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**TOP-DOWN BUDGETING  
AS A TOOL FOR CENTRAL RESOURCE MANAGEMENT**

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# Top-down Budgeting

As A Tool For Central Resource Management

December, 2005

KOREA  
INSTITUTE OF  
PUBLIC  
FINANCE

Korea Institute of Public Finance

Organisation for Economic  
Co-operation and Development



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**Korea Institute of Public Finance**

**OECD**



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# **I. Issues in Top-down Budgeting**



## 1. Introduction

Traditionally, budgets have been formulated according to a bottom-up approach. Line ministries submitted their Budget Requests, which were usually in excess of what they realistically expected to obtain in the end, to the Finance Ministry at the early stage of budget process. Based on the Requests, the negotiation between the Finance Ministry and line ministries began and would go through several rounds until they reached an agreement. Following further discussions on resource allocation issues in ministerial meetings, the government finalized its Budget Proposal in the Cabinet Meeting. This system conferred centralized authority for resource allocation on the Finance Ministry, which managed public finance by controlling individual appropriations and budget items of line ministries.

In the early 1990's, most OECD member countries suffered from growing fiscal deficits, which, in some countries, deteriorated into fiscal crises. As an effective response to such fiscal crises, the newly devised top-down budgeting system attracted considerable public attention during that period. In this system, the budget was formulated in a different way from the bottom-up approach. The Finance Ministry set the overall expenditure ceiling based on macro-economic assumptions and the medium-term fiscal management target. Sub-ceilings, such as sectoral expenditure ceilings, were set according to policy priorities. These expenditure ceilings were confirmed in the Cabinet Meeting at an early stage in the budget process. Detailed resource allocation decisions to individual appropriations were then made by line ministries within their expenditure ceilings. In other words, the authority over resource allocation which the Finance Ministry had retained in the bottom-up approach was delegated to line ministries.

A budget system reflects the power structure, history and socio-economic background of a state. As a result, each country's budget process has its own distinctive features. While the Parliament in some countries enjoy a stronger influence on the budget process than that of the Government, it is also true that the Parliament in other countries plays a much smaller role the budget process. Such differences between countries can also be found in top-down budgeting. Even among governments that employ the top-down budgeting system, detailed operation schemes such as the level of delegation and the method of determining the expenditure ceilings vary country by country. Therefore, there is reason to expect that a comparative analysis of top-down budgeting systems as they are run by different countries can identify common features and policy implications that may not be readily apparent from a case study limited to an individual country. For this purpose, OECD held a special session to discuss issues in top-down budgeting

at the OECD headquarters in November of 2005, in which Senior Budget Officials from 8 countries participated, including Australia, Canada, Chile, Denmark, Korea, the Netherlands, Sweden and the United Kingdom.<sup>1</sup> The two-day session consisted of in-depth discussions about each country's experience of the top-down budgeting system, its background as well as operation. The purpose of this report is to derive policy suggestions that will be useful to member countries from the information brought forth at the special session on top-down budgeting and from other reference materials.

That top-down budgeting is the most efficient way of budget formulation is by no means a definite conclusion—the bottom-up approach still enjoys widespread use as the common budget formulation method in many countries. However, governments intending to improve their existing top-down budgeting systems or those who wish to replace their traditional bottom-up systems will find much useful information in this report.

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<sup>1</sup> Additionally, a counsellor in the Japanese Permanent Delegation to the OECD and an OECD Secretariat consultant from Norway related their respective country's experience with the top-down approach.

## 2. Overview of the Top-Down Budgeting Process

### 2.1. Background of Top-Down Budgeting

In the early 1990's, many OECD member countries suffered huge fiscal deficits, brought on by shrinking tax revenues and sustained increases in public expenditures. As Table I.1 shows, the average economic growth rate of OECD member countries was only 1–2% during this period, with some countries (e.g., Sweden) even recording negative growth. The lacklustre economies pulled down tax revenues, which in turn kept growing the fiscal deficits. Policy measures that had been implemented to counter the growing fiscal deficits of the 1980's by controlling public expenditure did not prove effective against the deteriorating fiscal situation.

As the public finances worsened and led countries into or up to the brink of fiscal crises, governments of member countries decided to reform their existing budget formulation systems to achieve efficient management of government debt and fiscal consolidation. Such reforms emphasized tighter control of public expenditures and fundamental principles of fiscal discipline. Top-down budgeting, which had been used as a budget formation approach in some countries like Denmark (since the 1960's) and Canada<sup>2</sup> (1970's), lay at the core of these reforms.

As can be verified from the table below, these reforms of budget formulation systems coincided with the period of increasing fiscal deficits. Canada introduced its EMS (Expenditure Management System) in 1994, Sweden adopted top-down budgeting in 1996, the Netherlands implemented prudent economic assumptions in 1994, the U.K. began enforcing her two fiscal rules<sup>3</sup> in 1997, and Chile established a structural fiscal surplus target in 2000.

The top-down budgeting system as a fiscal management reform initiative allows the government to manage fiscal deficits more efficiently than the bottom-up budgeting system. In the top-down system, the first priority of the Finance Ministry lies in setting the fiscal management target for fiscal sustainability and ensuring compliance with this target, in contrast to the emphasis on allocating financial resources to individual appropriations in the bottom-up system. Once the fiscal target is confirmed in the Cabinet

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<sup>2</sup> The Royal Commission on Financial Management and Accountability (Lambert Commission) enforced the principle of top-down budgeting. It had evolved several times, and in 1994 transformed to EMS(Expenditure Management System) which put a strict control on public expenditure.

<sup>3</sup> They are the well-known 'Golden Rule' and 'Sustainable Investment Rule'.

Meeting at the early phase, it becomes a rule that is binding upon every cabinet member during the budget process, and defended vigorously by the Budget Office staff. With the fiscal management target enforced as a rule and backed by an influential Budget Office, the government is able to regulate public expenditure and thereby control the fiscal balance efficiently.

**Table I.1. General Government Fiscal Balance (as a percentage of GDP) and Real GDP**

(%)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
<b>• Fiscal Balance</b>										
Australia	-3.8	-6.0	-5.6	-4.6	-3.7	-2.2	-0.5	0.6	1.6	0.1
Canada	-8.3	-9.1	-8.7	-6.7	-5.3	-2.8	0.2	0.5	1.6	3.2
Chile	1.4	2.1	1.8	1.6	2.4	2.1	1.8	0.4	-1.4	0.1
Denmark	-2.4	-2.2	-2.9	-2.4	-2.3	-1.0	0.4	1.1	3.2	2.5
Korea	1.8	1.4	2.5	3.1	4.2	3.8	3.6	1.9	3.1	6.9
Netherlands	-3.2	-4.4	-3.6	-4.2	-4.2	-1.8	-1.1	-0.8	0.4	2.2
Sweden	-2.0	-7.8	-11.4	-10.8	-7.7	-3.1	-1.6	2.1	1.3	3.7
United Kingdom	-3.1	-6.4	-7.9	-6.7	-5.8	-4.4	-2.2	0.4	1.1	1.6
OECD	-3.7	-4.6	-5.0	-4.2	-3.9	-3.2	-1.8	-1.4	-0.9	0.0
<b>• Real GDP Growth (%)</b>										
Australia	-0.7	2.3	3.9	4.7	3.9	4.1	3.7	5.4	4.3	3.3
Canada	-2.1	0.9	2.4	4.7	2.8	1.6	4.3	3.9	5.1	4.4
Chile	8.0	12.3	7.0	5.7	10.6	7.4	7.4	3.9	-1.1	5.4
Denmark	1.1	0.6	0.0	5.5	2.8	2.5	3.0	2.5	2.3	3.0
Korea	9.2	5.4	5.5	8.3	8.9	6.8	5.0	-6.7	10.9	9.3
Netherlands	2.4	1.5	0.7	2.9	3.0	3.0	3.8	4.3	4.0	3.5
Sweden	-1.1	-1.3	-2.0	4.0	4.2	1.3	2.6	3.7	4.3	4.4
United Kingdom	-1.4	0.2	2.3	4.4	2.9	2.8	3.3	3.1	2.9	3.9
OECD	1.2	2.1	1.4	3.2	2.5	3.0	3.5	2.7	3.1	3.9

Source : OECD

In Sweden, for example, the government decided to introduce top-down budgeting in 1995 after it had undergone a series of huge fiscal deficits in the early 1990's, which reached up to 11.4% of GDP in 1993. With tight control over public expenditure followed by the introduction of a top-down budgeting system, Sweden was able to overcome her fiscal deficits to record a surplus in 1998 for the first time since 1990.

### ***Box 1. Introduction of Top-down Budgeting in Sweden***

In the first half of the 1990's Swedish public finances faced serious deterioration and the deficit peaked at 11.4% of GDP in 1993. At the same time, greater attention was drawn to the relationship between the institutional structure of the budget process and the outcomes of public finance. In early December of 1995, the Minister of Finance presented the intended reform plan of the budget process to Parliament. The plan consisted of two phases with the objective of restoring fiscal soundness.

The first phase consisted of taking concrete actions to reduce public expenditure and increase revenue to bring down the fiscal deficit to around 7% of GDP. The second phase consisted of institutional changes that would prevent a recurrence of similar budgetary problems. The core feature of the new system in the second-phase changes was a medium term expenditure ceiling and top-down budgeting, which still continue today. A reference was made to the expenditure ceiling and the surplus target in the annual government address presented to Parliament. The general assessment of top-down budgeting by the Swedish government is that it has served well for achieving fiscal soundness.

Secondly, the top-down budgeting system helps to reduce inefficient budget formulation practices that can usually be found in a bottom-up system. While top-down budgeting generally delegates the authority for allocating financial resources among individual appropriations to line ministries, the bottom-up approach is a centralized system in which the authority for resource allocation remains vested primarily in the Finance Ministry. Budget formulation in the bottom-up budgeting system begins when all agencies and ministries send their requests for funding to the Finance Ministry. These requests typically far exceed what the agencies or ministries realistically expect to get. Starting from these requests, the Finance Ministry and line ministries will go through iterative rounds of negotiation until some common point is found. This is time-consuming and essentially a game between the Finance Ministry and other line ministries. Therefore, there is no system for re-allocation of resources within line ministries.

In contrast, in the top-down budgeting system, the Finance Ministry is able to concentrate on setting the expenditure ceilings and controlling additional requests by setting rules, while line ministries are able to devote themselves to allocating financial resources efficiently to individual programs within their assigned spending ceilings. The roles between the Finance Ministry and line ministries are clearly differentiated. The Finance Ministry does not need to intervene in detailed resource allocations made by line ministries if they conduct it in line with the rules. Line ministries can make the best use of their expertise in allocating

financial resources to their various programs in order to achieve their policy objectives. Therefore, the budget process will not only be less time-consuming, but the secondary allocation within each line ministry can now take place because this system creates ownership in line ministries for the actions they take. For example, the Korean government introduced top-down budgeting in 2004 in place of the bottom-up approach which had been maintained for more than 50 years. In the bottom-up budgeting system, line ministries used to submit budget requests that were typically about 30% over the previous year's budget to the Ministry of Budget & Planning. However, starting from the 2005 budget, the practice of excessive requests has been drastically reduced with the introduction of the top-down budgeting system. The increase rate of budget requests by line ministries for the general account dropped significantly from 30.8% in the budget of 2004 to 11.7% in that of 2005, and 7.0% in 2006. Moreover, autonomous re-structuring of spending by line ministries increased sharply as shown in Table I.2 below.

**Table I.2. Comparison of FY2004 and FY2005 Budget Requests in Korea**

		'04 Budget	'05 Budget	Changes
<b>Re-Structuring of Multi-year Programs</b>	Programs	308	416	134
	Amount (trillion won)	-1.6	-2.7	-1.1
<b>Introduction of New Initiatives</b>	Programs	351	459	108
	Amount (trillion won)	1.5	3.0	1.5

Source : Ministry of Planning & Budget , Korea

Thirdly, the top-down budgeting system makes it easier to have the budget aligned appropriately with policy priorities. In the bottom-up budgeting system, the Finance Ministry reviews individual programs based on the requests from line ministries and agencies, and financial resources are allocated to individual programs according to the result of program reviews. The aggregate and sectoral expenditure limits emerge at the latter stage of budget process as the sum of all individual appropriations.<sup>4</sup> Therefore, it turns out to be very difficult in the course of budget formulation to allocate resources among the different policy sectors in accordance with the policy priorities. In contrast, the top-down budgeting system makes it possible to have policy priorities included as a key factor to consider in allocative decisions from the very first stage of budget formulation. If the government wants to put high priority on a certain sector, say social

<sup>4</sup> In theory, this is the nature of the final budget under the bottom-up approach. However, in practice the provisional aggregate expenditure target is determined to an approximate level by the Finance Ministry at the early stage of budget process, taking into account the economic forecast and the fiscal situation.

security, and low priority on another sector, say national defense, it can achieve the priority objectives easily just by allocating more financial resources to the social security sector and less to the defense sector. In conclusion, the move toward top-down budgeting among OECD member countries began as fiscal reforms for overcoming the fiscal crises in the early 1990's. The primary motivation for these reforms was to promote economic growth through more disciplined, sustainable public finances. It was believed that these goals could be accomplished through the delegation of authority in budgeting for lower-level decisions, while enforcing strict limits at the aggregate levels. In addition, it was believed that top-down budgeting could better reflect political priorities in resource allocation. The general assessment of the top-down budgeting system as a tool for achieving fiscal consolidation has been positive so far.

