in what amounted to classic incrementalism. The weakness of spending review processes was an important factor in this. However, even in countries where spending review was undertaken, baseline expenditure was sometimes treated effectively as the property of individual spending ministries.<sup>4</sup>

24. The real problem was not primarily the lack of tools for reallocation, but rather the limited willingness to undertake it. If spending cuts were required, reliance tended to be placed on the usual range of indiscriminate instruments – uniform across-the-board cuts, capital expenditure squeezes, and new hiring freezes – rather than targeted reallocation. Even the much-trumpeted “efficiency dividend”

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<sup>4</sup> In Canada, for example, the practice developed of motivating spending ministries to identify savings options by implicitly promising to return a large portion of these savings to the same ministries to fund new spending initiative. The results was that the government “had limited success in expenditure reallocation *across* government” (Good, 2008: 191-2). This practice of returning a significant portion of identified savings was continued even in the *Strategic Review* process undertaken over the three years from 2007-8 to 2010-11, but was discontinued under the 2011-12 *Strategic and Operating Review* (Robinson, 2013).

mechanism developed during the decades prior to the GFC was little more than the old-fashioned uniform across-the-board cut, rebranded and given a superficially plausible rationale (based on expectations of productivity growth).

25. Some major reallocations did, of course, occur prior to the GFC. These were, however, rare and episodic, and only undertaken as part of major fiscal consolidation – as, for example, in Sweden and Canada in the 1990s.

26. In post-GFC circumstances, the inability to carry out targeted resource reallocation across government has become a fatal weakness in budgeting systems. New fiscal space is, as noted above, limited and in some cases negative (in the sense that projected baseline expenditure exceeds affordable aggregate expenditure). It is precisely for this reason that spending review – properly defined as the review of *baseline* expenditure to identify savings options – is now one of the top budgeting reform agenda items in OECD countries.

27. However, reallocation is one of the toughest processes in budgeting. Selectively cutting the budgets of specific ministries and programs in order to reallocate funds to other ministries and programs is difficult and painful, both politically and technically. The disappointing aftermath of Canada’s campaign in the early 2000s to build a “continuous culture of reallocation” is but one example from experience of such difficulties. The “political” (using the term in a broad sense) reasons for this have been extensively analysed in the academic budgeting literature.

28. Notwithstanding this, under the difficult circumstances of the post-GFC era the development of better budgetary instruments and structures for resource reallocation has become an urgent imperative for most OECD governments.

29. In this context, we must beware of thinking of politics and technical rationality as so inherently contradictory that any attempt to design budgetary instruments and structures to facilitate reallocation is doomed in advance to fail. In countries with good governance, where the quality of service delivery by government significantly affects citizen choice in elections, there is substantial room for considerations of effectiveness and efficiency to more systematically influence the allocation of resources, even if electoral calculus will inevitably have the final word in budgetary allocation decisions. It is important in this context that the design of budgetary processes for reallocation should not be politically naive, and should not seek to transform inherently political resource allocation decisions into purely technical processes. This is why, for example, spending review should always be designed to deliver savings *options* to the political leadership for their decision, and not to make decisions about cuts on their behalf. It is not surprising that, for example, a recent Italian spending review effort led by a technocrat failed whereas politically-led spending review processes in countries such as the United Kingdom have been much more successful.

30. Developing reallocation mechanisms which are both politically and technically rational is not the only challenge. Another important challenge is that of achieving the right balance between centralized and decentralised allocative decision-making. If in the decades before the GFC, governments and ministries of finance delegated allocative decision-making excessively to spending ministries, it does not follow that the correct antidote to this is to now attempt to completely centralise decisions about expenditure priorities. The failure of communist economies during the last century demonstrated graphically the limits of central planning, and everyone now understands the informational problems which make it impossible for central planners to determine the optimal allocation of resources. Although greater use of mechanisms for introducing consumer choice into the public sector can help with this problem, its contribution will only ever be marginal, given the fundamental problems of market failure which dictate the role of government.

31. Good expenditure prioritization in government therefore requires a balance between centralized central decision-making (in the hands of Cabinet and the MOF and other key central agencies) and decentralised decision-making by the spending ministries themselves. Getting the balance right is difficult, and what constitutes the right balance will vary between one country and another. What is clear is that there needs, in most countries, to be a significant rebalancing toward a stronger central role.<sup>5</sup> Baseline expenditure – let alone new fiscal space where it exists – can no longer be treated as the property of individual spending ministries to allocate as they wish.

32. A key element in the development of a stronger central role in expenditure prioritization is the development of spending review systems which are fully integrated into budget preparation processes. However, spending review alone will not be enough. Budget preparation processes more generally will require major modifications. For example, it will be important to improve the design of top-down budgeting systems so that they facilitate, rather than obstruct, reallocation (Robinson, 2012).

33. Improving the information base to support expenditure prioritization decisions is considered by many countries to be an important priority. This raises the issue of the relation between reallocation and performance. Performance budgeting is discussed in greater detail below. However any discussion of reallocation would be incomplete without reference to the potential contribution of performance budgeting. It is striking that few of the many OECD which introduced performance budgeting systems in the pre-GFC era viewed them as tools for expenditure reallocation. With rare exceptions<sup>6</sup>, even after the GFC, OECD countries do not view performance budgeting as an instrument for expenditure prioritization decisions and therefore have not harnessed it to the spending review systems which are being developed.

34. This seems strange on the surface. The majority of the performance budgeting systems which exist today are program budgeting systems, such as the French *LOLF* system (implemented progressively over the five years 2001-2005) and the Canadian *Management Resource and Results Structure* system (introduced in 2005). Historically, program budgeting was developed as a tool mainly for improved expenditure prioritization. The basic aim was to help governments to improve allocative efficiency by structuring expenditure prioritization around programs based on policy objectives. The program classification of the budget would, on the one hand, show the allocation of money to policy objectives, while the accompanying program performance information would indicate the efficiency and effectiveness of that expenditure. Armed with this information about costs and benefits, budgeters would supposedly be in a position to make much better decisions about how much money to allocate to each program.

35. Improved allocative efficiency was the core aim of all of the “first wave” performance budgeting systems developed in the late 1960s and 1970s, which were based on the original US program budgeting model (the Planning Programming Budgeting System). In France, for example, the allocative objective was highlighted by the decision to name the program budgeting system which was introduced at the time: “*rationalisation des choix budgétaires*”.

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<sup>5</sup> A key requirement for this rebalancing will be the strengthening of the capacity of ministries of finance and other relevant central agencies in expenditure policy analysis. Strengthening the central component of resource allocation also will require better staffing of ministries of finance – inevitably, a sensitive matter during tough times. All too often, ministries of finance have taken the lead in downsizing in order to set an example to others. This can, however, be profoundly counter-productive in terms of the mission that they will need to fulfil in the coming years.

<sup>6</sup> Canada is perhaps the clearest exception, where the program budgeting system seems to have been generally regarded as an important tool for budget decision-making and the program structure has been the basis of spending review.

36. It was in sharp contrast to this approach that most OECD countries which introduced (or re-introduced) program budgeting systems during the “second wave” of performance budgeting reforms prior to the GFC viewed them principally as instruments for improving VFM, by motivating spending ministries to manage better and thereby to improve the effectiveness and efficiency of expenditure. One manifestation of this conception of program budgeting was the fact that a number of countries did not consider program-based *appropriations* to be an essential feature of a program budgeting.<sup>7</sup>

37. The conception of performance budgeting as a tool for promoting VFM, rather than for improving expenditure prioritization, applied even more explicitly to the other models of performance budgeting adopted by several OECD countries during the 1990s which did not follow the program budgeting template – such as the target-based Public Service Agreements system in the UK and the accrual output budgeting systems of Australia and New Zealand (see below).

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<sup>7</sup> If performance budgeting is not viewed as an expenditure prioritization tool, then there is little benefit in preparing and appropriating the budget on a program basis. Thus, when Australia developed a program budgeting system in the 1990s, budget appropriations to spending ministries were not for programs but rather took the form of a global amount which a spending ministry could allocate as it wished between programs. Although the system was referred to at the time as “program budgeting and management”, the emphasis was on management, not budgeting. Even where budgets were formally appropriated on a program basis, programs were typically not used as an allocative tool. For example, in the United Kingdom, a system of program allocations to ministries (under which programs were known as Requests for Resources - RfRs) was in the 1990s allowed to wither away as part of the process, discussed above, of giving ministries a large degree of allocative discretion while the Treasury focused on tighter aggregate spending control. Although the budget appropriations continued to be formally based on RfRs, in practice these were only a formality and not a tool either for budget preparation or budget execution control. The RfR system was formally abolished after Treasury's 2009 "alignment" project, at which stage over half of ministries had only one RfR (HM Treasury, 2009).

### 3. PROMOTING EFFECTIVENESS AND EFFICIENCY VIA BUDGETING

38. Alongside the growing focus on improving the capacity of budgeting to reallocate resources, there is at present a re-evaluation underway of the pre-GFC budget reforms focused on promoting effectiveness and efficiency (VFM). As noted at the outset, these reforms are increasingly under criticism as both burdensome and disappointing. Accruals and performance budgeting are particular targets for criticism. This raises major questions about the future of the VFM budgeting reform agenda.

#### *Accrual Accounting and Budgeting*

39. The pre-GFC campaign led by the accounting profession for the adoption of accrual accounting in government was strikingly successful. Most OECD countries implemented accrual accounting in the general government sector, and a significant minority implemented accrual budgeting. The information costs of the move to accrual *accounting* have been quite large. Accrual *budgeting* – which is inherently much more complex and demanding to operate than a cash budgeting system – involves even larger additional administrative as well as informational cost. It is impossible to operate these systems without employing a small army of accountants and, in the case of accrual budgeting, without continuing large-scale effort to help operational staff work within a budget system which they find complex and confusing.