## **2.2. Relationship with Bottom-up Approach**

What is the relationship between top-down budgeting and the bottom-up approach: are they incompatible systems that can only replace one another or are they more or less complementary systems that can work together? It appears that, to a great extent, the two systems are mutual complements. In Table I.3, the budgeting systems of 8 countries participating in the SBO special session on top-down budgeting were reviewed to see which approach is used for setting the overall ceiling and sectoral ceilings, and whether these countries conduct individual program reviews, which is the distinction of a bottom-up approach. As shown in the table, most countries employ both methods in budget formulation. The overall expenditure ceiling is set through a top-down approach that takes into consideration various economic assumptions and the fiscal target. It is reported that even governments with typical bottom-up systems tend to set their aggregate expenditure limits via a top-down approach in order to control public expenditure. The actual method of setting sectoral ceilings and sub-ceilings differs from country to country, but the majority of cases consist of some mix of the two approaches. Program reviews are used in all of 8 countries studied. Even Sweden, known for its strict adherence to the top-down philosophy, conducts program reviews to monitor program performance.

It appears that a top-down budgeting system necessarily has to incorporate elements of the bottom-up approach as a complementary method in the budget process because of the following reasons. First, funding decisions for new policy initiatives should be determined through a program-based review, since the Finance Ministry will often lack information on data pertinent to judging the fiscal implications of the proposed initiatives, such as performance data and total program cost projections over the long term. Therefore, line ministries are usually required to submit detailed proposals to the Finance Ministry, which

are then reviewed by the Finance Ministry or a Cabinet Committee<sup>5</sup> composed of several ministers, after which a final decision is made by the Prime Minister or the President.

**Table I.3. Approaches to Determining Expenditure Ceilings**

	Top-Down Approach		Bottom-Up Approach		
	Overall Ceiling	Sectoral Ceiling	Overall Ceiling	Sectoral Ceiling	Program Review
Sweden	○	○	-	-	△
Netherlands	○	○	-	△	○
United Kingdom	○	○	-	△	○
Denmark	○	○	-	△	○
Korea	○	○	-	△	○
Canada	○	-	-	○	○
Australia	○	-	-	○	○
Chile	○	-	-	○	○

○ : actively used, △ : used as reference, - : not used

Secondly, individual programs need to be reviewed in order for the Finance Ministry to monitor whether they are consistent with the fiscal rules. This process, however, runs the risk of serious protests by line ministries, who may view the monitoring as inappropriate intervention by the Finance Ministry in their internal resource allocation decisions. Monitoring or intervening? In the top-down system, this is a delicate question to which the Finance Ministry needs to find a solution. The answer lies partly in the Finance Ministry ensuring that its staff should acquire greater expertise in analytical capacity and program review techniques. Additionally, greater care must be taken to maintain good working relationships with line ministries than in a bottom-up system. Despite these additional burdens, in order for the Finance Ministry to accomplish its most important mission in the top-down budgeting environment, which is to uphold the fiscal rules, it needs to proactively embrace certain bottom-up methods, including program reviews.

<sup>5</sup> Australia and Canada have such Cabinet Committees review new policy initiatives.

### **Box 2. Comparison of Bottom-up with Top-down**

#### **• Bottom-up**

- Ministry by ministry analysis that largely ignores economic forecasts
- Annual
- Time consuming
- Ownership of proposals is more agency-specific
- Reactive

#### **• Top-down**

- Aggregate fiscal analysis that takes into account economic forecasts
- Multi-year
- Delegated authority
- Creates joint ownership of proposals
  
- Proactive

## **2.3. Medium-Term Budget Frameworks**

The top-down budgeting system cannot work as expected without an effective medium-term budget framework (MTBF). Most countries that employ the top-down budgeting system have also adopted medium-term budget frameworks, which facilitate fiscal consolidation. In an MTBF, the government must first state its major policy objectives clearly. These will be the medium-term fiscal objectives which are prioritised where appropriate, including levels of the aggregate expenditure and revenue, the fiscal target, and policy priorities among and within spending categories. This statement of objectives is necessary because of the key role they play in fiscal management and because fiscal objectives that reflect economic forecasts and policy directions over the medium term has greater credibility than those based on an annual framework. Once the MTBF objectives are set, these high-level targets are operationalised by establishing hard budget constraints for individual ministries and programs over a span of multiple years. This helps to strengthen stability as well as the credibility of the government's fiscal objectives.

The MTBF is also a system that is effective at redressing the problems stemming from the short time-limit of the annual budget process. The budget in most countries is formulated annually because a democracy needs a process in which the parliament authorizes any government spending periodically, most commonly every year. The short time-limit inherent in the democratic process of budgeting has several drawbacks. The most frequently cited criticisms are that fiscal policy is likely to be myopic; which undermines economic stability in the medium-term and results in ad hoc allocation of resources. Introducing an MTBF that properly reflects medium-term forecasts of the macroeconomic variables often alleviates such problems stemming from annual budget formulation.

The MTBF cycle can either be rolling or periodical. Rolling frameworks are drawn up during budget preparation every year or every two years.<sup>6</sup> Year 1 in the previous year’s framework becomes the basis for the budget and a new year 3 is added (in case of three-year frameworks). Thus an MTBF cycle in a rolling framework will necessarily overlap with the previous and subsequent cycles by one or two years by design. In contrast, a periodical framework has cycles that run in sequence one after another. Specifically, a periodical MTBF is drawn up at the beginning of the period to which it applies and stays effective until that period has lapsed. Both rolling and periodical frameworks may be revised in the middle of their lifetime.

The period, or time span, of an MTBF may run for two, three, four, or five years, including the upcoming fiscal year. The most commonly used period is three years, as shown in Table I.4.

**Table I.4. Period of MTBF**

<b>Two years</b>	<b>Three years</b>	<b>Four years</b>	<b>More than Four years</b>
Italy	France	Australia	Canada (5)
United Kingdom	Germany	Netherlands	Denmark (Denmark2010)
	Spain	United States	Korea (5)
	Sweden		
	Chile <sup>7</sup>		

Source: OECD

Even though MTBF has spread to many countries as a major instrument for fiscal management, it is reported to contain several significant problems. The OECD summarised the problems into three typical types in a 2002 report as follows:

- (1) There was a tendency to overestimate the growth potential of the economy when making the multi-year budget forecast. This made excessive resources available in the forecast period and created an upward pressure on public expenditure.
- (2) Ministries and departments viewed their resource allocations in the forecast period as an entitlement. This made subsequent downward revisions in expenditures difficult, even when it became clear that the basis on which the allocations were made was not correct.

<sup>6</sup> The United Kingdom revises its mid-term budget frameworks every two years.

<sup>7</sup> In 2000, the Finance Ministry in Chile started maintaining baseline projections of government revenue and expenditures for the next three years. However, this is an internal document of the Finance Ministry and is only released to the public at a very aggregate level. The document is not used as a tool for resource allocation. The Finance Ministry uses it to evaluate the overall trend in public revenue and expenditure.

- (3) The multi-year budget forecasts were made in real terms rather than in nominal terms. In the 1970's, when economic growth subsided and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically for increases in prices while revenue suffered.

The third problem is quite simple in that the solution only requires a change from real to nominal terms, and MTBF are now invariably made in nominal terms. In order to overcome the first and second problems, 'prudent' economic assumptions are essential to avoid having excessive resources made available. This will be discussed in chapter 3.

### ***Box 3. MTBF in the U.K. and Denmark***

The U.K., a pioneer of multi-year budget frameworks, has run a distinctive MTBF for effective fiscal management. It introduced the Comprehensive Spending Review (CSR) in 1998, which estimated the subsequent three years' expenditures and revenues. In the CSR, all expenditure items are classified into either the Departmental Expenditure Limits (DELs) or the Annually Managed Expenditures (AMEs).

AMEs generally include programs such as social security benefits and debt interest payments that are subject to volatilities, making them difficult to budget sensibly for over a three-year time frame. AMEs represent half of the total expenditure. On the other hand, DELs include discretionary spending for both the current and capital accounts. Complying with the overall spending totals set to meet the fiscal rules, the U.K. government sets out limitations so that DELs are guaranteed their level of funding for three years rather than just one. This may give public services the stability to plan their operations on a sensible timetable. The third-year spending of DELs is revised and rolled over to the next Spending Review, as the Spending Review is revised every two years. In other words, the British system can be taken practically as the biennial budget, which fixes the two-year spending of DELs.

Denmark has a widely supported medium-term economic and fiscal program called 'Denmark 2010', which aims to foster fiscal prudence in preparation for the onset of major demographic changes. The Denmark 2010 program is the anchor for budgetary policy which applies to all levels of government, not just the central level. It enjoys broad political support in Denmark and has been upheld by successive governments. The overall objective of the program is to ensure that fiscal policy is sustainable in the long term. In essence, this means running budget surpluses until 2010 in order to reduce the amount of the debt and the associated cost of borrowing. According to projections, sustainability requires an average government surplus of 1.5–2.52% of GDP until 2010.



## 3. Determining Expenditure Ceilings

### 3.1. Economic Assumptions

A cautious macro-economic forecast is a key requirement for achieving fiscal consolidation. Even should the government adopt both top-down budgeting and MTBF in response to an increasing fiscal deficit, the effort for fiscal consolidation can be undermined by an overall expenditure ceiling grounded in an optimistic economic forecast. Moreover, if the actual economic performance should deviate beyond a reasonably allowable range from the economic assumptions underlying the MTBF's expenditure limit and revenue forecasts, the government's fiscal policy will suffer a drastic drop in credibility. In this vein, governments need to bear in mind that an MTBF by its nature is susceptible to the incentive to overestimate potential economic growth, as discussed in the former chapter. Given that an economic forecast with an 100% accuracy is impossible, deliberately erring on the side of caution rather than optimism in making forecasts helps to guard against the problems of overestimating in an MTBF and thereby improve fiscal soundness.

Cautious economic assumptions also enable the government to occasionally gain 'windfalls', which can be used according to its policy priorities. Thanks to the built-in caution, the economy is more likely to operate better than the economic assumptions. As a result, the government can benefit from some unexpected surpluses, or windfalls.

The tone of economic forecasts, whether they are prudent or optimistic, may be influenced to a great degree by the matter of who does the forecasting<sup>8</sup>. Therefore, the government may need to push for institutional reforms to ensure that the use of cautious assumptions is built into the forecasting process. Properly devised, such institutionalised features can act as safeguards against arbitrary assumptions of the person in charge of forecasting. One method adopted by most countries is sensitivity analysis, which is a technical approach for examining the impact that variations in the key economic assumptions would have on the budget. Additionally, some countries have introduced a new institutional feature in which the initial aggregate targets in the budget process are based on independent, private-sector economic forecasts. Further along this direction, there are cases where an independent body has been appointed for recommending the economic assumptions to be used in the budget formulation. The following describes three cases of institutional reform for cautious economic assumptions.

Canada is an example where the private sector's economic forecast is used in the budget process. Before the introduction of this practice, the perception that 'optimistic' economic assumptions were used in the budget had significantly downgraded the credibility of government-generated economic forecasts. Rather than relying on internally generated economic projections for use in budgeting, the government now begins with the average of forecasts made by private sector economic forecasters. The Department of Finance gathers economic forecasts from about 20 private research organizations and convenes an economic advisory group consisting of the central bank and four major research organizations, in which an agreement on economic assumptions for next 5 years is reached. This is done in order to ensure credibility. On top of this, the Department of Finance systematically revises the private sector forecasts downward as a further measure of prudence. This takes the form of the government adding 50–100 basis points (0.5–1.0 percentage points) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower projections of economic activity. This provides a buffer for safeguarding the government's fiscal objectives.

The Netherlands and Chile are cases where an independent body was established for politically neutral and prudent economic forecasts. In the Netherlands, economic forecasts are made by the Central Planning Bureau (CPB), which is a government institution but is nevertheless completely independent. Charged with responsibility not only for economic forecasts but also for economic policy analysis, the CPB's macroeconomic forecast serves as basis for budget forecast. As the CPB enjoys the confidence of all political parties and the public at large, the CPB economic forecasts are taken as given. The CPB produces two economic scenarios; the first one gives the most likely economic growth rate, while the second one is a cautious growth rate for use in budgetary policy. The political parties have agreed that the cautious scenario would be used because they would rather be faced with 'good surprises' than with 'bad' surprises. Windfalls resulting from the cautious scenario have been used for both deficit reduction and expenditure increases.

In Chile, there is institution called the 'output gap' panel which independently produces the macroeconomic forecasts for budgeting.<sup>9</sup> The panel consists of 14 economists appointed by the Minister of Finance. The members of 'output gap' panel are most often well-known economists from academia and

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<sup>8</sup> Sometimes the economic forecast is affected by political pressure, which is also a matter of person who has the power.

<sup>9</sup> There is another institution called the 'copper price' panel, as Chile's fiscal finances are heavily dependent on the volatile price of copper, which accounts for 4% of total government revenue. The panel consists of 14 persons appointed by the Minister of Finance from mining companies and related enterprises. This committee estimates the average long-term price for copper as the reference price. The method of determining the price is identical to that used by the 'output gap' panel.

research organizations, split between economists identified with the opposition and with the ruling political parties. At the first meeting, the panel discusses methodological aspects of the model used. At the second meeting, each member of the panel submits a forecast for the various inputs that go into the model. All of the 14 estimates are published anonymously so that each forecaster can verify his/her own figures. The two extremes on either end are discarded and then a simple average of the remaining 12 forecasts is used.

## 3.2. Composition of Expenditure Ceilings

### 3.2.1. Overall Expenditure Ceiling

After the economic assumptions for budgeting are made by Ministry of Finance or independent bodies, the government begins the process of formulating the coming year's budget by setting the overall expenditure ceiling.<sup>10</sup> This is a very important phase in budget formulation under the top-down approach, as it sets the overall policy tone for fiscal consolidation and fiscal discipline. In its decision as to the appropriate level of the overall expenditure ceiling, the government will take into account both the economic forecasts and the fiscal target. Once these two factors have been determined, then it becomes a matter of relatively simple calculation to derive the overall expenditure ceiling.

Of the two key determinants of the overall ceiling, economic forecasts are more or less a technical exercise involving analytical tools from macro-economics and econometrics. The other key factor, the fiscal target, in contrast primarily reflects the government's will as to how rapidly it wants to achieve fiscal consolidation. If the government's agenda calls for a rapid reversal of a fiscal deficit, it will impose a tight balance target, and vice versa. In practice, many member-country governments in the early 1990's emphasized tight control on public expenditure. This was possible because the fiscal target, usually expressed as the percentage of the fiscal deficit relative to GDP, was accorded the highest priority in achieving fiscal discipline after having run large consecutive fiscal deficits in the previous years. For example, in Sweden, strict fiscal discipline reduced the fiscal deficit from 11% of GDP in 1993 to 7% in 1995. In Canada, the target was to lower the deficit to 3% of GDP by fiscal year 1996–1997.

However, as the fiscal situation improved enough to realise fiscal surpluses by the late 1990's, there has been a tendency to slacken fiscal discipline since 2000. In Sweden, during 1997–1999 the overall

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<sup>10</sup> If the government takes the fixed MTBF, the coming year's expenditure ceiling will already have been determined when the MTBF covering that year is confirmed. Under the flexible framework, it will be adjusted according to the economic situation. Details will be discussed in chapter 3.

expenditure ceiling was enforced as an instrument for reducing public expenditure, while since 2000 its purpose has been to maintain a more or less constant ratio of expenditure to GDP. In Canada, tight control was exercised over expenditures by imposing two-year ceilings from 1994 to 2004; this was loosened to five-year ceilings in 2005.

The overall expenditure ceiling is seldom legislated, but submitted to the parliament together with, or as part of, the budget proposal. Even strong measures for fiscal discipline such as Chile's 'structural budget surplus of 1% of GDP' are not formally legislated, but are rather understood to be the political commitment of the government.

#### ***Box 4. Legislation of spending limit***

In 1991, the Canadian government legislated a spending limit in 'the Spending Control Act' for the period of 1991/1992 to 1995/1996. The limit was based on the total spending target announced in February 1991 period for the next five years. Excluded from the limits were public debt charges, programs that were financed through 'dedicated' revenues/charges, and expenditures related to events that occurred prior to 1991. As this was a five-year program, under-spending in one year could be carried forward to offset over-spending in some future year. If the aggregate spending limit was exceeded after the five-year period, the Government had to indicate in the following budget how it intended to make up any shortfall. Over the 1991/1992 to 1995/1996 period, the limit was not exceeded and the Act was not extended subsequently.

#### ***Box 5. Recent fiscal disciplines on aggregate expenditure of major countries***

- Sweden: Structural fiscal surplus of 2% of GDP.  
(Overall expenditure ceiling: 4% of GDP)
- Denmark: Fiscal surplus of 1.5–2.5% of GDP.
- Chile: Structural budget surplus of 1% of GDP.
- United Kingdom
  - Golden rule: balance current budget over economic cycle.
  - Sustainable investment rule: keep net debt at sustainable level (40% of GDP).
- Canada: Balanced budget or better.

### 3.2.2. Sub-Ceilings

After the overall expenditure ceiling has been set, the next step in top-down budgeting is to determine the sub-ceilings. The sub-ceiling is the smallest unit of resource allocation that can be determined by the Finance Ministry in the top-down budgeting system. Resource allocation below the sub-ceiling level, such as for individual appropriations, is done by line ministries. This dichotomy of responsibilities allows the Finance Ministry to have resource allocation among sub-ceilings determined solely in consideration of the government's policy priorities and efficiency of implementation, free from pressures from line ministries.

The management of sub-ceilings differs somewhat among countries. In Sweden, there are only the overall and 27 sectoral expenditure ceilings, with hardly any restrictions among wages, transfers, and investments within sectoral ceilings.<sup>11</sup> In Denmark and the U.K., operating expenditures are subject to a separate ceiling from capital investment and transfers. In Canada, the current expenditure ceiling applies only to the aggregate level. However, since entitlement expenditure programs have largely been exempt from any ceiling in recent years, the ceiling principally relates to non-entitlement spending.

#### *Sectoral ceilings*

Sectoral ceilings are the expenditure limits for major policy areas, examples of which would typically include agriculture, social security, national defense, etc. They are therefore determined by allocating resources out of the overall expenditure ceiling to each of these policy areas according to the government's policy priorities. This top-down decision-making on sectoral ceilings is supplemented by bottom-up measures such as program reviews.<sup>12</sup> By reviewing individual programs, the Finance Ministry can reduce the decision-making errors that may result from inadequate information, which is a consequence of delegating some budgetary decisions to line ministries.

Of utmost importance in taking decisions on sectoral ceilings is that they should not affect the overall expenditure ceiling, which is already determined. Having the sectoral ceilings set within the overall expenditure ceiling, without any possibility of allowing them to push up the latter, is a fundamental requirement for top-down budgeting to function successfully. Moreover, in some countries, the Finance Ministry requires that line ministries propose savings that can be used to finance reforms when they submit

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<sup>11</sup> However, the Ministry of Finance monitors individual programs to verify that they conform to the fiscal rules.

<sup>12</sup> Exceptionally, Sweden does not use program review for setting sub-ceilings, but only for monitoring.

their budget requests. This requires a system that is designed to give line ministries adequate motivation for such savings, which can absorb additional expenditures generated by policy reforms in a budgetary sector.

The sectoral ceiling usually overlaps with a ministerial ceiling because each ministry covers a major policy area, for example, the Ministry of Defense is in charge of the national defense policy area. In some countries like Korea, two or three ministries cover one policy area in common, requiring a more detailed sub-hierarchy of sub-ceilings. In contrast, the Netherlands has only 3 sectoral ceilings, among which the ‘core’ sector is the joint responsibility of several ministers.

***Box 6. Canada’s expenditure setting procedure***

Each fall, departments and agencies submit their requests to the Treasury Board, seeking approval of their budgets through the Annual Reference Level Update (ARLU) process. This is primarily a technical exercise that updates departmental funding levels for the next fiscal year as well as the two years after that. The ARLU process is not generally a mechanism for departments to seek new funding approvals but rather an exercise that recognizes incremental approvals given since the previous year. These incremental approvals primarily relate to new policy initiatives announced in the previous budget.

The Treasury Board Secretariat reviews the individual departmental submissions and makes recommendations to the Treasury Board. They then compile the approvals and submit them to the Department of Finance. If the totals fit within the overall expenditure ceiling provided, no further action is taken. If they exceed the ceiling, reduction would be required.

The major adjustments to the expenditure ceilings result from the introduction of new policy initiatives or enhancements to existing programs. In some years, incremental adjustments have been made to the departmental reference levels based on assessments by the Treasury Board Secretariat on health and safety issues. In all cases, since 1994/1995, these adjustments have been accommodated without jeopardizing the annual budgetary balance target.

### ***Box 7. Sectoral ceilings in the Netherlands***

In the Netherlands, there are three sub-ceilings: the core sector, social security sector and health care sector. The separation of the latter two sectors from the ‘core’ sector is in part due to the fact that they have their own dedicated financing sources. The latter two sectors are each the responsibility of a single minister, respectively. The core sector, however, is the responsibility of a number of ministers. In principle, shifting money between each sector is prohibited. In practice, however, shifting money happens often. For example, the social security sector is currently in strong surplus due to a more favourable economic situation than assumed. This surplus is being used to finance additional expenditures in other sectors, mainly the health care sector. Surpluses in one area, however, can only be used to fund existing policies that are experiencing higher costs than projected.

### ***Operational & capital ceilings***

Operational expenditure and capital expenditure are designated as separate sub-ceilings in some countries because the Finance Ministry prohibits improper budget transfers from capital investment to operational spending.

In Denmark, the Ministry of Finance establishes the expenditure ceiling for each line ministry, within which the ministry then has the responsibility for final allocation of funds. The expenditure ceiling for each ministry is divided into two parts: a maximum for operating expenditures and a maximum for non-mandatory transfer expenditure. Shifting money from transfers to operating expenditures is not permitted. A sub-ceiling is also set for the wage within the operational expenditure ceiling. Money may be transferred from wages to other expenses, but not from other expenses to wages. Mandatory transfers such as social pensions, unemployment benefits, and capital expenditures are not included in the system of expenditure ceilings.

In the U.K., the government has been setting separate current expenditure and capital expenditure sub-ceilings since 1998 in order to correct a natural bias against capital expenditure and to ensure consistency with fiscal rules. Current expenditure is consistent with ‘Golden rule’ and capital expenditure ‘Sustainable investment rule,’ respectively. Moreover, this prevents the tendency to cut capital expenditure, the benefits of which may only be seen in the medium or long term, to fund current pressure.

Regarding operational costs, Sweden has a unique formula-based system. For example, wages (60% of total operational cost) are determined by applying a productivity index to previous spending levels, and accommodation costs (15% of total operational cost), by applying a price index.

### *Number of sub-ceilings*

The number of sub-ceilings also varies by country; Korea has more than 200 sub-ceilings; Sweden, 27; and some other countries, less than 10 sub-ceilings. The reason Korea has so many sub-ceilings compared to other countries is because of the complexity of its budget system. There are 23 separate budget accounts, consisting of 1 general account and 22 special accounts, and an additional 47 public funds, most of which are financed heavily from the general account. With sub-ceilings that are set for 30 spending areas, in each of which the individual budget accounts and public funds must be separately accounted for, such a huge number of spending limits may appear to be unavoidable.

It should be borne in mind, however, that the advantages of top-down budgeting diminish rapidly as the number of sub-ceilings increases. Resource allocation among sectoral ceilings becomes a much more difficult decision politically with a large number of ceilings. Additionally, having the Finance Ministry involved in such detailed decisions deprives the line ministries of the opportunity to utilise their expertise in their respective areas to make allocative decisions within their individual ceilings, which is one of the key rationales for top-down budgeting. Therefore, it is advisable to keep the number of sub-ceilings small, optimally around 30 as a rule of thumb.

### **3.2.3. Budget Margins**

The budget margin functions as a buffer against increases in expenditure ceiling arising from economic forecast errors or unpredictable events. Once the overall expenditure ceiling has been confirmed, the government is better off spending money within that limit because frequent changes in the ceiling can hurt its credibility as well as impair fiscal soundness. Therefore, most countries designate some portion of financial resources of the overall expenditure ceiling as a budget margin, which acts as a buffer to be used for unforeseen situations.

A different kind of policy buffer for fiscal soundness is prudent economic assumptions, which was discussed in the former chapter. Therefore, even when a large amount of money is required to compensate

for a forecast error or a natural disaster, the government can finance them without increasing the overall expenditure ceiling by utilising the budget margin and realized windfalls from prudent economic assumptions. The following illustrate how budget margins operate in each country.

In Canada, a budget margin called ‘contingency reserve fund’ exists officially. The government allocates 2.5 billion–3.0 billion Canadian dollars each year to this fund, which can only be used to compensate for forecasting errors and unpredictable events. It cannot be used for any new policy initiatives. This fund is held centrally, its use to be determined at the discretion of the Prime Minister and Minister of Finance. Recourse has never had to be made to the contingency reserve funds and they have been applied to deficit reduction in their entirety in each year. However, in recent years, the government enacted the ‘Unanticipated Surplus Act’ as the accumulated fiscal surplus increased, by which the fiscal surplus is allowed to be used for expenditure increment.