#### **Box 1: Accrual Accounting versus Accrual Budgeting**

Accrual accounting means financial reporting on an accrual basis. Accrual budgeting, on the other hand, means arrangements under which budget appropriations (legal authorizations) are formulated in terms of accrual concepts rather than as authorizations to make cash payments (or to enter into commitments) (Blöndal, 2004; Robinson, 2009). The essential feature of accrual budgeting is therefore that the budget allocates to spending ministries *expenses budgets* – that is, allocations from which ministries must cover the expenses which they incur rather than the payments which they make. Discussions about accrual budgeting have, unfortunately, been marred by conflicting definitions of the concept.<sup>8</sup>

40. For aggregate fiscal policy purposes, information provided by accrual accounting is clearly valuable – particularly in giving a broader measure of debt (based on all liabilities and financial assets) than is provided by cash accounting. There may be questions about how far this information is actually used in fiscal policy formulation, given that in most countries fiscal targets and rules are formulated on a cash or near-cash basis. Nevertheless, in the post-GFC world, where fiscal sustainability concerns have intensified considerably, the broader perspective on the fiscal position provided by accrual accounting is welcome.

41. However, it is not on the basis of fiscal policy benefits that accrual accounting (and budgeting) was “sold” to governments. Rather, it was the managerial advantages of accruals as an instrument for

<sup>8</sup> In particular, there are those who have put forward an alternative definition according to which accrual budgeting means nothing more than using accrual information in the budget preparation process and budget presentation (Khan, 2013). This alternative definition is analytically unhelpful. It is a definition which makes it impossible to distinguish between accrual and cash budgeting (a term which everyone understands to mean appropriations for cash expenditure) – because any cash budgeting system in which accrual information was used in budget preparation and presentation would simultaneously qualify as an accrual budgeting system. It is also a definition which tends to divert debate about the merits of accrual budgeting away from the considerable challenges which arise in appropriating based on expenses to the largely uncontroversial issue of whether accrual accounting can provide information which is useful for fiscal policy and budgeting planning.

improved efficiency and effectiveness which were emphasised. These putative advantages were of three main types:

- Improved decision-making based on accurate output cost measures – i.e. measures of the full costs of the services delivered by government,
- Better capital asset budgeting and management, and
- Better control and management of liabilities.

42. How does experience stack up against these anticipated advantages? The outcome would appear to have been particularly disappointing with respect to the use of accruals as the basis for development of output cost measures. Developing output cost measures requires the combination of accrual accounting with product (output) accounting – i.e. managerial accounting to accurately allocate costs (measured in accrual terms) to the range of outputs delivered by government. Yet it would appear that this type of managerial accounting has made only quite limited progress in OECD countries generally. The UK – the first OECD country to move to both accrual accounting and budgeting – seems to be representative in this respect. Output costing was identified at the outset as a key objective of the UK’s accrual accounting and budgeting reform (HM Treasury, 1994). However, a decade after the reforms were introduced, few spending ministries were able to meet a Treasury request, as part of the 2010 Spending Review, to provide output unit cost and volume data from spending ministries (NAO, 2012: 21-4).

43. The story is broadly the same in France. One of the avowed aims of the *LOLF* reforms was to “endow the state with a real system of accrual accounting which would permit it to measure its true costs” of service delivery (MINEFI, 2005). To this end, the 2001 *LOLF* legislation (Article 27) specifically mandated the introduction of management (“analytic”) accounting. However, a study undertaken by the Cour des comptes [supreme audit institution] a decade later found that the use of management accounting across government “remained weak” (CdC, 2011: 149).<sup>9</sup>

**Box 2: Output Costing and “Accrual Output Budgeting”**

Limited success with output costing was one important factor in the failure of the accrual output budgeting (AOB) systems developed in Australia and New Zealand in the 1990s. AOB, which was an atypical form of performance budgeting, aimed to use output unit cost measures as the basis for a purchaser-provider model of budgeting in which government would fund spending ministries by paying “prices” for the services they delivered. The AOB objective was to apply pressure to spending ministries to improve the efficiency of output delivery (Robinson, 2007).

44. Experience has been no more positive in respect to the supposed capital asset budgeting and management advantages of accruals. Here the proposition put forward by accrual advocates was that decisions about acquiring and holding physical assets, and decisions about whether to hold or sell these assets, needed to be informed by an appreciation of the ongoing costs which they generated (depreciation and the “opportunity cost” of the capital invested) and of the cost of holding rather than selling them. It was argued that accruals was the way to ensure that this information was taken into account.

45. However, merely providing accrual accounting *information* to spending ministries could not be expected to significantly change behaviour with respect to capital asset budgeting and management. To change behaviour, it would be necessary to change the *incentives* facing spending ministries, so they were

<sup>9</sup> There are multiple reasons for the limited progress with cost accounting across government as a whole, but one of them is undoubtedly an insufficient recognition of the complex and diverse character of many government outputs. In many cases the “heterogeneity” of government services means that unit cost measures are of limited management value (Robinson, 2007). It is therefore unsurprising that output costing has in general only made substantial progress in specific sectors, such as hospitals.

forced to take depreciation and opportunity costs properly into account. It seemed to follow from this that to achieve the desired improvements in capital asset budgeting and management, it would be necessary to implement accrual *budgeting* rather than merely accrual accounting. More specifically, it would be necessary to design the accrual budgeting system so that incentives for better capital budgeting and management were built into the system of spending authorizations.

46. There were two main ways in which certain OECD countries designed their accrual budgeting system so as to provide incentives to spending ministries for better capital budgeting and management. These were *capital charging* and *depreciation funding of capital expenditure* (see Box 3)<sup>10</sup>. Both were strategies for factoring capital costs into the expenses budgets (see Box 1 above) allocated to spending ministries under accrual budgeting.

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<sup>10</sup> Some might suggest that this omits a third important tool for improved capital budgeting, mainly *net capital appropriations* – which refers to arrangements which allow spending ministries to sell assets and use the proceeds to fund new capital expenditure, as a result of which the capital expenditure appropriations in the budget cover only capital expenditure net of that financed by asset sales. The idea is, of course, to give spending ministries incentives to identify and sell surplus assets. However, it is not necessary to have accrual budgeting system – nor even accrual accounting – to run a system in which spending ministries can spend the proceeds of asset sales on new asset acquisition. Having said this, net capital appropriations are (with certain qualifications) a valuable instrument which does not (unlike, for example capital charging) involve large administrative costs. It continues to exist in a number of countries – including New Zealand (where it was originally introduced in 1989 (NZ Treasury, 2005: 22)) and the UK (HM Treasury, 2014b: 67).

**Box 3: Capital Charging and Depreciation Funding**

The idea of capital charging, which was first introduced on a whole-of-government basis in the UK and New Zealand, was to levy a budgetary charge on spending ministries as a percentage of the value of their assets. The “capital charge” was then treated as an expense which each spending ministry was obliged to cover from the expenses budget which it received under accrual budgeting arrangements. If a spending ministry sold a surplus asset, it would reduce the capital charge burden on its budget. Similarly, if the ministry avoided undertaking an unnecessary new capital expenditure, it would be better off because it would avoid the capital charge which that capital expenditure would generate in the future. The aim of including the capital charge within spending ministry budgets was to make agencies aware of the opportunity costs of their assets and give them incentives, firstly, to assess carefully whether planned new capital assets were really needed and, secondly, to identify and sell surplus assets. The idea sounded good in theory, but was in fact both conceptually flawed and quite costly to operate (Robinson, 1998). It was abandoned in Australia in 2002, and in the UK in the 2010-11 budget.

Under the system of funded depreciation, the expenses budget of each spending ministry not only included depreciation on their capital assets, but this depreciation component of the expenses budget was intended to serve as its main source of funding for future capital expenditure. Spending ministries were not bound to use the depreciation funding they received in the year it was provided, but were in theory permitted to “save” it for future use – and in particular, for the replacement of assets when they reach the end of their useful lives. The motivation of the system was to promote more efficient capital asset management by mimicking corporate practices (Robinson, 2002). It reflected a private sector corporate analogy in which government ministries were conceptualized as stand-alone enterprises which had a responsibility to appropriately manage “their” capital stock. The fundamental problem with this system was that it was inconsistent with the need of government to control the level of aggregate capital expenditure in order to be able to achieve government-wide fiscal targets. It also had other major defects including the loss of transparency in democratic accountability in capital expenditure appropriation arrangements. It was for these reasons that Australia abandoned this system in the 2010-11 budget (DOFD, 2012: 23).

47. It is therefore significant that both capital charging and depreciation funding have, in almost all of the countries which introduced them, been abandoned as excessively cumbersome and ineffective. Moreover, the majority of countries which adopted accrual budgeting systems never implemented these mechanisms in the first place. This was mainly part because countries like Switzerland (FFA, 2008) clearly recognized from the outset that limiting government debt in order to maintain fiscal sustainability necessarily requires setting limits for the capital *expenditure* of spending ministries, which meant that budget authorizations for capital had to remain essentially on a cash (payments) rather than an expense basis (Robinson, 2009).

48. The absence of these mechanisms means that, with scarcely an exception, the accrual budgeting systems which exist in OECD countries today are systems which do not budget for capital on an accrual basis. Rather, it is with respect only to *expenses which involve future payments* that the accrual budgeting principle applies. That is, the expenses budgets given to spending ministries serve, whether explicitly or implicitly, to limit only expenses in the current or future financial years. Although depreciation (an expense arising from *past* payments) may be formally included in the expense appropriations (as in the UK), there is no mechanism for using this depreciation component of expense budgets to fund future capital expenditure, so that the inclusion of depreciation has no practical expenditure control significance.

49. In the absence of the main accrual budgeting mechanisms for motivating spending ministries to improve their capital budgeting and management, it seems doubtful that accruals can have delivered anything like the improvements promised.

50. Finally, what has been the experience with respect to improved liability control? The case for accruals started from the familiar point that under cash budgeting spending ministries can incur liabilities requiring payments in future years without having to count them against their budgets at the time the liabilities are incurred. This creates perverse behavioural incentives for individual spending ministries (and

for the government as a whole) by encouraging them to spend now while deferring payments to the future. Again, however, it would be naive to expect that such behaviour would change merely as the result of introduction of accrual accounting providing *information* about outstanding liabilities. If spending ministries were to be induced to control their liabilities better, it would have to be through accrual budgeting which would force them to count against their budgets expenses which involve future payments.