In Sweden, there is a budget margin that is approximately 2% of the total expenditure.<sup>13</sup> It also exists officially, requiring approval by parliament, and can be used only to offset expenses attributable to economic forecasting errors. Besides the margin, some ministries hold their own contingency reserves as a separate appropriation in preparation for emergencies such as fires and damages from natural disasters. If a huge natural disaster occurs and the government cannot cover the emergency expense with the contingency reserve, the extra spending is covered by reallocation within the existing expenditure ceilings and tax reductions. The reallocations between expenditure areas and appropriations in the budget are submitted to Parliament in a supplementary budget, which has been regularly approved twice a year.

The U.K. also has a small centrally held DEL (Departmental Expenditure Limit) reserve. It is available only for genuinely unforeseeable contingencies which departments cannot be expected to manage within their DEL.<sup>14</sup> For AMEs (Annually Managed Expenditures), cautious estimates and an AME reserve are built in when forecasting AMEs in order to reduce the risk of overspending on AMEs. In Chile and Korea, there is a central contingency fund of around 2% of the overall expenditure ceiling, which is available for unpredictable events.

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<sup>13</sup> Budget margin = Overall expenditure ceiling – Sum of 27 sectoral expenditure ceilings.

<sup>14</sup> Expenditures for the war against Iraq came out of the DEL reserve, not from the defense sector DEL.

### 3.2.4. Entitlements & Discretionary Programs

In general, discretionary programs are included in the expenditure ceiling. However, this is not always the case for entitlement programs and interest payments on national debt. Including entitlement programs in the expenditure ceiling may tempt ministries to reallocate in favour of these programs, especially when there is a need to find room for large, additional requirements that follow institutional reforms of entitlements. Several countries exclude interest payments from the expenditure ceiling, out of concern that foreign investors, who may regard the inclusion of interest payments in the expenditure ceiling as an intention to restrict interest payments, may demand a higher interest rate.

In Sweden, entitlement programs are naturally included in the expenditure ceiling because the portion of entitlement programs in the overall expenditure ceiling exceeds 60%. On the other hand, interest payments are excluded from the expenditure ceiling. The reasoning behind this arrangement is that the interest rate is beyond the government's control, while entitlement expenditure such as social pension and unemployment allowances can be managed by the government. In Canada, entitlement programs have largely been exempted from the expenditure ceilings. As a result, the expenditure ceiling primarily applies to discretionary programs. As a notable exception, a compensation reserve is set up within the overall expenditure ceiling to manage upcoming negotiated wage and salary increases. In Denmark, mandatory transfer programs and interest payments are excluded from the expenditure ceiling. Chile, the Netherlands,<sup>15</sup> and Korea all include both entitlement programs and interest payments in the expenditure ceiling.

### 3.2.5. Policy Initiatives

Decisions on policy initiatives, in general, are made through a program review process in the cabinet. Since the government in general has less information on policy initiatives than the proposing line ministry, prudence requires that a formal process be in place for reviewing individual programs in order to reduce decision-making errors. The review process begins with line ministries submitting proposals to the Finance Ministry. After an internal process of review, the Finance Ministry brings up the proposals for discussion at the cabinet meeting. The final decisions are usually made by the Prime Minister or the President.

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<sup>15</sup> Recently, the Dutch government has been considering the possibility of excluding interest payments from the expenditure ceiling. This is because the interest rate is forecast to increase in the long term, which poses greater difficulty for the government in controlling the expenditure ceiling.

In some countries, such as Sweden, where the overall expenditure ceiling is fixed over the period of MTBF, funding for new policy initiatives are absorbed within the expenditure ceiling. On the other hand, in most countries, the overall expenditure ceiling is adjusted to finance new policy initiatives at the latter stage of budget process. The decision-making process on policy initiatives varies among countries. A special cabinet committee is composed to review individual policy initiatives in Australia and Canada. In Denmark and the Netherlands, since the coalition agreement at a new government's inauguration sets the political priority for MTBF, the decision-making process simply checks whether new policy initiatives are in line with the existing coalition agreement. Chile provides yet another example, in which it operated a special fund for policy initiatives. The following describes the cases of Canada and Chile.

In Canada, two Cabinet committees, called the 'Economic Union Committee' and the 'Social Union Committee,' take charge of reviewing the policy initiatives. New policy initiatives are presented directly by ministers to the committees, which are held every week during the budget process. The committees discuss the merits of the policy proposals presented by ministers and in the end rank them for possible funding. The two committees may have joint meetings to discuss such proposals. The Treasury Secretariat has also instituted a separate 'Program Integrity' process. This is designed to correct any critical shortfalls in funding of current programs. Late in the year, the Finance Minister and the Prime Minister will decide how much money to allocate for the policy initiatives, taking into account the rankings established by the committees and the results of the Program Integrity process. The Prime Minister and the Finance Minister make the final decisions on resource allocation after consultation with ministers. The expenditure ceiling is adjusted by new policy initiatives which are decided to be funded.

In Chile, the government operated a fund called the 'Bidding Fund'<sup>16</sup> from 2000 to 2004 for new policy initiatives. It was financed by a savings from existing programs that did not pass critical assessment and by the added resources provided by a growing economy. Line ministries submitted the funding requests to the Finance Ministry, which analysed the various bids and drew up a short list of new initiatives to be funded. The Minister of Finance, after a meeting with line ministers to discuss the proposals, reported to the President, who made a final decision. As the government moved closer to the end of its term, the Bidding Fund was discontinued in 2005 in order to concentrate on existing reforms rather than launch new initiatives.

### 3.3. Role of the Prime Minister/President and the Finance Minister

#### 3.3.1. Setting Political Priorities

Setting political priorities is the first step of budget formulation in top-down budgeting. The government is responsible for soliciting the diverse opinions and demands from all levels of society and incorporating them into government policy according to its political priorities. Policy measures thus determined are carried out in order to provide the nation with goods and services of good quality, which is financed by the national budget. Therefore, the government needs to establish its political priorities before the budget formulation process begins. These priorities, in general, are stipulated in the MTBF as high-level objectives of the government. In countries where a minority government has been in power for a long period, a coalition agreement among allied political parties incorporates the political priorities followed during the term of office.

Political priorities in the top-down budgeting system influence the overall expenditure ceiling as well as sectoral expenditure ceilings. Determining the overall expenditure level in the top-down budgeting system is, to some extent, related to the political philosophy subscribed to by the government. This means that the overall ceiling should be determined by the answer to asking what kind of society is the government aiming for in the future. In the end, this is a choice between whether it is aiming for the society with a large public sector, say, with public expenditures over 60% of GDP, or one with a small public sector, say, less than 30%. Such decisions are by nature far beyond the scope of routine decision processes within the administration, and require a social consensus through political channels. In the top-down system, such political decisions should be made prior to any other budgeting procedure. Once that question has been settled, the government needs to decide its fiscal management target. The decision as to whether the government will tighten fiscal control to move quickly from deficit to surplus, or instead take a gradual approach that balances the budget over the long term, is one that should also be made politically. Finally, the government will consider priorities among policy sectors and accordingly allocate financial resources to individual policy sectors.

While the Prime Minister (or the President) and the Cabinet members all participate routinely in various decision-making processes, needless to say the Prime Minister/President and the Finance Minister play the most significant role. The Prime Minister/President, in most countries, makes the final decision on major

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<sup>16</sup> The purpose of introducing Fund was; first, it was designed to counter the incremental nature of the traditional budget process by having line ministries prioritise their requests for funding new initiatives, second, it was designed to improve the technical quality of the funding requests which was often deficient.

fiscal policy issues, often in consultation with the Finance Minister. Therefore, their political leadership and expertise are required for the success of the top-down budgeting system. It is worth emphasising that whether the rules of a top-down system can be successfully upheld often depends more on the capacity and influence of these key players, rather than on specific institutional or legal features.

### 3.3.2. Role of Rule Keeper

Once the government's objectives are confirmed, the Finance Minister bears responsibility for achieving those objectives through efficient use of fiscal policy measures. As the fiscal rule keeper, the Finance Minister has to play a more active role in the top-down budgeting system than in the bottom-up system. One consequence of partially delegating authority in budgeting to line ministries is that the latter may fail to observe fiscal rules, e.g., by submitting a budget request in excess of the approved expenditure ceiling or by effecting a prohibited transfer of expenses between budget accounts or expenditure ceilings. Such actions would seriously impair fiscal consolidation, which is the most important mission of the Finance Minister.

Therefore, the Finance Minister and his staff in most countries make every effort to protect the fiscal rules throughout the budget process. Part of this effort is to review individual programs to verify that they are in line with the fiscal rules. Enforcing the expenditure ceiling requires that they not only deal firmly with a violating ministry, but also try to persuade it. For example, the Finance Minister typically needs to spend a lot of his time in advance with line ministers for discussing issues and persuading them before reaching an agreement on sectoral expenditure ceilings. In the U.K., if there is a disagreement on the DEL (Departmental Expenditure Limit), the Finance Minister acts as a mediator in the Public Service Expenditure Committee (PSX), which he also chairs.<sup>17</sup> Once the expenditure ceiling is confirmed in the Cabinet Meeting, however, the Minister of Finance and his staff will exert themselves to defend it, firmly refusing any further negotiation against violations by line ministries. Similarly in Chile and Sweden, the Ministry of Finance takes a very firm stance on such violations: 'send them back if line ministries submit budget proposals in excess of the allocated ceilings.'<sup>18</sup>

Additionally, in most countries, the Ministry of Finance issues guidelines that help line ministries observe the fiscal rules. In Sweden, the Ministry of Finance lays down the 'financing rule,' which describes what kind of reallocations are allowed or not allowed, e.g., money may not be transferred from an entitlement

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<sup>17</sup> A minister who disagrees with the mediation in PSX can request final mediation by the Prime Minister.

<sup>18</sup> In practice, such violations have never occurred in either country.

appropriation to a discretionary investment appropriation, or new permanent expenditure may not be financed from temporary savings. In Australia, the Department of Finance issues the budget rule, which applies to the entire budget process from beginning to the end and enforces it as a strict guideline.

To perform his duty as rule keeper successfully, the Finance Minister needs the support of the Prime Minister/President. This most often takes the form of publicly expressing confidence in the Finance Minister and according first priority to the latter's advice in any important decision. Since the Prime Minister/President and the Finance Minister will have frequent opportunities in the budget process to discuss fiscal issues, including the fiscal target and new policy initiatives, it would not be unusual for them to have built strong mutual confidence in each other.

### **3.3.3. Program Review**

In most countries employing the top-down budgeting system, the Finance Ministry conducts 'program reviews' of individual programs for several purposes; to monitor whether programs are consistent with the fiscal rule; to support the decision process for setting expenditure ceilings; and to facilitate decisions on new policy initiatives. Beyond these purposes, there are distinctive 'program review' systems for budget saving in Canada and Denmark. These systems are judged to have been very effective for securing available resources under the unfavourable fiscal situation of the 1990's. On the other hand, in Australia, there is a powerful program review committee which is responsible for major decisions on fiscal management.

In Canada, the 'Program Review' was announced in 1994. It was a comprehensive assessment of the proper role of the government in the economy and as such included reviews of the various programs that the government was involved with. The Program Review exercise was headed by a special Minister Responsible for Public Service Renewal. A special Cabinet Committee on Program Review was established, which was composed of the Finance Minister, the Treasurer, and several Senior Ministers. In the first instance, six criteria for carrying out the Program Review were enunciated and departments and agencies were given the mandate to self-review their programs according to the six criteria. This process did not yield significant savings. As a result, each department and agency was given a target for expenditure reductions. The targets were proposed by the Finance Ministry and the Treasury Board Secretariat and approved by ministers. Each minister was given the responsibility for developing program

changes to meet the assigned targets.<sup>19</sup> Departments and agencies had to submit formal business plans that showed in detail how to change their activities in order to achieve the reductions. It was reviewed in the Committee and confirmed in the Cabinet Meeting. This system contributed to a quick escape from a fiscal crisis in the late 1990's. In recent years, however, with the fiscal situation improved to surplus, its key role has changed from budget reduction to efficient resource allocation.

**Box 8. Six criteria for program review (Canada)**

1. Does the program serve a public interest?
2. Is this an appropriate role for the government?
3. Could this be done better by another level of government – provincial? – municipal?
4. Could this be left to the private sector or volunteer sector?
5. Could the program be delivered more efficiently?
6. Is it affordable?

In Denmark, the government runs a particular system called 'Special Study.' It is normally associated with specific cuts in expenditure programs. The programs for review are decided by the Cabinet Committee, and generally excluded from the total expenditure ceilings. Special studies are carried out by teams of civil servants representing the Ministry of Finance and the relevant line ministry. Depending on their terms of reference, these teams will either present specific proposals or a menu of possible proposals for saving. There is a very short period of time for these teams to operate, as they will generally only have about 1.5 months to carry out their studies. Despite this, it is estimated that the special studies have produced significant savings.

In Australia, there is a very important committee called the 'Expenditure Review Committee' (ERC) as a sub-committee of Cabinet. It is responsible for examining all expenditure proposals in light of the government's overall fiscal strategy, advising Cabinet on budget spending priorities, and initiating reviews of individual ongoing program expenses. Moreover, it considers the various new policy initiatives and saving proposals. The Committee consists of the Prime Minister, the Finance Minister and two Senior Ministers. When making its decision on budgetary issues, ERC uses information from the Portfolio Budget Submission and briefs prepared by the Department of Finance.

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<sup>19</sup> The targets ranged from 5% to 60%, and were to be implemented over the coming three years.

### 3.3.4. Cabinet Meeting/Final Decision

The expenditure ceilings and the Budget Proposal are usually confirmed by the approval of the full Cabinet Meeting; the former in early stage of budget formulation, the latter in final stage of budget formulation within the government. In Sweden, Denmark, and Korea, the Cabinet Meeting for determining expenditure ceilings is held for two consecutive days with all Cabinet members and senior budget officials participating. All the major issues related to the expenditure ceilings and fiscal rules are put on the table and in-depth discussions are held among participants. With this meeting, Cabinet members have an opportunity to understand current fiscal circumstances more precisely and thereby reach a consensus on complicated budgetary issues. Both the expenditure ceilings and Budget Proposal are made public after confirmation in the Cabinet Meeting, except for Sweden and Korea, where the results of the Cabinet Meeting for expenditure ceilings are announced only in abbreviated form. The Budget Proposal, upon confirmation by the Cabinet Meeting, is submitted to the Parliament.

## 3.4. Flexibility

### 3.4.1. Economic and Fiscal Circumstances

Economic and fiscal circumstances affect how the budget system functions. In societies where social demands for budgetary spending keep growing even as available resources decrease, the government will need to reform the budget system to achieve fiscal consolidation. Top-down budgeting began as such a reform of budget formulation in order to overcome the fiscal crises of the early 1990's. However, as the economy and the fiscal situation change with time, the system needs to adjust flexibly in order for the government to continue to obtain satisfactory results in the new environment. For example, a favourable fiscal circumstance will allow the government to alleviate constraints on public expenditure, whereas an unfavourable circumstance will demand tightening control over spending. The necessity of reserving such flexibility in fiscal policy and budgetary systems means that, in most countries, the government does not enact the fiscal rules as a law but maintains them as a political commitment. This allows the budget system to adjust and evolve with changes in a country's economic and fiscal circumstances. Canada's experience offers a good case in point.

In Canada, the government decided to introduce the PEMS (Policy and Expenditure Management System) to control the aggregate expenditure in response to the growing fiscal deficit in 1980. PEMS followed the typical top-down budgeting approach in that the government created a five-year medium-term budget

framework of expenditure ceilings, with 10 sub-ceilings set within the overall ceiling. However, as the fiscal deficit continued to grow in the early 1990's to reach alarming levels, the government replaced the PEMS to the EMS (Expenditure Management System) in 1994, which emphasized even stricter control on expenditure. With the introduction of EMS, the government established a tight fiscal target that would lower the deficit to 3% of GDP by fiscal year 1996/1997.<sup>20</sup> The period of MTBF was adjusted from 5 years to 2 years because the government wanted to be confident that it could deliver what it had promised and be held accountable for meeting its promises. The 'prudent economic assumption' and 'contingency reserve' were also introduced under EMS. These reforms of the budget system contributed to improving the fiscal situation in Canada, turning the deficit into a surplus by the late 1990's. As the surplus continued, the government started to alleviate control and changed the period of MTBF back to 5 years from 2004.

Flexibility is an important factor in the budget process, and this is evidenced by the evolution of fiscal systems in various countries. In many countries the number of sub-ceilings has tended to diminish. In particular, Sweden has abolished most controls on transfers among budgetary categories such as wages, transfers, and investment in order to enhance flexibility. Another example of flexibility in top-down budgeting can be found in the budget margins designed as reserves against economic forecast errors and unpredictable events. Additionally, in some countries, the government formulates one or more supplementary budgets regularly during the fiscal year in order to adjust expenditures and revenues in view of changes in economic circumstances and newly introduced policy initiatives.<sup>21</sup> The following gives more specific examples of flexibility in top-down budgeting.

In the Netherlands, thanks to its cautious economic assumption rule, the government usually reaps windfalls at the end of the year. How to spend the windfalls depends on the macro-economic and fiscal situation. If the budgetary situation turns out to be more favourable than the government expected, e.g., as a result of higher economic growth, then the following rule applies: If the deficit is greater than 0.75% of GDP, 75% of windfall goes to reducing the deficit and 25% to tax cuts. If the deficit is less than 0.75% of GDP, then 50% of windfall goes to reducing deficit and 50% to tax cuts.<sup>22</sup>

In the United Kingdom, end-year flexibility (EYF) is guaranteed from department to executive agencies. While DEL (Departmental Expenditure Limit) plans are set firmly for departments for three years, carrying forward unspent DEL provision from one year to the next is allowed to encourage them to plan over the

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<sup>20</sup> The fiscal deficit in 1993 was 8.7% of GDP.

<sup>21</sup> In Sweden, a supplementary budget is formulated twice during the fiscal year; the first is formulated in April when the MTBF is confirmed, and the second, in September when Budget Bill is confirmed.

<sup>22</sup> This was set in the Coalition Agreement.

medium term and avoid wasteful end-year surges. Three year budgets and end-year flexibility give the public service the stability to plan their operations on a sensible time scale without the fear that resources may be cut back in the following year. EYF also removes the perverse incentive for departments to use up their provision as the year end approaches without regard to value for money.

### 3.4.2. Pro- vs. Counter-cyclical Spending

#### *Fixed vs. flexible overall expenditure ceilings*

MTBFs can be classified into two different types according to flexibility of adjustment. One is a flexible framework which allows the overall expenditure limit to adjust to shifting economic and budgetary circumstances from year to year. The other is a fixed framework which does not permit such adjustments. In a fixed framework can be one which rolls over the frames, but once determined, the caps for even future years cannot be adjusted. The Netherlands, Sweden and the U.K. operate MTBFs as a fixed framework, while other countries in this study have a flexible framework. For example, in Sweden's 3-year rolling MTBF, the government hardly adjusts the overall expenditure ceilings of years  $t+1$  and  $t+2$ , which are determined in previous MTBF cycles, but only adds a year  $t+3$  ceiling when confirming the new MTBF every year.<sup>23</sup>

Under a fixed framework, the general budget fund functions as an automatic stabilizer for macro-economic purposes. In such a framework, tax revenues fluctuate according to the economic cycle and bear the full load of acting as a stabilizer. In a business upturn, tax revenues increase, thereby limiting private sector consumption and investment, which helps to prevent overheating of the economy. In a business downturn, the opposite happens; tax revenues decrease to allow private spending increases, thus countering the business cycle. Some government spending such as unemployment benefits or subsidies for low-income families also can function as an automatic stabilizer if they are not under a fixed expenditure limit. It should additionally be noted that a fixed framework functions to stabilize the fiscal balance automatically over the long term. Since the expenditure limit is fixed in the medium term regardless of economic fluctuations, a fiscal surplus (or lower deficit) may be expected in an economic upturn while a fiscal deficit (or lower surplus) is likely in a downturn. As the surplus in economic upturns offsets the deficit in

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<sup>23</sup> In contrast, in case of the 27 sectoral ceilings, the government determines the ceilings for  $t+1$ , and manages those of  $t+2$  and  $t+3$  as a guideline when confirming the MTBF every year.

downturns, the fiscal situation can be maintained at balance over the long term.<sup>24</sup> This means that the effect of the fixed framework on the economy is pro-cyclical, rather than counter-cyclical (for the latter, expenditures would need to be increased if tax revenues fell behind the trend).

In contrast, under a flexible framework, the government adjusts the expenditure limit discretionally according to the economic cycle. However, it should be borne in mind that the government has to adjust the expenditure limit based on an accurate forecast of the cycle in order to get better results from adjustment. Making such forecasts with an accuracy that is useful for fiscal policies has proven to be a near impossible task. Even worse, if an adjustment is based on a poor economic forecast, it could exacerbate the fiscal situation. Therefore, in top-down budgeting, a government aiming for fiscal consolidation would do well to seriously consider the potential costs of using a flexible framework.

### *Tax expenditures*

What fiscal policy instruments are available to a government with a fixed framework? Is it even possible for them to take any actions even in a serious economic situation like a sharp increase in unemployment? The solution often adopted by governments under strict spending restrictions is to use tax expenditures. In many countries, tax expenditures tend to increase as the governments take advantage of them to work around spending limits. Recently, in Sweden, in response to a much shrunken budget margin, tax expenditures have increased up to 0.6% of GDP.

### *Structural fiscal target*

The purpose of a structural fiscal target is to eliminate the effects of cyclical fluctuations of economic activity from the fiscal target. When the economy is performing above its long-term potential, the budget balance should record a nominal surplus. With a sub-potential economy, the balance should return to a nominal deficit. Over the cycle, these should balance each other out. Therefore, the merit of a structural fiscal target is that it functions as an automatic stabilizer similarly to a fixed medium-term framework. However, one must keep in mind that the rationale for the structural fiscal target rests on the premise that

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<sup>24</sup> A fixed medium-term framework also brings greater stability to the budget system because tax revenue fluctuations are no longer a reason for adjusting expenditure limits.

that medium-term economic forecasts can be made very accurately. The following examines the case of Chile, which maintains a tight structural fiscal target.

The Chilean government adopted its fiscal target of operating each year with a structural budget surplus of 1%<sup>25</sup> of GDP from 2001, which has served to set a hard budget constraint for the overall expenditure ceiling. Additionally, the government established two independent panels composed of private sector specialists in order to enhance the accuracy and objectivity of forecasts. As the overall expenditure ceiling is defined by the structural parameters, changes in revenue forecasts reflecting cyclical factors do not affect the expenditure ceiling. Only when revenues fall short of the original estimation for reasons not associated with the cycle is it necessary to adjust the expenditure ceiling. In such circumstances, it is common to ask line ministries to accept proportional adjustments in their current expenditures. In case of excess revenues not attributable to cyclical factors, there is room for extra expenditure. The President will decide how to use the additional resources after consulting the Finance Minister, in ways which do not build expenditure pressure for subsequent years.

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<sup>25</sup> The decision to target a surplus of 1% of GDP was taken in order to offset a perennial deficit of 1% of GDP at the Central Bank of Chile. When the two are consolidated, the public sector has an approximately zero balance.

## 4. Changing Behaviour

### 4.1. Inertia in Behavioural Change

From a behavioural point of view, the key feature of top-down budgeting is the delegation of authority to line ministries. Considering the magnitude of the transfer of authority from the Finance Ministry to line ministries upon switching to a top-down system, behavioural changes on the part of all participants in the budget process is a required for the new system is to fulfil its intended purpose. In actual budget processes, however, it seems to be very difficult to change existing practices that were established under the bottom-up approach. As the role of Finance Ministry becomes setting the expenditure ceilings in a medium-term perspective, it will still tend to maintain its influence over line ministries by intervening in the latter's internal money allocation to individual appropriations. As for line ministries, whose role is now redefined as responsibly allocating money to their appropriations within sectoral expenditure ceilings, it may be difficult to break away from the old practice of submitting excessive budget requests (above the expenditure ceilings) in order to get a larger budget approved by the Finance Ministry. Even after the budget system has changed to top-down budgeting for fiscal consolidation, Parliament will often continue to push up the expenditure ceiling for votes rather than control it.

This tendency to hold on to old patterns of behaviour can sometimes prevent the new top-down system from taking root. In 1990's, the U.S. government introduced the top-down budgeting system to replace the existing bottom-up approach. However, hardly any changes in behaviour followed the new system's introduction for participants in the budget process. As a result, budget formulation ended up reverting to the former bottom-up approach in 2000.

The budget-saving mechanism in Canada's PEMS (Policy and Expenditure Management System) also provides an example of a system that ultimately failed because of unchanging behaviour. The overall expenditure limit in PEMS was divided into several spending envelopes,<sup>26</sup> each of which included all spending in a particular policy area. For example, a single envelope for economic development included all spending for agriculture, fisheries, tourism, industry, commerce, transportation and regional development. Since a spending envelope included the expenditures of several ministries, it was administered by a Cabinet committee of all ministers whose spending belonged to the envelope. This arrangement was intended to foster resource reallocation by having all government programs in a given field judged side by

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<sup>26</sup> Originally, there were 10 spending envelopes.

side; so that funding for one program could be reduced to finance an increase for another. Therefore, for this system to be able to work efficiently, ministers had to propose savings available in the expenditures of their own policy fields first. In reality, however, no minister suggested savings initiatives because those savings would go to the envelope 'pool' directly without any guarantee of being reallocated to another spending program of her own ministry. As a result, no reallocation took place, as neither did any voluntary savings. The system did not succeed because the requisite new behaviour in the form of ministerial partnership never materialised.