51. It is probable that accrual budgeting has, in the countries where it has been introduced, had the effect of forcing spending ministries to improve their control of liabilities involving future payments. However, it is not clear that improved liability control provides an adequate justification for adopting accrual budgeting. It is not the case that, in the absence of an accrual budgeting system, there is no control over the incurring of liabilities. In the chain of expenditure, the incurring of commitments (legal obligations to spend money) precedes the incurring of liabilities. All well-developed budgeting systems, including cash budgeting systems, have mechanisms to control commitments and, to the extent that these function properly, the incurring of liabilities is thereby also controlled.

52. The most sophisticated mechanism for commitment control is that which operates in France, under which spending ministries are given annual budgets both for cash and for commitments. The French system is, in other words, a system of dual cash budgeting and commitment budgeting. The commitment budgeting element means that spending ministries are given an annual limit for the value of commitments into which they can enter, as well as a conventional cash budget authorization which limits the payments they may make. A persuasive argument can be made that such a system of commitment budgeting is superior to accrual budgeting. Because commitments arise prior to liabilities, an accrual budgeting system does not prevent excessive commitments from being incurred, so that it remains necessary (as under a cash budgeting system) to have additional mechanisms to control commitments. Commitment budgeting, on the other hand, directly controls commitments and indirectly controls liabilities. It is also less complex than accrual budgeting. It can, finally, serve as the basis for improved multi-annual capital budgeting. It is therefore unsurprising that the French have shown little interest in moving to accrual budgeting. Limited interest in accrual budgeting has also been apparent in the United States and Germany, both of which have long operated partial forms of commitment budgeting.

53. The case for adopting accrual budgeting on “managerial” grounds such as improved liability control, or improved capital asset budgeting and management, is therefore hardly compelling. Moreover, it is clear that even if a country sets fiscal targets based on accrual rather than cash measures (as, for example, in Canada, where debt targets are formulated on the basis of the accrual measure of total liabilities net of financial assets), this does not make it necessary to shift budget appropriations onto an accrual basis. It is not difficult to understand why, after very detailed consideration by their ministries of finance, countries like the Netherlands and Canada decided not to adopt accrual budgeting. It also becomes clear why even in Australia the MOF has floated the idea of moving back to cash budgeting (DOFD, 2012: 23).

54. More generally, after a decade or more of experience in a number of OECD countries, it is clear the benefits which had been promised from the move to accruals – whether accrual accounting only or accrual budgeting as well – have only been realized to a quite limited degree. It is hard to argue with the conclusion reached by the Netherlands Ministry of Finance (2010: 7) – that there is “little doubt ... that accrual basis accounting does not live up to the ambitious expectations of its advocates”. Moreover, although the case for accrual accounting is much stronger than that for accrual budgeting, major challenges remain ensuring that the accrual-based financial reports are useful for government. It is widely recognized that accounting standards have to date been insufficiently tailored to public sector requirements. Important work is underway to address this problem – for example, through the revision of IPSAS accounting standards – but much remains to be done.

### *Performance Budgeting*

55. Performance budgeting – which as noted earlier has been generally conceived as an instrument for promoting VFM – was perhaps the most prominent single area of budgeting reform during pre-GFC era. Today, however, many OECD MOF officials consider that it failed. They believe that performance budgeting has been merely a “paper” exercise, with little significant impact on budget decision-making. Critics also suggest that little budgetary use has been made of the performance indicators developed as part of the performance budgeting reforms, and that many of these indicators are irrelevant to budget decisions.

56. This poses the question of whether to abandon performance budgeting, or to seek to modify it to turn it into a useful budgeting tool.

57. However, before concluding that experience has demonstrated it to be useless, it should be noted that in practice so-called performance “budgeting” has, in most countries, not in fact operated as a budgeting tool *per se*. Even in those OECD countries which had implemented performance budgeting reforms, little consideration was given to performance during budget preparation. The observation of Küchen and Nordman (2008: 5) in respect to the Swedish budget preparation process – that “only to a very limited extent do the discussions between the spending ministries and the Ministry of Finance’s budget department concern previous performance or concrete ambitions for the future in terms of performance” – has been true of most countries with program budgeting systems. In France, for example, a major 2011 review of the LOLF performance budgeting system by the *Cour des comptes* noted that there was no discussion of ministry performance during budget preparation prior to the point when ministry budget allocations were finalised (CdC, 2011: 176-77).<sup>11</sup>

58. One of the reasons for this was precisely that most countries which introduced program budgeting systems during the pre-GFC era did not to view these systems as expenditure prioritization instruments. As discussed earlier, this lack of interest in performance budgeting as a tool for expenditure prioritization reflected the widespread lack of interest in reallocation at the time.

59. However, this does not provide an adequate explanation for the failure to use performance information during budget preparation. Even in a program budgeting system designed only to promote VFM, it makes sense to closely review performance when deciding ministry budget allocations. This is because spending ministry incentives to improve efficiency and effectiveness will be strengthened considerably if ministries know that the MOF will carefully scrutinise their performance, and that they are likely to be exposed to tough bilateral discussions on performance during budget preparation.

60. Why, then, the lack of consideration of performance during budget preparation? To some extent, the problem may be traced to an implicit assumption that merely shining the spotlight on spending ministry performance through the publication of key program performance indicators would be sufficient to encourage better performance. In some cases, the problem lay in a different assumption – namely, that merely providing relevant performance information would be enough to ensure that it was used during the budget preparation process.

61. However, overarching all of this is the fact that prior to the GFC so-called “performance budgeting” was generally more focused on performance *management* than on budgeting. It was, in other

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<sup>11</sup> Until recently, the budget calendar in France was organised in such a manner that performance was discussed only right at the end of the budget preparation process, and the focus was then primarily on the preparation of the required performance reports and selection of performance indicators, rather than on the review of performance to date (Direction du Budget, 2013: 17-8).

words, seen more as an instrument for general performance-oriented public management reform, then as a budgeting tool.

62. Despite the widespread dissatisfaction with the performance budgeting reforms of the last decades, there is in the wake of the GFC a widely recognized need to make budgeting more performance-informed. In particular, the renewed emphasis on reallocation is generating a desire to see relevant performance information harnessed to the task of expenditure prioritization.

63. One of the key lessons of pre-GFC experience is, however, that performance information – no matter how pertinent – will only be put to full use if specific routines are created within the budget preparation process for the systematic review of spending ministry performance. One of the most important ways of doing this is to establish a *performance dialogue* between the MOF as a routine at an appropriate stage during the preparation of each budget. Another is to create mechanisms to ensure the systematic use of the information generated by performance budgeting systems in spending review processes.

**Box 4: Budgeting and Performance – the UK PSA System**

Arguably, one of the most successful performance budgeting systems of the pre-GFC era was the UK Public Service Agreement (PSA) system, precisely because of the systematic link between performance and budget preparation. The essence of PSA system, as it operated between 1997 and 2007, was multi-year outcome targets which were set as an integral part of the preparation every three years of the multi-annual budget (the so-called Spending Reviews referred to previously). The system’s primary objective was to increase the effectiveness of expenditure, and it was not a tool for expenditure prioritization. The close link between budget preparation and target setting appears to have ensured that spending ministries took the targets seriously and worked to achieve them (Smith, 2007).

64. It is today widely recognized that, if performance is to be seriously reviewed during budget preparation, it is also essential that the performance information available to the MOF is *relevant* for budget decision-making. There have been many problems at this level also. In many countries, it was assumed that the only type of performance information required were performance *indicators*. However, it is well known that indicators by themselves (even when well chosen) are of limited decision-making value.<sup>12</sup> All performance indicators need careful analysis and interpretation to yield actionable information for either budgeting or management purposes. This is why evaluation – using the term in the broadest possible sense to include efficiency as well as effectiveness analysis – is crucial to the success of performance budgeting systems. However, during the pre-GFC wave of reforms very few countries considered evaluation to be a necessary part of the information base of performance budgeting. Only a handful of countries – most notably Canada and Chile – operated government-wide evaluation systems (run by the MOF). Even in those countries, evaluation was viewed more as a management tool for spending ministries than as a budgeting information tool (Robinson, 2014).

65. There is today a growing recognition amongst OECD countries of the potentially important role of evaluation as a tool to inform budgeting. Evaluation is, in particular, seen as a means of improving spending review processes. This renewed emphasis on evaluation is most welcome. At the same time, however it is important not to forget the lessons of the past. During the first wave of performance budgeting reforms in the 1970s, evaluation was much emphasised and many governments devoted large

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<sup>12</sup> On the one hand, outcome performance indicators either do not distinguish (or distinguish only to a limited degree) between the outcomes achieved by government programs and the influence of external factors. On the other hand, output indicators face a range of important limitations. For example, efficiency indicators such as unit output costs may raise question marks about efficiency which require investigation, but are not capable in themselves to show conclusively that, say, efficiency has been deteriorating or that one service provider is less efficient than another.

resources to the construction of government-wide evaluation systems. However, disenchantment rapidly set in because much evaluation was excessively academic, lacking in timeliness, and not designed to provide conclusions tailored to decision-makers' needs. If evaluation is to be resurrected, it must be practical, timely and client-focused. The differing information requirements of program managers and budget decision-makers will also need to be recognized and accommodated in the design and presentation of evaluations (Robinson, 2014).

66. This points to the need, in future, to give much closer consideration to the specific ways in which additional information generated to support VFM-oriented budgeting reforms will actually be used by budget decision-makers. As the US Office of Management and Budget has observed, "prior reforms [have] tended to increase the passive collection and reporting of performance information but not its active use" (OMB, 2014: 60). There is a general tendency – whether it is on the part of accountants, evaluators, performance management specialists, or IT systems developers – to advocate large investments in the acquisition of additional information which is expected to be of great value for decision-making purposes, but which turns out to be much less useful than they had imagined. One of the reasons for this is that the professionals who supply information often have only a very general notion of the requirements of those who are supposed to use that information. Experience clearly demonstrates that, prior to launching major new information initiatives, the manner in which the additional information will be used by the decision-makers needs to be very precisely defined, and the information tailored accordingly.