## **4.2. Delegation and Accountability**

As noted previously, the introduction of the top-down budgeting system mandates that the division of roles between the Finance Ministry and line ministries be reorganised. The Finance Ministry has to concentrate on establishing management strategies for fiscal consolidation from a broader perspective. Greater accountability is required from line ministries than in the bottom-up budgeting system as they are now responsible for allocating money to their individual appropriations. Parliament also needs to redefine an appropriate role for itself that allows it to contribute to the efficient operation of the new system. Thus, all participants in the budget process will need to embrace changes in their behaviour in order to reap the originally intended benefits from the new top-down environment.

### **4.2.1. Finance Ministry**

The Finance Ministry needs to restrain itself from intervening in the internal resource allocation by line ministries. This rule is firmly settled in countries where the top-down budgeting system plays a substantial role. In Sweden, once the overall and the 27 sectoral ceilings are set in the Cabinet Meeting, line ministers are responsible for allocating money to the 500 appropriations within the expenditure ceilings. The Finance Ministry hardly intervenes in this internal allocation process, but still monitors whether the ministries' decisions conform to its 'financing rules.' The U.K. Finance Department does not involve itself in departments' internal allocations once a DEL is allocated to each department, but still scrutinizes whether departments observe the DEL envelope and the objectives of the Public Service Agreement (PSA).<sup>27</sup> If the budget request of each department meets these two requirements, it is incorporated into the government Budget Proposal without any adjustment.

With little room for direct intervention in the top-down system, Finance Ministry staff must augment their capacity for fiscal management. They have to improve their performance in producing economic assumptions and forecasts, setting the fiscal management target, and defending fiscal rules. Although in theory the delegation of many budgeting decisions to line ministries ought to free up considerable time for Finance Ministry staff, in reality, top-down budgeting requires a greater workload and more diligence because of the increased need for up-to-date information and for acquiring strategic skills for efficient fiscal management. An important point that follows is that the top-down budgeting system should not be used for the purpose of saving staff. Even in Sweden, where the Finance Ministry delegates most authority to line ministries, there have been no staff reductions since the introduction of top-down budgeting. Instead, Finance Ministry staff should be provided with the opportunity for re-educating themselves to adapt to the new system, bearing in mind that in any case such efforts at self-innovation are inevitable.

Thirdly, the Finance Ministry needs to establish better relationships with line ministries than that in the bottom-up budgeting system. Finance Ministry staff, armed with enhanced information and skills for fiscal management, should be ready to provide advice on whatever issues brought up by the line ministries in a cooperative approach to finding solutions together. The Finance Ministry and line ministries are not game players in the budget process any longer, but have to establish a cooperative partnership with each other.

#### **4.2.2. Line Ministries**

First of all, all line ministries must observe the expenditure ceilings, which is the *sine qua non* of an effective top-down budgeting system. Line ministry budget requests that exceed the expenditure ceilings approved in the Cabinet Meeting directly undermine fiscal soundness, which usually is the main reason for adopting top-down budgeting in the first place. Moreover, such violations may result in serious distrust of government policy by the public. Therefore the budget office in most countries with a top-down system maintains that budget requests exceeding the approved expenditure ceiling will not be accepted and simply be sent back. In budget execution, as opposed to budget formulation, the Financial Administration Act (FAA) of Canada obliges departments to observe the expenditure limits. If a department spends in excess of the expenditure limit, the expenditure limit of the department will automatically decrease in the subsequent year by the amount of excess spending in the current year.

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<sup>27</sup> This is a kind of performance management system in which the Finance Department takes into account the objectives of each department for the coming 3 years when it sets the expenditure limits.

Secondly, line ministries need to take on greater responsibility in allocating resources to individual programs. Under the bottom-up approach, line ministries tend to increase the budget for every program with little effort at achieving a better reallocation of resources among them because funding for the programs is decided through negotiations with the Finance Ministry. In the top-down budgeting system, in contrast, line ministries need to show responsible ownership in their actions. Re-structuring of individual programs would be necessary so that programs with low-priority or poor outcomes should be decreased in funding or eliminated altogether, while programs with high-priority and excellent outcomes should gain more money. Delegation should go in hand with enforced accountability. In the top-down budgeting system, “Each Minister is his own Finance Minister.”

#### **4.2.3. Parliament**

Since the relationship between the government and the parliament takes various forms that reflect each country’s political structure and history, it is hard to find a general answer as to how the legislature ought to change its behaviour in the top-down budgeting system. However, it is clear that the parliament should try to improve its review process of the government’s budget proposal either institutionally or practically as top-down budgeting sets root in the Government sector. The case of Sweden gives a good example of how the legislature adapted its budget review process for top-down budgeting.

In Sweden, the reform efforts were well coordinated. Following enquiries by a parliamentary working party in the beginning of the 1990’s, Parliament decided in 1993 to introduce a separate procedure for the preparation and approval of the Budget Bill in Parliament. The process has all the characteristics of a top-down procedure; first one votes on the frames for all the 27 expenditure areas and on the estimate of the revenues, and then votes on the appropriations within each expenditure area. First the aggregate is approved, then the details. During the second stage Parliament is allowed to reallocate funds between appropriations within an expenditure area, providing the frame for the area is not violated. The procedure was first used in 1996 for the preparation and approval of the 1997 budget. The government also used its new top-down procedure in 1996 for preparing the 1997 budget.

### **4.3. Leadership**

The objective of top-down budgeting is to achieve fiscal consolidation. To this end, the Finance Ministry focuses its energy on setting the expenditure ceilings and upholding fiscal discipline, delegating the details

of resource allocation to line ministries. Therefore, this system can produce positive results only when the manager at the centre of the system, *viz.*, the Finance Minister, runs the system with sufficient skill and leadership. Moreover, if he is backed sufficiently by the Prime Minister or the President, top-down budgeting will take root successfully as the new budget formulation system.



## 5. Conclusion

The top-down budgeting system was introduced as an institutional reform for overcoming the serious fiscal situations faced by many OECD member countries during the early 1990's. This system enables the Finance Ministry to manage public finance efficiently from a medium-term perspective, and is judged to have contributed significantly to achieving fiscal consolidation, particularly in Sweden and the United Kingdom. However, top-down budgeting does not always guarantee successful fiscal management, as evidenced by the PEMS (Public Expenditure Management System) of Canada in the 1980's. The following summarises several key points drawn from this study, to which a government should give serious consideration when designing a top-down budgeting system.

Firstly, there needs to be greater effort to uphold fiscal discipline. Since top-down budgeting's purpose is to achieve fiscal consolidation by having the Finance Ministry control aggregate expenditure, fiscal discipline must be established and enforced thoroughly. If the fiscal situation becomes worse than expected, tighter discipline on aggregate expenditure will be required. Moreover, the overall expenditure ceiling in a medium-term budget framework should preferably be fixed over the framework's period. No adjustments should be allowed except for legitimate and very serious reasons, in order that the automatic stabiliser of fiscal policy can function effectively.

Secondly, cautious economic forecasts are required to achieve fiscal soundness. Prudent and objective economic assumptions, rather than optimistic ones, facilitate the government's efforts to achieve fiscal soundness. For this purpose, a government may consider either establishing an independent body for economic forecasting like the Netherlands' CPB (Central Planning Bureau), or using private-sector forecasts as a baseline for budget formulation as is done in Canada. Moreover, windfalls that are realised as the result of prudent economic assumptions can be spent for repaying debt or to finance spending increases, decisions on which should be made with due consideration of the state's fiscal situation.

Thirdly, flexibility in operating the system is very important. In this vein, it is not desirable to have an excessive number of sub-ceilings or to over-regulate against fund transfers among budget categories. The government needs to make appropriate adjustments in the fiscal system according to the state's economic and fiscal circumstance. As a general rule, the worse the circumstance, the tighter should be control on expenditure. End-year flexibility (EYF) may be able to provide departments with greater flexibility in multi-year spending, ultimately enhancing responsibility and accountability in their spending.

Fourthly, there has to be behaviour change by the participants in the budget process if the transition to top-down budgeting is to succeed. The Finance Ministry should not intervene in the internal allocations of line ministries but focus on strengthening a fiscal management strategy from a medium-term perspective. Line ministries should observe the expenditure ceilings approved in the Cabinet Meeting and be more responsible in allocating money to their individual appropriations. It is worth emphasising that each Minister is his own Finance Minister in the top-down budgeting system.

Lastly, strong leadership is required of the Finance Minister. Charged with ultimate responsibility for the system's success, the Finance Minister needs to lead line ministers with his expertise as well as personal skills. Additionally, adequate backing from the head of the Cabinet will improve the odds that the top-down budgeting system will fully perform as expected.

The factors above are the key considerations that merit serious attention when a government designs a top-down budgeting system. Other technical issues, such as the composition of the expenditure ceiling and the extent to which the ceilings should be made public, are matters for each government to decide in view of public opinion in the society it belongs to. Finally, top-down budgeting has contributed to achieving fiscal consolidation in many countries, but this does not necessarily imply that it is unequivocally the best practice that has yet emerged in budgeting. The best budget system for any particular country must always remain one that adequately reflects the established political structure and that society's historical as well as socio-economical background.

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## **II. Country-specific Case Studies**



# 1. Canada

## 1.1. Overview of the Top-Down Process and Fiscal Rules

- *What were the original goals for introducing a top-down budgeting process? When was top-down budgeting introduced? How has it evolved (changed) since its inception? What is the general assessment of the top-down process at present?*

Top-down budgeting has been in existence at the federal level since Confederation, although adherence to the principle has varied over time. The Financial Administration Act (FAA) entrusts the Minister of Finance with “the management of the Consolidated Revenue Fund and the supervision, control and direction of all matters relating to the financial affairs of Canada not assigned to the Treasury Board or any other Minister”. In this role, the Minister of Finance has traditionally taken the lead in recommending the level of the total expenditure target in relation to general economic considerations.

In the early years, the expenditure limit was largely dictated by the revenues that the government could raise from its limited sources (largely custom duties) and its obligations and guarantees on its capital investments. However, as the government expanded into new programs and revenue sources throughout the 1920s and 30s, the top-down approach gave way to more of a bottom-up process. For example, in the lead-up to the 1938 budget, the Prime Minister forewarned his Ministers that he wanted to keep expenditures down so that the 1938 budget could be balanced. However, in the end, the revenue forecast was adjusted so that requests from Ministers for increased spending in their departments could be accommodated. Although the budget was in surplus for a number of years after World War II, the expansion of the federal government’s role and responsibilities in economic and social development in the 1960s and 70s saw a rapid growth in new programs, with little regard to an overall expenditure limit.

In 1976, the *Royal Commission on Financial Management and Accountability* (Lambert Commission) was established, in part, due to the unprecedented demands placed on the government by the growth in its responsibilities and programs. The Committee re-enforced the principle of top-down budgeting: *to forecast revenues and determine appropriate expenditure limits and debt ceilings as they accord with present and prospective economic conditions and circumstances and that responsibility for establishing the government’s fiscal position cannot be divorced from responsibility for setting expenditure limits for departments and agencies.* The Commission’s report resulted in the creation of the Policy and Expenditure

Management System (PEMS) in 1979. PEMS provided the framework for five-year planning and created a system of resource envelopes. The Department of Finance was the lead agency in formulating recommendations to Cabinet on the overall limit to be imposed on government spending and the broad allocation of funds to functional categories of government expenditures, over a five-year period. Departments and agencies were allocated into “envelopes”, each with an overall limit. Treasury Board, through the Treasury Board Secretariat, would then allocate the total to the various departments and agencies for the first three years of the plan. The limits and allocation among and within the envelopes were updated on an annual basis. Reserves were allocated to each envelope for potential policy initiatives, while the Treasury Board was given an Operating Reserve to adjust departmental and agency reference levels for unanticipated operating pressures.

The envelope system remained into effect until 1988, but the limits on overall expenditures remained in effect thereafter. To address the fiscal crisis in 1994, the five-year Fiscal Plan was replaced with a two-year Fiscal Plan and the policy and operating reserves were eliminated and replaced by the Contingency Reserve and economic prudence. PEMS was replaced in 1995 by the Expenditure Management System.

From a Finance perspective, the top-down budgetary process has assisted in the preparation of the budget. The experience of the 1930s to 1970s clearly indicated that the lack of adherence to the expenditure limits exacerbated the deficit situation. Setting an overall expenditure limit provides the context for internal reallocations to meet the various pressures for increased resources. It is relatively easier to say no with an overall expenditure limit. However, to be effective, there needs to be a “strong”, informed and effective Treasury Board Secretariat that challenges departmental/agency requests and can oversee and effectively manage reallocations when necessary.

- *Is the expenditure ceiling linked to a formal fiscal rule, either in terms of deficits, debt and/or expenditures? If so, please describe the fiscal rule and how it is “operationalised” in the annual budget process.*

In 1991, the government legislated spending limits through the *Spending Control Act* for the period 1991-92 to 1995-96. The limit was based on total spending set out in the February 1991 period for the next five years. Excluded from the limits were public debt charges, programs that were financed through “dedicated” revenues/charges, and expenditures relating to events that occurred prior 1991. As this was a five-year program, under spending in one year could be carried forward to offset over spending in some future year. If the aggregate spending limit was exceeded after the five-year period, the Government had

to indicate in the following budget how it intended to make up any shortfall. Over the 1991-92 to 1995-96 period, the limit was not exceeded. The Act was not extended.