#### 4. AGGREGATE FISCAL DISCIPLINE

67. The third major objective of budgeting is to assure aggregate fiscal discipline. Under the difficult fiscal conditions facing most OECD countries in the wake of the GFC, this is increasingly becoming the primary preoccupation of budget reform. Indeed, even the increasing focus on improving the mechanisms of expenditure prioritization is in large measure driven by an understanding that better prioritization can help to control aggregate expenditure and thereby substantially contribute to aggregate fiscal discipline.

68. The main PFM response to this need to strengthen aggregate fiscal discipline has been to demand the use of tougher forms of instruments developed by reformers prior to the GFC. Tougher limits on aggregate expenditure – through top-down budgeting, expenditure ceilings and expenditure rules<sup>13</sup> – are a particularly important contemporary theme. So is the tightening of fiscal rules by, for example, establishing automatic “correction mechanisms” which apply when the rules are breached (as in the Swiss and German “debt brake” systems), or by more explicitly defining and limiting provisions for the adjustment or suspension of these rules under circumstances such as major recessions. Closely linked to this is the call for increased fiscal transparency, both through better reporting of the government’s overall fiscal position and through the use of independent fiscal councils. Finally, the merits of medium-term budgeting frameworks are today being emphasised with intensified fervour.

69. It is, however, important not to entertain exaggerated notions of what can be achieved through budgeting mechanisms. Aggregate fiscal discipline is above all a question of political will, cultural attitudes and expenditure policy choices, rather than of the design of budgetary instruments and structures. Mechanisms designed to enforce aggregate fiscal discipline have a poor track record in countries where there is little popular understanding of the importance of fiscal responsibility, and where political leadership on these issues is lacking.

70. Fiscal transparency, for example, is a thoroughly good thing, but its benefits will always be marginal. The fiscal risks which financial bubbles poses for government can only be resolved by fundamentally reforming the framework of financial regulation, not through improved transparency. After the GFC, who needs transparency to know that inadequately regulated banking poses a huge fiscal risk for government? Similarly, although fiscal councils are undoubtedly useful, it would be profoundly naive to believe that even the most frank and fearless commentary by fiscal councils on inappropriate government fiscal policies can have great effect on public opinion and change the political calculus of fiscal matters. Nor is it realistic to view fiscal councils as having a major impact via the disciplinary effect of financial markets upon government. The financial markets have a track record of blissfully lending freely to irresponsible governments one day, and then taking extreme fright the next day, without paying close attention to the objective facts of the situation.

71. Nor is it appropriate to expect too much from stronger *permanent* fiscal rules. Fiscal rules tend to work best in the countries which have least need for them. But even allowing that they play a useful role,

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<sup>13</sup> It is important to distinguish clearly between expenditure *rules* and expenditure ceilings or targets. Consistent with the general distinction between fiscal *rules* and fiscal *targets* (Kopits and Symansky, 1998; Robinson, 2012), an expenditure *rule* is a limit on a broad category of government expenditure which is formulated in a general form intended to have permanent or *continuing* application. By contrast, an expenditure ceiling or target is a limit which is formulated so as to have purely one-off application. A government commitment that expenditure should not exceed 30% of GDP is an expenditure rule, whereas a decision to limit expenditure next year to less than \$300 billion is an expenditure ceiling. It is unfortunate that some have muddied the distinction, by re-defining the concept of fiscal rules to include purely temporary fiscal targets and ceilings (e.g. IMF, 2014a: 43; Schaechter et al, 2012: 6).

permanent fiscal rules do not provide an adequate framework for fiscal policy when major fiscal consolidation is required, as is the case in most OECD countries today. Fiscal rules are by definition not forward-looking, because they do not take into account prospective fiscal developments which are not part of the measures of financial flows and stocks upon which rules are based. For example, the need for surpluses in the medium-term to cover longer-term demographically-induced deficits (especially from pension expenditure) cannot be captured in a permanent fiscal rule.

72. Permanent fiscal rules are in general more suited as an instrument for maintaining fiscal sustainability than for consolidating public finances when they have already become unsustainable. Any permanent rule which will over time deliver fiscal consolidation – such as a traditional cash balance budget rule – will be unduly restrictive in the long term (in the case of the traditional budget balance rule, by inappropriately banning the use of debt for infrastructure financing).

73. Expenditure rules which are appropriate for permanent application are inadequate for consolidation purposes. This is true, for example, of the recently-introduced European Union (EU) expenditure rule, which essentially requires that expenditure may not grow faster than the trend growth rate of revenue. The main value of a permanent expenditure rule along these lines is to prevent pro-cyclical surges of expenditure during the upswing of the business cycle. However, big spending based on cyclical surges in government revenues is hardly an imminent danger under current depressed macroeconomic conditions. The unkind might suggest that this type of rule is a case of shutting the gate after the horse has already bolted.

74. There has been also little success in designing *conditional* fiscal rules to force consolidation. The EU rule requiring countries with debt above the upper limit of 60 percent to reduce the excess debt by one-twentieth per year on average has worked poorly, largely because it is too arbitrary and mechanistic to take proper account of macroeconomic conditions. This points to a conundrum facing fiscal rule designers. On the one hand, the effectiveness of fiscal rules depends a great deal on their public credibility, for which purpose it is critical that they are simple and understandable. On the other hand, however, the GFC has underlined the need for fiscal rules to be designed so as, firstly, to take better account of potential unanticipated shocks and, secondly, to make it more difficult to circumvent them (e.g. by creative accounting). To do this, their design needs to be more sophisticated, which necessarily means that they become more complex and consequently less readily understandable.

75. For the purposes of the fiscal consolidation which most OECD countries will require in the years to come, it is not permanent rules which are important but rather fiscal *targets* and temporary fiscal rules (i.e. rules which are intended to apply over a significant period of time but not permanently). The Swedish objective of a 1% fiscal surplus to prepare public finances to cope with future age-related spending pressures falls into this category – it makes no sense as a permanent rule, but makes eminent sense when applied over, say, a 20 year period. Fiscal targets, which are time-bound objectives for aggregate fiscal variables (such as an objective of reducing debt/GDP by a certain quantum within a defined time frame) by definition lapse once they have been achieved their intended effect of consolidating public finances.

76. As a solution to the fiscal challenges facing most OECD countries, medium-term budgeting suffers from the same type of limitations as fiscal rules. While it is undoubtedly important to strengthen the medium-term perspective in budget formulation, what counts most in the majority of OECD countries at present is not the medium term but the long term. In most countries, fiscal policies need to be formulated primarily with an eye to addressing the problems of long-term sustainability, and medium-term fiscal policies should be derived from long-term objectives, rather than merely reflecting the object of maintaining medium-term fiscal sustainability. The long-term fiscal projections and analysis which is now produced by most OECD governments (and by the European Union) is particularly useful in this context, but need to be more closely linked to budgeting.

***Limiting Aggregate Expenditure***

77. Perhaps the most important PFM response to the need to tighten aggregate fiscal discipline has, however, been the increased emphasis on strengthening control over aggregate expenditure. The more widespread adoption of expenditure rules is one manifestation of this, as is reintroduction in the United States of *pay-as-you-go* (PAYGO) and the CUTGO version of this which requires adjustments exclusively on the expenditure side<sup>14</sup>. Moves towards the wider adoption of mechanisms whereby pension entitlements, including the retirement age, are automatically adjusted with life expectancy, are another.

78. Two instruments for aggregate expenditure control have assumed particular importance. The first is top-down budgeting, the defining characteristic of which is the imposition of an aggregate expenditure ceiling *during budget preparation*. The other is aggregate expenditure ceilings which are limits on aggregate expenditure which apply *during budget execution* (and may or may not apply during budget preparation), and which therefore require corrective action during the financial year if they look like being exceeded.

**Box 5: Expenditure Ceilings**

Discussions of expenditure ceilings sometimes become confused because the term “ceiling” is used in three different senses in the literature – as budget preparation ceilings, as budget execution ceilings, and as budget guarantees. A *budget preparation ceiling* is a planning limit on expenditure which applies during budget preparation. This involves a commitment that, at the end of the budget preparation process, the expenditure estimates for the coming year will be consistent with that ceiling. A *budget execution ceiling*, on the other hand, is a limit which must be respected during the execution of the budget. This means that, if during the year it looks like actual expenditure is on track to exceed the ceiling; immediate cuts must be applied to ensure that this does not happen.

It is possible to set a budget execution ceiling at the end of the budget preparation process without having applied that ceiling during budget preparation. The converse is also possible: as discussed later in this paper, budget preparation may be framed by a ceiling which the government recognizes may, for reasons outside its control, be exceeded during budget execution. For this reason, although top-down budgeting necessarily involves the application of an aggregate expenditure ceiling during budget preparation, it should not be considered to *necessarily* require enforcement of that ceiling during budget execution.

If fixed multi-annual expenditure ceilings are set, the outer-year ceilings necessarily operate both as budget preparation ceilings and as budget execution ceilings. In other words, when those outer years arrive, the ceiling will need to be respected in both the preparation and execution of the budgets for the years concerned. A multi-year budgeting system based on fixed multi-annual ceilings therefore mandates a top-down budgeting system, as well as firm budget execution ceilings.

Although the plain meaning of the term “ceiling” is that of a limit on expenditure, the term is also used in the third sense of a guaranteed minimum level of expenditure, particularly in the context of fixed medium-term *ministry* ceilings. The role of ceilings as guarantees is discussed further below.

In this paper, the sense in which the term “ceilings” is being used will either be clear from the context or is expressly indicated.

79. Since the GFC, the use of both top-down budgeting and aggregate (budget execution) expenditure ceilings has increased. Germany, for example, adopted top-down budgeting in 2011. Portugal has done the same. In Denmark, 2013 amendments to the Budget Law introduced four year expenditure

<sup>14</sup> PAYGO requires that new mandatory expenditure initiatives must be compensated by measures which cut other spending or raise revenue sufficiently to avoid a net negative impact on the fiscal balance (see OMB, 2014: 94-7). In the CUTGO version adopted procedurally by Congress, the adjustment must be made solely on the expenditure side.

ceilings (which were fixed for the first time for the period 2014-17). There has also been a tendency to call for the application of tougher forms of aggregate expenditure ceilings – in particular, ceilings with more comprehensive coverage (EC, 2013; IMF, 2014b).