Although there is no formal, legislative fiscal rule, the government's has set annual budget targets since 1994. Originally, these were set as a percentage of GDP (reduce the deficit to 3 per cent of GDP in 1996-97). Since balancing the budget in 1997-98, the government has set an annual target of a balanced budget or better.

On a status quo basis, based on the average of private sector economic forecasts, the Department of Finance prepares forecast of budgetary revenues and statutory program expenses. The Treasury Board Secretariat provides Finance with the total of non-statutory (voted appropriations) expenses. This amount cannot exceed the difference between revenues and statutory expenses, after allowance for prudence (Contingency Reserve and economic prudence) to ensure that the balanced budget target is met.

## 1.2. Determining Expenditure Ceilings

- *When are the expenditure ceilings set? For how long are they set? If multi-annual, are the ceilings adjusted every year?*

The expenditure ceilings are set in the budget. For the period 1994-95 to 2004-05, they were set for two years, but update every year. In the 2005 budget, expenditure dealings were set for a five-year plan. They will be updated every year.

- *How are the annual ceilings determined? Do spending ministries submit bottom-up proposals ahead of the top-down ceilings being established, i.e. in order to inform the top-down decision? Or, are they required to submit proposals that do not exceed the ceiling in the first instance? In practice, do the annual ceilings usually end up as incremental adjustments to the previous year's ceilings?*

Each fall, departments and agencies make submission to the Treasury Board seeking annual approval of their budgets (non-statutory) through the Annual Reference Level Update (ARLU) process. This is primarily a technical exercise that updates departmental funding levels for the next fiscal year as well as the two years after that. The ARLU process is not generally a mechanism for departments to seek new funding approvals but rather it is an exercise that recognizes incremental approvals given since the

previous year. These incremental approvals primarily relate to new policy initiatives announced in previous budgets.

The Treasury Board Secretariat reviews the individual departmental submissions and makes recommendations to the Treasury Board. They then compile the approvals and submit them to the Department of Finance. If the totals fit within the overall spending limit provided, no further action is taken. If they exceed the target, reductions would be required.

The major adjustments to the expenditure ceilings result from the introduction of new policy initiatives or enhancements to existing programs. In some years, incremental adjustments have been made to the departmental reference levels based on assessments by the Treasury Board Secretariat on health and safety issues. In all cases, since 1994-95, these adjustments have been accommodated without jeopardizing the annual budgetary balance target.

Given that the federal government is currently in a surplus position, has surpassed its fiscal targets in each year since 1994-95 and releases a portion of the economic prudence in each new budget plan, adjustments have been made to the expenditure limits in most years.

- *Please describe the political aspects of determining the expenditure ceilings. What is the role of the Minister of Budget vis-à-vis the Presidency / Prime Minister & Cabinet, and other spending ministers? When do most changes typically take place in the relative amounts of the ceilings? When a new government takes office? When a crisis takes place? Are there other “politically opportune” moments to affect significant changes?*

Ministers make presentations to their respective policy Cabinet committees for new policy initiatives, consistent with the government’s stated objectives as set out in its most recent Speech from the Throne, or in reaction to current developments. These presentations are made following approval by the Operations Committee, which serves as a gate-keeper as to which initiatives can be reviewed by the policy committees. The policy committee reviews the proposal and, based on the consensus view, can give approval-in-principle to the initiative. This puts the initiative in a queue, for consideration by the Prime Minister and the Minister of Finance for funding in the upcoming budget. For existing programs, the Treasury Board may also recommend new funding for consideration by the Prime Minister and the Minister of Finance. The Minister of Finance (Budget) updates the revenue and expense projections on an annual basis. Based on these projections and the amount of new room (excess over annual balanced budget targets and

prudence) adjustments will be made to the expenditure limits. The adjustments will primarily be based on the approvals-in-principles from the various policy committees and the Treasury Board. Cabinet will be informed of the potential adjustments. Final decisions, however, are made by the Prime Minister and Minister of Finance.

Although the expenditure limits are traditionally made in a budget, adjustments have been made throughout the fiscal year to react to current developments and emerging issues. In most years since 1999, the government has released an *Economic and Fiscal Update*, which updates the economic and fiscal forecasts since the last budget, based on the most recent information and current economic forecasts. These updates will revise the expenditure limits to incorporate new policy initiatives, if required

- *Are the ceilings made public? If so, when and how?*

See above.

- *If there are changes between the initial economic assumptions (revenue forecasts) used as the basis for calculating expenditure ceilings and revised final ones, how are the ceilings adjusted to take account of this? How is the difference allocated among the ministries?*

Given that the federal government is currently in a surplus position, has surpassed its fiscal targets in each year since 1994-95 and releases a portion of the economic prudence in each new budget plan, adjustments have been made to the expenditure limits in most years. In most cases, these adjustments reflect government priorities, as set out in its election campaign, Speech from the Throne, current developments and emergencies. Allocation among the ministries will be dependent on the priorities and current developments. Final decisions on these adjustments are largely based on recommendations made by the various policy committees. However, final decisions are made by the Prime Minister and Minister of Finance.

However, even in the current surplus environment, the government has undertaken “reallocation” exercises. Targets were set for each department/agency, largely based on their operating budgets.

- *At what level of detail are the expenditure ceilings set? One global amount per ministry, or separate ceilings for sub-components, such as salary, other operating expenditure, transfers and investments?*

*If so, what is the rationale? Are there different mechanisms in how the ceilings are decided for each category? Is there any possibility to transfer amounts between the various sub-categories?*

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The current expenditure ceiling is at the aggregate level only. However, in recent years, the statutory expenditure programs have largely been exempt from any ceiling. As a result, the ceiling primarily relates to non-statutory spending. Within the overall limit, a compensation reserve is set up to manage upcoming negotiated wage and salary increases. The size of the reserve is based on a number of factors, including economic conditions and human resource considerations. Once the overall expenditure limit has been allocated among the ministries, they are expected to manage within their limit. Under PEMS, limits were set for each envelope. Reallocations were done within the envelope but not among the envelopes.

- *Are any specific items in a ministry's overall ceiling, "ring-fenced," so that a spending ministry cannot allocate that money to other uses?*

Parliament exercises control over the spending approval that it grants through the "vote" structure established for each department and agency. Subject to thresholds in terms of the amount of spending authority contained, there may be separate votes for operating, transfers and capital. In terms of parliamentary control, a department is free to reallocate within an individual vote, provided the revised expenditure plans are consistent with the department's legislated mandate. By contrast, parliamentary approval is required to reallocate funds between votes – from transfer payments to operating, for example. Similarly, parliamentary approval is required for reallocation between departments. Where it is needed, parliamentary approval of in-year reallocations between votes is sought through the Supplementary Estimates.

- *If applicable, how are programs run jointly by two or more ministries handled in the top-down budgeting process?*

Not applicable.

- *Are differences made between mandatory (entitlement programs) and discretionary spending in calculating the top-down ceilings? In particular, are automatic stabiliser programs, such as unemployment insurance and other low-income social programs, subject to expenditure ceilings?*

As noted above, entitlement programs have largely been exempt from the expenditure ceilings. However, in the 1990 Expenditure Control Plan and the 1995 exercise to address the fiscal situation, controls were put certain entitlement transfer programs to the provinces and territories. As well, during the earlier 1990s, major structural changes were made to the unemployment insurance programs, to address disincentives in the program as well as the fiscal situation.

- *If the budget contains a contingency fund for “routine” emergencies, are such funds allocated separately for different ministries in the first instance, or is there a single fund at the centre that ministries may apply to during the course of the year?*

The fiscal plan includes both a Contingency Reserve as well as extra economic prudence to ensure that the annual budget target is met. These reserves are held centrally, at the discretion of the Prime Minister and Minister of Finance. The Contingency Reserve is used to guard against unforeseen circumstances. It cannot be used for new policy initiatives. The economic prudence is built into the planning framework to provide further assurance against falling back into deficit. If it is not needed, it can be directed to increased spending in priority areas, tax cuts, or further debt reduction.

- *How does the top-down budgeting process take account of major "non-routine" emergencies that require additional funding in excess of what is covered by "routine" contingency funds? Is it understood that these expenses are not bound by existing ceilings?*

To date, in the current surplus environment, this situation has not presented itself. However, even in the current surplus environment, the government has undertaken reallocation exercises, not for fiscal purposes, but to fund higher priority initiatives. Given the commitment to an annual balanced budget (rather than to the expenditure ceiling), it is expected that reallocations would be undertaken, if there were concerns that the government could possibly go back into deficit. In part, this may be conditioned by the nature of the emergency and the time available to undertake reallocations.

- *Are there any other reasons for adjustments top the ceiling during the year?*

As indicated, the ceilings have been adjusted for new policy initiatives.

### 1.3. Interactions between the Central Budget Office and Spending Ministries

- *Do ministries have an opportunity to appeal their given expenditure ceilings? Are ministries given feedback on why their ceilings were adjusted from the initial, bottom-up figures they gave (assuming there is a bottom-up component)? If so, in what form?*

Each fall, departments make submissions to the Treasury Board seeking annual approval of their departmental budgets (non-statutory programs) through the Annual Reference Level Update process. The Treasury Board reviews these submissions and provides a detailed report to the Treasury Board of its assessment and recommendations, which form the basis for Treasury Board consideration. In developing this report, the Treasury Board Secretariat will be in regular contact with the departments, seeking additional information/justification and advising them of any proposed adjustments. The Departments will appeal to senior management of the TBS, as required. Ministers, who disagree with the TBS's assessment can ask to appear before the Treasury Board Ministers, before the final decision with respect to their reference level is made. Decisions of the Treasury Board are final.

Decisions made by the Treasury Board through the ARLU process are presented to Parliament by the President of the Treasury Board through the Main Estimates (normally tabled in Parliament in late February). These will be reviewed by the various committees of the House of Commons. Adjustments can be made to reduce the requested spending, but not to increase them. Recommendations by the committees are then debated by the House of Commons and voted upon. Defeat of the Estimates in the House of Commons is viewed as a vote of confidence.

Departments can also make submissions to the Treasury Board to seek increases to their reference levels throughout the year. This is done through the tabling of Supplementary Estimates. The same process is followed as described above.

Ministers may also seek increases to their reference levels for new policy initiatives by first seeking authority from the Operations Committee to present their proposal(s) to the applicable Cabinet committee. If approved, the applicable Cabinet committee would review the proposal(s) and could provide approval-in-principle for consideration by the Prime Minister and Minister of Finance for either funding in the Budget or at another point in time.

- *How have ministries performed their role in making final allocation decisions within their respective spending ceilings? Do spending ministries have the capacity to make such decisions? Have there been significant reallocations, or has it been largely incremental from the previous year? What is the overall assessment of spending ministries taking on this role?*

The current Expenditure Management System requires ongoing assessments/evaluations of current spending and the need for Ministers/departments to demonstrate that they have explored all avenues for reallocations prior to seeking incremental funding, either for existing programs or new initiatives.

Departments are constantly undertaking internal reallocations in order to keep within their approved reference levels. They are in the best position as they know their programs better than anyone else. This was not always the case. Up to the mid-1990s, the Treasury Board Secretariat was well versed in the various departmental programs, undertaking ongoing assessments and evaluation. With the move to a “management board”, their focus shifted more to the establishment of policies and away from hands-on involvement in departmental programs.

The reallocations currently being undertaken by departments themselves have largely been at the margin, through the delaying of certain capital expenditures. However, their capacity to do so is limited, without major structural changes, which are usually resisted by their respective Ministers.

- *What kind of “assistance” does the Budget Office provide to spending ministries in this respect, if any? Does the Budget Office provide guidelines to each spending ministry for their internal allocation decisions?*

The major reallocation exercises that have occurred at the federal level have largely been to-down exercises, with the Department of Finance recommending the overall targets and at times the departmental targets as well. To oversee the implementation of these targets, the Government has traditionally established an ad hoc committee of Cabinet, with input from the three central agencies.

In other cases, the Treasury Board Secretariat, with input from the Department of Finance and the Privy Council Office has suggested areas where the reallocations should occur or the base on which the reallocations should be applied.

Also see above.

- *What can the central budget office do if ministries' budgets (formulation/execution) violate its ceiling? Can the respective ministries be penalized? If so, how?*

Under the Financial Administration Act, departments cannot exceed their approved reference levels. If a vote is exceeded, the department's following year's appropriation is automatically reduced by a corresponding amount. The over spending is also noted in the Public Accounts of Canada. In at least one instance, the Deputy Minister was replaced. The applicable House of Commons committee examining that department's estimates may also question the Minister and senior management about the over spending.

- *Under what circumstances can the Budget Office overrule internal allocation decisions made by individual ministries? In practice, does this happen? In general, do ministries "worry" about defending their decisions to the Budget Office?*

The Treasury Board can and has overruled internal reallocations when these reallocations were deemed to compromise health and safety issues within the department and/or to the public. In addition, the Treasury Board and Cabinet have overruled internal reallocations when these reallocations were deemed to be inconsistent with government priorities or politically sensitive. House of Commons Committees have also questioned Ministers and their departments about the impact of reallocations, either proposed or implemented. From the above, Ministers are required to defend their reallocations in a number of different arenas.