80. Strengthening control over aggregate expenditure is highly desirable. However, there are dangers which should be recognized and properly addressed. In particular, there are sometimes trade-offs between, on the one hand, strengthening control over aggregate expenditure and, on the other hand, improving allocative efficiency, effectiveness and efficiency. Linked to this, there are major risks in the imposition of *arbitrary* limits on aggregate expenditure which do not take proper account of the underlying dynamics of expenditure – i.e. of trends in baseline expenditure on a “constant policy” basis. Purely top-down limits which are set without regard to bottom-up expenditure pressures may raise major problems.

81. PFM tends to be characterised by a permanent tension between the different perspectives of, on the one hand, those whose primary focus is on the “macro” task of controlling aggregate expenditure, and those who are more focused on the “micro” objectives of improving VFM and allocative efficiency. Some of the former (who are mainly economists) have little awareness of the potential adverse implications for VFM and allocative efficiency of some of the mechanisms which they favour for improving aggregate expenditure control. They also often have a tendency to favour arbitrary top-down limits on spending without fully acknowledging the strength of the bottom-up expenditure dynamics. They do not necessarily understand that controlling aggregate expenditure is not simply a matter of deciding how much spending is to be authorized, and issuing orders to that effect.

82. On the other hand, many of those whose main focus is on improving VFM and allocative efficiency – who are often accountants and public administration specialists – have an inadequate understanding of aggregate fiscal policy and do not attach sufficient importance to controlling aggregate expenditure. In the pre-GFC era their myopia was often aggravated by the fashionable pursuit of private sector models, which has led many to seek to apply management models based on the notion of ministries operating as independent stand-alone enterprises, without recognizing the crucial importance of whole-of-government perspectives.

83. Prior to the GFC, the emphasis given to the VFM-oriented budgeting reforms, and the inadequate understanding on the part of the “micro” budgeters of expenditure control imperatives, resulted in the adoption of some reforms which undesirably weakened aggregate expenditure control. In the coming years, there is a danger that the reverse may occur – that well-intentioned reforms designed to strengthen aggregate expenditure control will have unintended and unnecessary adverse effects on the pursuit of VFM and allocative efficiency.

84. Perverse effects on aggregate expenditure control arising from pre-GFC VFM oriented budgeting reform may be illustrated by two examples. The first is expenditure carryovers, and the second concerns medium-term budget guarantees to spending ministries.

### ***Expenditure Carryover***

85. The introduction of automatic expenditure carryover arrangements, under which spending ministries were allowed to retain unspent expenditure appropriations rather than return them to the MOF, was a major reform of the 1980s. However, in the decade prior to the GFC a number of OECD countries regarded as leaders of budgeting reform dramatically increase the level of carryover which was allowed. Moreover, they did so in ways (e.g. removing limits on carried over expenditure, or permitting indefinite carryover into the future) which seriously eroded the capacity of MOFs to control annual aggregate expenditure. In Sweden, for example, the accumulated carried over expenditure entitlements of spending ministries were characterised as a “time bomb” (Blöndal, 2001: 48).

86. British experience with unconstrained carryover is noteworthy. In that country, most limits on carryovers were removed as part of 1998 reforms to expenditure control mechanisms (HM Treasury, 1998). Over the years that followed, spending ministries accumulated increasing amounts of carryover expenditure entitlements and it was increasingly understood that, should they choose to exercise these rights in any particular year, there would be a large impact on aggregate expenditure levels. As a consequence, some initial steps to rein in carryover rights were taken in 2005, just prior to the GFC. It was, however, in 2011 that the UK government took more radical action to limit the extent of expenditure carryover available to ministries, when it replaced the previous “End Year Flexibility” system with a new “Budget Exchange” system (HM Treasury, 2010, 2014). At the time it did so, accumulated carryover expenditure rights across the entire UK Government had reached the remarkable level of approximately £20 billion. The new Budget Exchange system aimed explicitly to strengthen aggregate expenditure control, while nevertheless retaining flexibility “within prudent limits”.<sup>15</sup>

87. So far, the UK appears to be the only country which has moved to restrict carryover in the interest of expenditure control. It is, however, likely that other OECD countries will in the coming years to limit the extent of carryover permitted.

### ***Medium-Term Budget Guarantees to Spending Ministries***

88. A key focus of the massive literature on medium-term budgeting is the role of medium-term expenditure ceilings. However, as noted in Box 5 above, there is a certain ambiguity in the term “ceiling” as used in some of the literature. It is clear that any expenditure ceiling must represent a level of expenditure which is not to be exceeded – that it must represent a *maximum* level of expenditure. However, the term is also used to refer to government commitments to spend at that level, in which case the ceiling also functions as a *minimum*.

89. For spending control purposes – which is the main focus of *aggregate* expenditure ceilings – it is the core notion of a ceiling as a maximum which is crucial. Indeed, the idea of locking government years ahead into minimum levels of expenditure raises potential problems for aggregate fiscal policy.

90. Prior to the GFC, however, a small number of OECD countries firmly committed to the idea of ceilings as both expenditure minimums and maximums – specifically, as a means of providing firm guarantees to spending ministries about their future budgets over the medium-term time horizon. The main objective was to improve VFM. Giving spending ministries certainty about their budgets over, say, a three-year time horizon was expected to improve the effectiveness and efficiency of spending by permitting better planning and implementation of expenditure. For example, when in 1998 the UK introduced three-year fixed “departmental expenditure limits” (DELs), it did so in order to enable ministries to “prioritise resources and plan ahead, providing a more stable foundation for managing public services” (HM Treasury, 1998: 3.4). It was the same VFM objective which inspired France’s adoption in 2009 of two-year fixed *program* expenditure ceilings. This point is perhaps not universally understood, because some of those who today argue for fixed medium-term ministry expenditure ceilings seem to believe that such ceilings are first and foremost an instrument for fiscal discipline.

91. In the presence of uncertainty about medium-term revenues, there is always a potential conflict between, on the one hand, providing medium-term budget guarantees to spending ministries and, on the other hand, committing to specific targets or rules for the fiscal balance or other fiscal aggregates. In the decade before the GFC, buoyant revenue conditions in many OECD countries prevented this potential

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<sup>15</sup> Under the new system, automatic expenditure carryover for large ministries is limited to 0.75% for current expenditure and 1.5% for capital expenditure (the percentages are larger for smaller ministries). Restrictions on the accumulation of carryover rights were introduced, as was an advance notification requirement.

conflict from manifesting itself. In the UK, for example, repeated positive revenue surprises not only supported the operation of the medium-term ministry expenditure ceiling system introduced in 1998, but permitted the government to *increase* on a number of occasions the supposedly fixed ministry ceilings (Keynes and Tetlow, 2014: 43).

92. In the post-GFC era, circumstances have been completely different. Revenue growth has generally been slow and has often surprised on the downside, while at the same time increased attention has been given to achieving aggregate fiscal targets. The potential conflict between medium-term budget guarantees and aggregate fiscal policy has progressively manifested itself.

93. Thus in recent years, revenue shortfalls have put significant pressure on the U.K.'s system of fixed medium-term DELs. The outer year DELs which were set in 2010 were subject to subsequent substantial downward adjustments for a number of important ministries (NAO, 2012: 40). In 2013, six months after setting supposedly firm DELs for 2015-16, the government cut 1% off those of most ministries (Keynes and Tetlow, 2014: 43).

94. In France, the government has in recent years made increasing use of controls over the release of budget allocations to spending ministries during the course of the financial year to impose de facto cuts to ceilings when deemed necessary for deficit control purposes.<sup>16</sup> This practice has significantly increased *within-year* budget uncertainty for spending ministries, and has been repeatedly criticised by the *Cour des comptes*, which has urged that “this type of management involving the significant reduction of budget allocations during the course of the year should not be allowed to continue” (CdC, 2013a: 80; 2013b: 121-25; 2014: 95-96). Increasing the within-year budget uncertainty facing spending ministries hardly fits with a policy of giving them greater budgetary certainty over the medium-term time horizon.

95. This tension between aggregate fiscal policy and ceilings which operate as guarantees of future budgets has, in fact, also impacted on countries which have operated systems of fixed medium-term *aggregate* expenditure ceilings without ever providing guarantees to individual spending ministries about their future budgets. Even in these systems, it was in the past not fully clear whether the aggregate expenditure ceilings were intended to function as minimums as well as maximums. Under difficult post-GFC fiscal circumstances, the answer is increasingly that the ceilings are purely maximums.<sup>17</sup>

### ***Strengthening Aggregate Expenditure Control in the Coming Years***

96. If, in the past, VFM-oriented budgeting reforms have sometimes been pursued to the detriment of aggregate expenditure control, there is now a reverse danger. This is that the design of tougher instruments

<sup>16</sup> This has been achieved by making increasing use of the so-called contingency reserve (*réserve de précaution*) for the purpose of rationing budget release. An increasing proportion of ministry budget allocations (rising to 7 percent of non-salary budgets in 2014) has been frozen as part of this reserve at the start of each financial year. The government then decides during the year how much to release (and how much to leave unspent), depending upon the evolution of receipts and its implications for the fiscal balance. The chronic tendency to over-estimate prospective revenues has contributed to the increased use of this instrument for cutting ministry budget during budget execution.

<sup>17</sup> Aggregate expenditure ceilings have suffered ex-post downward adjustment in a number of countries. In Finland, for example, the outer-year ceilings set in 2011 for the three years 2012-15 were subsequently adjusted downwards twice (in both 2012 and 2013) (Finnish MOF, 2013: 11-12). The same things happened in Sweden in 2012 when the supposedly fixed ceiling for that year which had been set in 2009 was cut (Finanspolitiska Rådet, 2013: 95). In Denmark, the Economic Council (Denmark's fiscal council) predicted in 2014 that structural balance requirements of the Budget Law would make it impossible to authorize expenditure up to the full amount of the newly-introduced four-year fixed expenditure ceilings (Economic Council, 2014: 5).

of aggregate fiscal control will fail to pay sufficient attention to the objectives of good expenditure prioritization and VFM. Strengthened aggregate expenditure control is undoubtedly vital, but it would be a huge mistake to sacrifice these other objectives of budgeting when asserting stronger spending control. Two examples – concerning, respectively, the comprehensiveness of expenditure ceilings and the process for setting spending ministry shares of the aggregate expenditure ceiling under a system of top-down budgeting – illustrate the danger.

### *The Comprehensiveness of Expenditure Ceilings*

97. As noted above, since the GFC there has been an increasingly assertive school of thought demanding that expenditure ceilings – by which is meant ceilings which apply during budget execution as well as budget preparation – should be as comprehensive as possible. Crucially, these advocates of “comprehensive” ceilings assert that a single aggregate expenditure ceiling should include all or most social security expenditure, which automatically ensures that the ceilings cover a very large percentage of government expenditure.<sup>18</sup> The Swedes have long been the firmest advocates of this position, having always included social security expenditure in the expenditure ceilings which have been a central feature of the budgeting system for almost twenty years.

98. Budget execution expenditure ceilings are, however, entirely unsuitable as an instrument for limiting social security benefit (and much other mandatory expenditure). As discussed above, a budget execution expenditure ceiling is a limit on aggregate expenditure which requires corrective action to cut spending during the financial year if it looks like being exceeded. It is not, however, possible to apply such an expenditure ceiling to social security expenditure, because the amount of spending is determined primarily by entitlements set out in legislation. Even if, at the time the budget is prepared, unbiased expenditure forecasts indicate that social security expenditure should remain within the planning limit, circumstances can and often do change during the year in such a manner that actual benefits expenditure, even without any policy changes, exceed the forecast level. The same is true for mandatory expenditure in general, which is by definition determined by either legislative or contractual rights, and not by quantitative budget allocations.

99. It is possible to apply a budget preparation ceiling to mandatory expenditure – that is, to set a planning limit for the projected amount of mandatory expenditure and then make adjustments to benefits and other legislation during budget preparation so that actual expenditure should remain within that limit. But it is not possible to use expenditure ceilings to subsequently enforce such a planning limit.

100. The problem which social security and other mandatory expenditure poses for fiscal policy is that such expenditure is essentially uncontrollable in the short run, but *must* be controlled over time if aggregate fiscal discipline is to be preserved.

101. In the extreme, the notion that ceilings can be used to prevent social security expenditure from exceeding a pre-set level leads to the proposition that, if benefits expenditure looks like exceeding the ceiling during the year, the government should stop paying citizens the benefits to which they are entitled.<sup>19</sup> However, making needy citizens uncertain as to whether they will receive benefits seriously

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<sup>18</sup> In the technical literature supporting this position, only one clearly-formulated justification for excluding expenditure from aggregate ceilings is recognized. This is the need to permit the expenditure-side automatic stabilizers to operate – a justification for exclusion which applies mainly to unemployment benefits. Sweden, however, even includes unemployment benefits with its ceilings, and Finland excludes only an estimated cyclical component of unemployment benefit expenditure. Exponents of comprehensive ceilings also generally accept the exclusion of interest expenditure, but without providing a clear rationale for this exclusion.

<sup>19</sup> The illusion on the part of certain fiscal economists that it is possible to apply ceilings to social security expenditure would appear to have been partly fuelled by a misunderstanding of a useful reform which has taken

undermines the effectiveness of the social security system, a key aim of which is to reduce insecurity. Yet precisely this type of quantitative rationing of social security benefits has been forced by international organizations on certain countries facing serious fiscal difficulties.<sup>20</sup>

102. Even if one excludes the notion of denying citizens social security benefits once a ceiling has been reached, the idea of including mandatory expenditure within a comprehensive budget execution expenditure ceiling remains deeply problematic. With a single comprehensive ceiling which includes mandatory expenditures, one faces a choice between two options neither of which is attractive. Option one is to maintain a *large* unallocated budget reserve (contingency reserve) in order to cope with unanticipated fluctuations in mandatory expenditure – and, in doing so, open the door to the abuse of this large reserve by governments to approve additional unplanned non-mandatory expenditure during the financial year. Option two is to keep the budget reserve small, in which case any unanticipated surge in mandatory expenditure may force disruptive cuts to non-mandatory expenditure during budget execution – running contrary to the objective of providing greater planning certainty to spending ministries in order to achieve better VFM. This unappealing choice between weakening the disciplinary value of expenditure ceilings, and permitting them to seriously disrupt budget execution with adverse consequences for the effectiveness and efficiency, has confronted Sweden repeatedly over the last decade (Robinson, forthcoming).

103. A more sophisticated approach, which properly balances the objectives of aggregate spending control and expenditure effectiveness – within the context of a top-down budgeting system – is the “welfare cap” on mandatory expenditure which has recently been introduced in the UK (HM Treasury, 2014). Under the new system the government sets rolling multi-year target planning limits which cover most social security expenditure. It is these limits which are referred to as “caps”. The government is then required to ensure that the budget presented to parliament respects these caps – in other words that *forecast* (not actual) social security expenditure is not in excess of cap. The entire emphasis is on *ex-ante* respect for the cap, and there is no mechanism for ex-post enforcement if actual social security expenditure exceeds the cap. In the terminology of this paper, the caps serve exclusively as budget preparation ceilings.

104. The design of the welfare cap system is driven by the explicit recognition that it takes time to change the level of social security expenditure. It is precisely for this reason that the welfare caps are not designed to operate as budget execution expenditure ceilings. The cap is not part of the UK’s system of DELs which, as discussed above, are ceilings which are enforced during budget execution. The DELs cover approximately half of central government expenditure and therefore remain quite deliberately very far from comprehensive.

### ***Setting Ministry Shares of Aggregate Ceilings***

105. The application of a crude approach to the design of expenditure ceilings is not the only way in which poorly-designed instruments for controlling aggregate expenditure can undermine allocative efficiency and expenditure effectiveness. Poor design of top-down budgeting processes can also generate the same undesirable consequences. There are two ways in which this can potentially happen. The first, which has already been discussed, is the inappropriate notion that top-down budgeting requires the setting of *ministry* shares of the aggregate expenditure ceiling right at the start of the budget preparation process,

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place in certain countries (e.g. Sweden and Italy) to require annual appropriations for entitlements expenditure – a reform which is wholly about transparency about the level of mandatory expenditure, and which in no way stops beneficiaries from receiving benefits to which they are legally entitled.

<sup>20</sup> For example, the 2010 Romanian Fiscal Responsibility Law – adopted as part of an IMF program – requires (in Articles 20 and 27) the setting of a specific expenditure ceiling for social security expenditure (as well as a broader ceiling for consolidated general government expenditure), together with mid-year corrective action if the ceiling looks like being exceeded.

before there is an adequate opportunity for proper consideration of the merits of competing new spending proposals or review of baseline expenditure. Some think that establishing ministry shares right at the start of the budget preparation process is an essential feature of top-down budgeting. This is, however, not the case – it is the early establishment of the *aggregate* ceiling which is essential in order to guarantee aggregate fiscal discipline in the face of bottom-up spending pressures. The process which is used to share the aggregate ceiling between spending ministries is a separate matter, and it is essential that it be designed so as to deliver good expenditure prioritization, and not simply to set shares based (at best) on some vague notion of government strategic priorities but without close consideration of concrete alternative spending options (Robinson, 2012).<sup>21</sup>

106. The other potential danger is the notion that the setting of *fixed* medium-term expenditure ceilings for spending ministries necessarily constitutes “best practice” which everybody – i.e. all OECD countries and even most developing countries – should follow. As noted above, there is a school of thought today which views fixed medium-term ministry ceilings as a key instrument for strengthening fiscal discipline. Setting aside the question of whether this is the appropriate way to view such ceilings, there are persuasive grounds to fear that setting medium-term fixed ministry ceilings may seriously undermine expenditure prioritization in some countries. Proponents of fixed medium-term ceilings have argued to the contrary – claiming, on debatable methodological grounds, that such ceilings generally lead to improved expenditure planning and, thereby, allocative efficiency (Harris et al, 2013). However, a more plausible hypothesis is that the impact on allocative efficiency of setting fixed medium-term ministry ceilings depends on national circumstances.

107. It is not difficult to accept that in the United Kingdom, where high levels of capacity and excellent budgeting systems – and in particular, what is now a well-developed system of periodic spending reviews – the system of fixed medium-term DELs is compatible with good multi-year expenditure planning and expenditure prioritization. However, in countries without such a well-developed budgeting system, there is a very real danger that locking in spending ministry budgets three years in advance may have precisely the opposite effect, by making it much more difficult to reallocate expenditure according to government priorities and effectiveness considerations. This is because, in the absence of highly sophisticated budgeting processes, including effective spending review, fixed medium-term ceilings are likely to be set on a largely incremental basis and would therefore have the effect of increasing the rigidity of expenditure allocations.<sup>22</sup>

108. Rather than advocating fixed medium-term as the best solution for everyone, a more nuanced and appropriate position would be that the choice between indicative and fixed medium-term ministry ceilings should be made on a country-by country basis, taking into account a set of relevant criteria.<sup>23</sup>

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<sup>21</sup> It should be noted in this context that few of the countries which introduced top-down budgeting systems prior to the GFC required that all new spending initiatives be included within spending ministry ceilings set in the early stages of the budget process (OECD/KIPF, 2005: 25).

<sup>22</sup> Even then, it is by no means clear that even for the most advanced OECD countries, fixed medium-term ceilings generate superior allocative outcomes. It has certainly not been established that, say, the Australian medium-term budgeting system, which has never operated fixed medium-term ministry (or even aggregate) expenditure ceilings, is weaker at expenditure prioritization than the UK system.

<sup>23</sup> The predictability of macroeconomic conditions – and therefore of medium-term revenues – is an important consideration in deciding whether medium-term fixed ceilings (aggregate as well as ministry) are feasible in any specific country. Concretely, fixed medium-term expenditure ceilings are much less practicable in a rapidly developing economy (e.g. a Poland or Vietnam) than in a mature developed economy.

## 5. A PRACTICE-ORIENTED ANALYTIC FRAMEWORK

109. From the practitioner point of view, there is a pressing need to develop a stronger corpus of budgeting literature focused explicitly on the normative question of the optimal design of budgeting instruments and structures to achieve the three key objectives of budgeting. Concretely, this means a literature which is directly geared to providing responses to questions ranging from the high-level (e.g. “what is the best way to design top-down limits on aggregate expenditure?”) to the quite detailed (e.g. “what is the optimal size of the budget reserve and what rules should govern its use?”). To support the development of such a literature, the analytic framework needs considerable strengthening.

110. From the practitioner point of view, the academic literature has major limitations. Although this is not the place for a comprehensive review of this literature, two particularly important strands of the academic literature are worth discussing in this context. The first of these bases its analytic framework on actors and their motivations. The second is based on a set of budgeting principles.

### *Actor/Motivation Frameworks*

111. There is a large family of budgeting literature based on institutional (and individual) *actors* and the self-seeking *motivations* that are attributed to these actors. One important branch of this family of literature is the political science school of public budgeting, which particularly strong in the United States. This is a school which views budgeting as an essentially political game between key groups of actors who strategize to achieve the expenditure objectives which motivate them. For example, in the classical guardians/spenders model developed first by Wildavsky, spending ministries’ driving motivation is to maximize their budgets, and central agencies’ motivation is the inverse. Reflecting the preoccupation with political games, the political science tradition has tended to focus particular attention on explaining allocative outcomes (who gets what).

112. The other major branch of the actors/motivations family of budgeting literature is the “political economy” school, developed by economists. This is essentially a variant of the political science tradition, in which the self-seeking nature of the motivations attributed to actors are presented in even starker terms, in line with predilection of economists for *homo economicus* representations of human behaviour.

113. Many of the writers from these schools are not directly interested in the design of budgeting instruments and structures, but are primarily focused on other questions. However, even when this is the case this literature has had enormous influence on practitioners, because it has supplied them with assumptions about the behaviour of actors in the budgeting process which have conditioned their approach to areas ranging from the design of institutions to assure aggregate fiscal discipline, through to the development of mechanisms to improve effectiveness and efficiency.

114. There is, in addition, a significant strand of the political economy school which does have an explicitly normative focus: specifically, on the design of fiscal rules and processes to guarantee aggregate fiscal discipline by constraining the inherent tendency of democracies to fiscally irresponsible outcomes. The main focus here is on high-level fiscal rules and processes (e.g. how to design the constitutional rules on Parliamentary approval of the budget), and the methodology is less well suited to addressing more detailed questions of budget reform design (partly for reasons discussed below).

115. As important as the contribution of the literature based on the actor/motivation framework has been, there are significant dangers and limitations for practitioners in relying excessively on budgetary theory based on this framework.

116. The first of these arises from the fact that both the political economy and political science schools have a tendency towards crude caricatures of actor motivation. A familiar example is the Niskanen model of the budget-maximizing bureaucrat, whose sole motivation is to build the largest possible bureaucratic empire. This is clearly an absurd one-dimensional description of bureaucratic behaviour.

117. The fashion for analysis based on these types of simple motivational hypotheses has faded somewhat. In recent decades, there has been a vigorous counter-assault directed at crude behavioural assumptions in the homo economicus tradition. Today, even many economists acknowledge that the behaviour of actors – whether in the budgeting process or in other contexts – is generally not as simple as this, and that both individuals and institutions are often guided by a mix of altruistic (principled) and self-seeking motives. Moreover, many analysts would today readily agree that the actor/motivation framework tends to accord far too little significance to differences in culture and political values as a determinant of fiscal outcomes – in explaining, for example, why it is so politically difficult for French governments to consolidate public finances while in Germany there is always a strong electoral constituency for “sound” public finances.

118. Acknowledging the complexity of human behaviour poses, however, a major problem for budgetary theory based on actors and their motivations. The predictive power and attractiveness of these models depends precisely upon making simple (“parsimonious” in the jargon of economists) motivational assumptions. As soon as these simple assumptions are dropped, it is no longer possible to clearly deduce the consequences – e.g. for aggregate fiscal discipline – of a given set of budgetary institutions and practices.

119. The application that practitioners should draw from this is that, while drawing on the insights which come from the actor/motivation analytic framework, they should use these with caution and the degree of scepticism when designing budgetary instruments and structures.

120. There is a second danger which faces practitioners in drawing on literature based on this framework. This is the danger of relying too much on the analytic framework and not adequately taking into account the intrinsic complexities of the public sector. The danger can perhaps be best illustrated by the example of the erstwhile fashion for contractual models. Under the influence of principal-agent theory, many OECD countries sought in the pre-GFC era to introduce contractual modes and quasi-market systems of internal governance into the public sector. One manifestation of this was the development in certain countries of the accrual output budgeting model which has been referred to earlier in this paper. As noted, this was a model which sought to transform budgeting into purchaser-provider transactions where the government purchased outputs, based on pre-specified prices, from ministries (and equally, from outsourced private providers). This was supposed to create intense pressure to improve efficiency, along the same lines that competitive markets operate. At a superficial level, the idea was an attractive one. However, it was a model which failed fundamentally when confronted with the realities of the complex mix of services delivered by government, many of which were highly heterogeneous, had no standard unit cost, and for which it was in some cases even difficult to define units of output (i.e. measures of the quantity of services delivered).

121. For practitioners focused on the design of detailed budgetary instruments and structures, the devil is always in the detail. The specificities of the public sector are of fundamental importance, whether it is in respect to the characteristics of public sector outputs, the drivers of expenditure (e.g. mandatory versus non-mandatory), the existence of the hard budget constraint (see below), or any of a number of other important matters. Swashbuckling reform campaigns based on bold academic theories in the actor/motivation tradition, undertaken with too little regard for the “nitty-gritty” detail, are bound to fail.

### *The Legal Principles Framework*

122. Another major strand of budgeting literature is the legalistic tradition which dominates in much continental Europe, including France and Germany. This is a literature which focuses on budgeting primarily through the prism of the design of laws and subordinate legislation governing budgeting processes. Its analytic framework is primarily based upon legal principles which are supposedly fundamental to budgeting, but which turn out in fact to have limited value as the basis for normative propositions. This can be illustrated by reference to two of these supposedly fundamental principles – the principle of the *annual basis* of the budget and that of the *universality* of the budget. With the focus on the development of multi-annual budgeting, the first of these principles has been increasingly ignored by OECD governments. As for the universality principle – the central aspect of which is the assertion that the budget should appropriate expenditure on a gross basis without any netting off of the own-source revenues of government agencies (i.e. no “net” budget allocations) (Lienert, 2004: 138; Bouvier, Esclassen and Lassale, 2013: 278) – this is a principle which many governments quite deliberately set to one side as part of the pre-GFC autonomy movement, in order to create revenue-raising incentives for ministries.

123. The problem with these sorts of legal principles is that they are not anchored in the basic objectives of budgeting, and therefore have an inherently arbitrary quality. As a consequence, much ink ends up being spilt explaining why there are in practice so many exceptions to the supposedly fundamental legal principles. Another problem with the legal tradition is that it can lead to the legal tail wagging the budgeting dog: in other words, the drafting of budget laws and regulations takes primacy over the appropriate design of instruments and structures, sometimes to the detriment of the latter.<sup>24</sup>

124. In their different ways, then, neither the actor/motivation framework nor the budgetary principles framework provide an adequate basis for the design of budgetary instruments and structures to achieve the three basic objectives of aggregate fiscal control, good prioritization, and value for money.

### *Proprietary Methodologies*

125. Nature abhors a vacuum, and into the partial void left by the academic literature step others – unfortunately, often management consultants. The consulting objective is to create a proprietary methodology which can be sold to unsuspecting governments on the promise of radically improving their budgeting systems. Often, these are simply recycled versions of proprietary methodologies originally developed to sell to the private sector, with little or no modification to take into account the significantly different circumstances of the public sector. A good example of this is the effort to sell the balanced scorecard as the basis for performance budgeting in government, with only a superficial “makeover” from the private sector version. Despite its genuine merits in a private sector context, the balanced scorecard is largely unsuitable for application to government-wide planning and budgeting. It tends to reinforce certain bad design practices (e.g., excessive use of internal process indicators rather than a focus on “big-picture” output and outcome indicators) (Robinson, 2010). Over the decades, there have been numerous examples of these types of inappropriate proprietary methodologies which have enjoyed temporary favour in the public sector in certain countries, before being recognized as burdensome and unsuccessful. These range

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<sup>24</sup> This can be seen in the unfortunate tendency of certain international organizations in advising developing countries to subsume the PFM reform task under the umbrella of redesign of the “organic” budget law, with the danger that an excessively detailed law ends up building in inappropriately designed instruments and structures which are then difficult to change. This approach is also a poor fit for developing countries with institutions of Anglo-Saxon origin, which generally avoid excessively detailed and prescriptive budget legislation (and for which, indeed, the concept of an “organic” budget law does not exist).

from zero based budgeting in the 1970s through to activity-based costing and budgeting more recently. Without exception, they have done more damage than good.

### *Towards Stronger Theory and Practice*

126. What is the best approach to developing a stronger analytic literature focused on the optimal design of budgeting instruments and structures? Essentially, what is required is the development of stronger theory based on close observation of practice. By “theory” is meant credible and detailed explanations – grounded in and consistent with observation of practice – as to why specific instruments and structures can be expected to have desirable (or undesirable) consequences for the achievement of the three key objectives of budgeting. In seeking to develop a stronger theory, the most valuable research tool is comparative analysis which sets out to contrast and evaluate the different instruments and structures which countries have used to achieve the three basic budgeting objectives, and uses this to derive hypotheses about what works best and what does not work – and under what circumstances. Hypotheses derived from comparative analysis need then to be tested for theoretical plausibility, in what is essentially an iterative process. Comparative analysis and theoretical development therefore go hand-in-hand.

127. Although the merits of comparative analysis might appear obvious, it is surprising how little good comparative analysis of budgetary instruments and structures has been undertaken. Good comparative analysis means more than simply describing different approaches taken by different countries. It requires an explicit evaluation of the merits of alternative approaches with the objective of saying what works best. As part of this, it needs to be capable of differentiating between, on the one hand, differences in national budgeting practices which reflect good versus bad practice and, on the other hand, differences which are legitimate responses to varying contexts and circumstances. The aim should be to yield *conditional* good practice recommendations – e.g. recommendations for the size and role of the budget reserve which differ depending on, for example, the coverage of the budget in the country concerned.

128. As part of this, studies of *national* budgeting practice need to become more internationally comparative – that is, to not only describe budgeting practices in the country concerned, but to contrast these explicitly with practices elsewhere and explain the differences.

129. An essential tool for better normatively-oriented comparative analysis is a more well-developed set of basic concepts for describing and classifying budget systems. At present, the set of such concepts is very incomplete, and differences in terminology alone present at present a major obstacle to international comparisons. In part, the problem is the use of many different terms to mean the same thing – for example *control aggregate* in one country for what another country calls an *expenditure ceiling* and a third country calls a *resource envelope*. But the problem is also that some widely-used concepts have such completely different meanings in different countries as to be of no value in comparative analysis. This is true, for example, of the concepts of *budgetary* and *extra-budgetary* expenditure, given that in some countries even mandatory social security expenditure is subject to (admittedly fictive) appropriation in the budget. One of the consequences of this lack of an adequate standardised conceptual framework is to make it difficult for readers of the typical “budgeting in country X” study to properly understand the budget instruments and structures described.

130. In addition to differences in terminology between countries, there is also a proliferation of divergent terminology in the budgeting literature itself. There is, for example, no universally (or even generally) accepted definition of what constitutes, say, accrual budgeting, a fiscal rule, or even a budget classification. Imagine how much difficulty the physical sciences would have had in progressing if scientists had been unable even to agree on a standard set of concepts and definitions.

131. The development of a stronger comparative budgeting literature focused on normative system design issues can potentially provide the best antidote to the constant danger that the limited normative literature which is produced (and technical assistance based on it) is largely comprised manifestoes by national experts preaching their own national systems, with little understanding of what is done elsewhere and little capacity to adapt their recommendations to the circumstances of countries with different traditions and circumstances.

132. International organizations are particularly well-placed to lead with this type of analysis. Indeed, it is they – and particularly the OECD – who have been responsible for most of the practical comparative work focused on the optimal design of budgeting instruments and structures which has been carried out to date. However, a great deal more needs to be done. Moreover, the international organizations cannot do the job alone. They face, for example, the constraint of diplomatic nicety when conducting analysis of the national budgeting systems. The potential contribution of academics and other independent analysts, who do not face this constraint, is invaluable.

**Box 6: Statistical Analysis of the Efficacy of Budget Instruments and Structures?**

In working to develop a stronger theory of effective budgetary instruments and structures, there are strong reasons to be suspicious of propositions derived from statistics. Over recent years there has been a proliferation of statistical studies, particularly from some international organizations, claiming to demonstrate the effectiveness of favoured budgetary institutions or processes. Some of these are better than others, but few would pass the test of rigorous review by independent external statisticians or econometricians. These studies are in many cases plagued by some of the most familiar problems of statistical analysis such as omitted variables, inadequate sample size and inability to distinguish correlation from causation. The budgetary institutions or processes the merits of which they purport to test tend to be poorly defined (in some cases to the extent that any country which claims to have a particular budgetary process in place is taken at its word and included within the sample tested). Remarkably crude proxies are frequently used for dependent variables which are intrinsically very difficult to measure (such as allocative efficiency). But even when based on reasonably sound methodology, these types of studies are unable to say much about the key design choices which interest practitioners, because in complex systems it is impossible to isolate the impact of one specific design choices from that of others – e.g. to provide answers to the question of whether, and under what circumstances, it is better to base medium-term frameworks on fixed or indicative expenditure ceilings. At best, all these types of studies can say with any degree of plausibility is that having a substantial set of “good practices” tends to produce better fiscal outcomes (e.g. Dabla-Norris et al, 2010). Although statistical analysis has some role to play, it needs to be recognized that the design of budget instruments and structures is not a field which lends itself to the extensive application of this approach.

## 6. IMPLICATIONS FOR FUTURE REFORMS

133. There is much work to be done to reconfigure the budget reform agenda to make it more relevant to the post-GFC era. To reinforce aggregate fiscal discipline, more attention needs to be paid to the manner in which aggregate fiscal targets and rules interact with bottom-up expenditure dynamics and budget preparation processes. As part of this, key design features of aggregate expenditure ceilings – such as the coverage of expenditure ceilings, the size and role of budget reserves – need much closer examination so as to ensure that they achieve their intended disciplinary effect without making it more difficult to improve allocative efficiency. More attention is also required to means of strengthening the link between longer-term fiscal consolidation requirements and annual and medium-term budgeting processes.

134. The development of instruments and structures for expenditure reallocation – including, but not limited to, spending review – is also a key priority for the coming years. With respect to VFM, the main issue is to determine concrete ways of ensuring that performance information is taken into account during budget preparation. This means integrating the review of performance into the budget process, and increasing the budgetary relevance of performance information.

135. In approaching these and other challenges, it may be useful to bear three considerations in mind. The first is the need for a holistic and integrated approach to budgetary reform. The second is the imperative of keeping all reforms firmly grounded in the realities of the public sector. The third is the importance of better matching the demand and supply of information, by tying the supply of additional information tightly to the specific processes which it will support, and to the needs of users.

136. There are at least five requirements for the development a more holistic and integrated approach to budgetary reforms:

- *A wider understanding that most budget reforms which are directed towards advancing one of the three key objectives of budgeting also have consequences for the others.* For example, VFM oriented budgeting reforms may have the unintended consequence of weakening aggregate expenditure control or allocative efficiency. Similarly, reforms intended to strengthen aggregate fiscal discipline may sometimes have the opposite effect of making good expenditure prioritization more difficult. It is therefore inappropriate to develop reforms based on a tunnel vision which focuses exclusively on a single budgetary objective.
- *A rapprochement between the “macro” and “micro” perspectives on budgeting.* Fiscal economists who are focused on the design of aggregate fiscal rules and targets need to develop a better appreciation of the detailed expenditure and revenue dynamics which hands-on budgeters must cope with. Conversely, budget reformers whose primary focus is on the design of detailed budgeting instruments and structures must always keep in mind the overarching imperatives of aggregate fiscal policy.
- *Improved institutional integration within ministries of finance.* For example, a recurrent problem in many OECD countries has been that MOF “performance” departments have little contact with the budgeting department. This is arguably the case in the US, where the management and budgeting sides of the Office of Management and Budgeting tend to operate as silos.
- *Careful avoidance of narrow national perspectives which transform practices which apparently work well in a specific country into supposedly universal “best practice” which should be followed worldwide.* The point here is not only that the design of budgetary instruments and structures should recognize each country’s stage of development. Even between countries with similar levels of institutional and human capacity development, differences in political, legal and institutional structures – together with cultural differences – have important implications for the design of budgeting reforms.

- *The avoidance of narrow professional perspectives on budget reform.* Budgeting is inherently multi-disciplinary. Those who approach it with the explicit or implicit intention of remaining true to a specific discipline – e.g. taking the “accounting perspective” or the “economists’ perspective” – are doomed to miss the big picture, and are likely to recommend reforms which will fail.

137. The need to insist that budgetary reform be approached from a firmly public sector perspective is a constant battle. There is a never-ending supply of snake oil merchants who suggests that the answer to all government’s problems is to remodel government from top to bottom along private sector lines. Countries with the strongest pro-business ideological traditions, such as the United States, are particularly prone to this phenomenon. However, even reformers who do not take such a shallow approach to governance questions have often been too easily seduced by private sector models.

138. There is no doubt that government can learn much – and has learnt much in the past – from good private sector business practice. However, government is fundamentally different from the private sector in ways which have ramifications for all aspects of budgeting and management. Most importantly, government expenditure is always faced with a hard budget constraint which does not apply to the private sector. In the private sector, additional expenditure can always be justified if it will generate additional sales and revenue. The only real constraint is the availability of appropriate equity or debt financing. In government, by contrast, revenue is not a function of sales, and increased expenditure rarely finances itself through additional revenue generated. The fact that government faces a hard budget constraint leads to the second key difference with the private sector – that the allocation of resources is always primarily a matter of planning rather than consumer choice and market processes. Recognizing the desirability of introducing a greater element of consumer choice into public service delivery in no way changes this reality.

139. From these basic facts follows the importance of always maintaining a firmly *whole-of-government* perspective on budgeting and other governance questions. It is inappropriate to propose VFM-oriented reforms based on treating individual ministries as if they are stand-alone corporations. Even an analogy between government and multi-divisional private sector corporations is only useful to a limited extent. Similarly, an exaggerated notion of the role of price signals and financial incentives is dangerous. Government has many flaws, and should always be open to learning lessons from the private sector which can help it deal with the challenges which it faces. But the fact that the public sector is often dysfunctional does not mean that the answer to its problems is the slavish pursuit of private sector models.

140. Finally, there needs to be a more sceptical approach in future to calls for additional information to support budgeting. Repeatedly, in areas ranging from accounting to evaluation, governments have made large investments in the acquisition of additional information which has proven to be much less valuable to decision-makers than had been anticipated. A key reason for this is that those expounding the need for additional information often have only a vague and general idea as to how this information will actually be used by budgeters and other decision-makers. At worst, they simply assume that all additional information provided will in some way be useful. However, the usefulness of information can only be assured if there is a very concrete vision of how it will be used.

141. This means that any proposal to expand the supply information should only be accepted if there is complete clarity about the specific budget processes, and specific budgeting actors, which will use that information. If the effective use of additional information will require changes to budget processes, these changes need to be clearly specified. Only by bearing this firmly in mind will it be possible to avoid the risk of future poor information investments – for example, in additional information to support improved fiscal and performance transparency.

142. The coming years will be particularly challenging for budgeters in OECD countries. Although the main responses to these challenges will need to be found in the areas of expenditure policy and politics, budget reform can play an important supporting role. Strengthening our theoretical and comparative perspectives on budgeting has an important role in helping to map the future directions of budget reform. Being clear about the lessons of the past, and about the changed parameters which face us in the future, is also vital.

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