- *Does the Budget Office have sufficient information in the top-down environment to effectively be able to second-guess and challenge the submission of spending ministries? At what level of detail does the Budget Office scrutinize the submissions by spending ministries?*

As noted above, the expertise today is not what it was in previous years. However, the Treasury Board Secretariat is still responsible for assessing and making recommendations with respect to departments' reference level. This requires that they possess or obtain a working understanding of the nature of a department's mandate and its resource requirements.

#### **1.4. Interactions between the Central Budget Office and the Legislature**

- *Did the legislature make any changes in its own procedures for approving the budget once the top-down approach was adopted for budget formulation? If so, what?*

The legislature can propose changes to a department's reference level. This is normally done through a review of the spending estimates by the various committees of the House of Commons (the Senate cannot make any changes). However, the committees can only propose reductions in spending, not increases. Increases require a Royal Recommendation: that is the sponsoring Minister must agree to the increase.

Supply or Appropriation Bills are considered votes of confidence. As a result, if a committee recommends a reduction, the Government must agree to the change. Normally, they would work a compromise with the Opposition and amend the Appropriations Act accordingly before final voting on the Bill. If the Government does not agree and the Opposition is successful in voting for a change in the Bill, the Bill would be defeated and the Government would be forced to call an election.

- *What is the legislature's role in determining the spending ceiling used in the budget formulation process? Is the legislature consulted? Does the legislature formally approve the ceilings?*

The legislature is not officially consulted in the setting of the aggregate spending ceiling. The Minister of Finance does appear before the House Standing Committee on Finance in the fall prior to the tabling of the budget. In the fall, he will present his Economic and Fiscal Budget, which will formally launch the pre-budget consultations. The Finance Committee will hold hearings across the country and make recommendations to the Government with respect to measures in the upcoming budget. In that context, they could recommend certain initiatives, which could result in changes to the spending ceiling set out in the fall update.

Following the tabling of the budget in the House of Commons, there are usually four days of debate on the budget, followed by a vote of the "budgetary policy of the government". This is a vote of confidence. In the committee examination of the budget, amendments may be proposed. Again, committees cannot recommend increases in spending unless accompanied by a Royal Recommendation.

The only real influence that the legislature can have on the spending limits set out in a budget would be in a minority government situation, where compromises are made to ensure that the Government is not defeated. This occurred in the debate on the 2005 Budget, whereby one of the opposition parties was able to increase the spending ceiling for two years in turn for supporting the government on the main Budget Bill.

- *Are there any mechanisms in place to ensure that the legislature honours the spending ceilings adopted by the government, either in aggregate or at a more detailed level? If not, is there a tradition for the relevant ministry to “volunteer” other offsetting savings so that the ministry's total will still come under its original ceiling notwithstanding the increases introduced by the legislature?*

See above. The issue only arises in a minority government situation. In cases where the committee recommended reductions, the government has either tried to broker a deal with the opposition or has amended the proposed Supply Bill to reflect the committee’s recommendations.

- What are the respective roles of the Budget Office and spending ministries in defending the government’s budget proposal before the legislature?

The President of the Treasury Board, officials from the Treasury Board Secretariat, Ministers and their officials regularly appear before Parliamentary committees to answer questions regarding their estimates.

- *After the Government submits its proposal but before the legislature approves the budget, should any unforeseen development arise that requires additional spending, how will this be worked out between the two? Will the ceiling also be adjusted, or will other spending be reduced to keep it intact?*

The Budget Plan includes provisions for potential adjustments related to unforeseen developments. This is through the Contingency reserve and economic prudence, which normally total \$4 billion in the first year of the plan. Provided that the balanced budget target can still be achieved, the spending ceiling would be increased. This would be done through the tabling of Supplementary Estimates during the course of the fiscal year or through programs that provide the Government with enabling authority without having to go back to Parliament for approval.

If the balanced budget target was threatened, the Government could undertake a reallocation exercise to find the required offsetting funds.

- *How has the overall relationship between the Budget Office and spending ministries vis-à-vis the legislature changed with the introduction of top-down budgeting, especially in terms of “tactics” employed?*

Not applicable.

## 2. Chile

### 2.1. Introduction

In June 2003, the Budget Office of the Ministry of Finance of Chile requested the OECD to carry out a review of the Chilean budgeting system in a similar fashion as it does for its Member countries.

The OECD responded positively to this request, recognizing that Chile is an established observer of the OECD Working Party of Senior Budget Officials and the strong interest in the Chilean budgeting system expressed by members of the Working Party.

This report is divided into four parts. *Part I* focuses on the budget formulation process. *Part II* discusses the role of the legislature in the budget process. *Part III* reviews management issues. *Part IV* is devoted to discussing performance and results reforms.

A mission consisting of **Mr. Jon BLONDAL** and **Ms. Teresa CURRISTINE** visited Santiago in June 2003 to carry out the review. During this visit, the mission met with senior officials from the Ministry of Finance, the Budget Office, the Presidential Secretariat Ministry, line ministries and agencies. The mission also met with members of the joint budget committee of Chile's National Congress and with senior officials from the Comptroller-General's Office.

The mission would like to express its gratitude and appreciation for the warm and cordial reception by the Chilean authorities and the uniformly frank and useful discussions with Chilean officials. In particular, the mission would like to express its thanks to **Mr. Mario MARCEL**, the director of the budget, for the generous time he shared with the mission during its stay in Santiago.

Finally, the mission would like to thank **Mr. Jaime CRISPI**, **Mr. Andrés COOPER** and **Mr. Juan Andrés ROESCHMAN** of the Budget Office for organizing the mission's visit and for their help throughout this review. The mission would also like to express its gratitude to **Ms. Marcela GUZMAN** of the Budget Office for her invaluable assistance with this review while she served at OECD Headquarters in Paris on secondment.

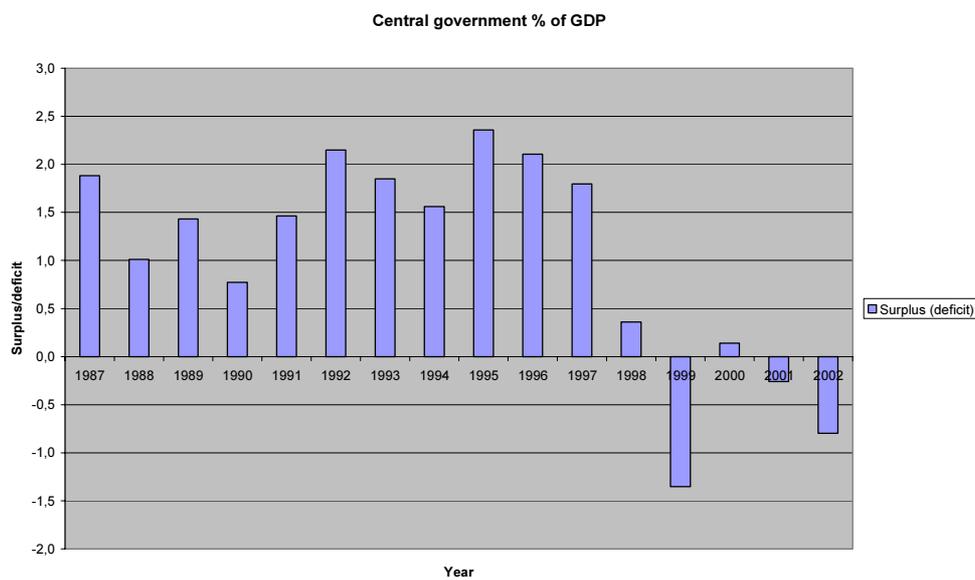
The views expressed in this report are those of the OECD Secretariat and should not be attributed to governments of OECD Member countries, or to any organizations or individuals consulted for this review. This review will be peer reviewed by budget directors of OECD Member countries at the next meeting of the Working Party of Senior Budget Officials.

## 2.2. Budget Formulation

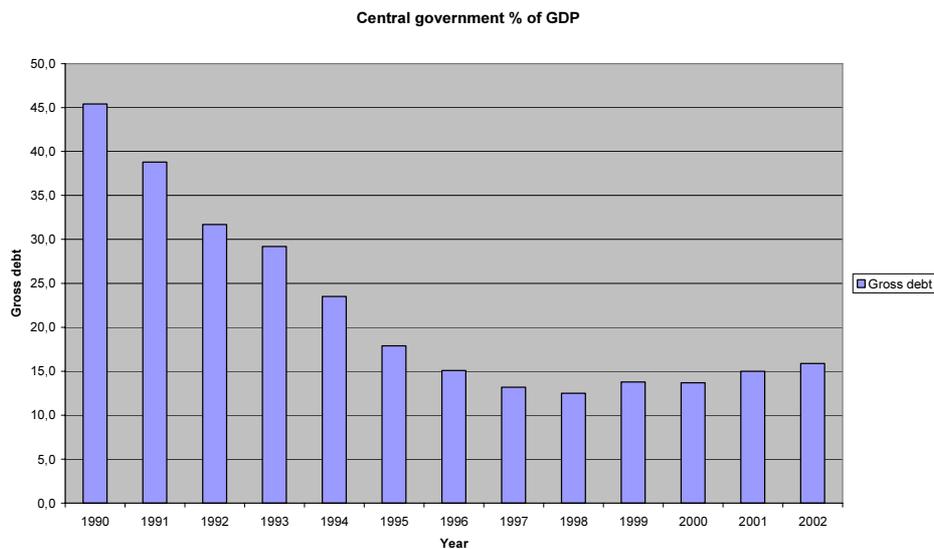
### 2.2.1. Introduction

1. One of the most recognized and distinguishing features of Chile is the sound handling of the economy during the past decades, especially the discipline with which public finances have been managed. This is particularly the case following the return to democracy in 1990.

**Figure II. 1. Nominal fiscal surplus-deficit 1987-2002**



**Figure II. 2. Gross government debt 1990-2002**



2. Why has Chile been able to accomplish this? The answer most likely lies in Chile's tumultuous political and economic history over the past decades.

3. In 1970, President Allende was elected president and a comprehensive socialist economic program was introduced. Banks, mines and many other foreign enterprises were nationalized. Workers' "self-management" was introduced in other firms. A general economic malaise followed. Fiscal deficits reached over 15% of GDP; inflation reached an annualized rate of over 500%. In 1973, the military overthrew the democratically elected government. The socialist experiment of President Allende was reversed – and indeed Chile's long tradition of statist economic policies. In 1975, a radical experiment with free market economics was introduced. The economy responded well to these policies and grew at very high rates until the early 1980s. In 1981, the international debt crisis led to severe economic problems in Chile – with high unemployment and the need for the government to bail-out the banking system. In the ensuing years, Chile consolidated its economic reforms and economic growth ensued<sup>28</sup>.

4. Following the return to democracy in 1990, successive elected governments have maintained a strong commitment to sound economic management and fiscal responsibility. In this context, it should be emphasized that the political situation in Chile was quite unstable at this time. The sustainability of democracy was by no means assured and in order to ensure political stability, democratic governments stressed responsible economic policies recognizing that this was one of the main pretexts for the military's take-over in 1973. The country had also witnessed the harsh consequences facing its neighboring countries which had followed less responsible policies immediately following their return from military rule. It should also be noted that successive democratic government have been served by very high-caliber economic teams.

5. This chapter reviews the budget formulation process in Chile. The first section discusses the fiscal rule that is the foundation of the budget policy in Chile. The second section discusses the key steps in the annual budget process.

### ***Box 1. The Private Provision of Traditional Public Services***

The size of the public sector in Chile is small compared to OECD Member countries. Total general government expenditure is circa 20% of GDP. The private provision of traditional public services is, however, extensive in Chile. When compared to typical public sectors in OECD Member countries, it is estimated that the equivalent of 11% of GDP is provided through the private sector in Chile.

A fully-funded pension system based on individual capital accounts, managed by private companies, replaced the traditional pay-as-you-go regime in the early 1980.<sup>29</sup> Individuals are required to deposit in such accounts an amount equal to 10% of wages, and to make an additional contribution of 2-3% of wages as a premium for disability and term life insurance as well as to cover administrative costs. Employers make no contributions.

A mandatory contribution of 7 per cent of wages and pensions must be used to purchase health care insurance. This system was introduced in 1981. People can either pay this contribution to a government health insurance financing scheme or to private health insurance companies. In addition, about 1/3 of all health care costs in Chile are paid out-of-pocket by the patients, rather than through the insurance schemes. Workplace injury compensation and disability compensation are also covered by compulsory private insurance schemes.

A system of individual unemployment insurance accounts was established in 2002. Employers and employees are required to pay 1.6% and 0.6%, respectively, of wages into an individual account for each worker. These accounts are managed by a private administrator contracted by the government.

Some of these schemes carry with them extensive contingent liabilities for the government. For example, the government guarantees a minimum rate of return for the individual capital accounts – in effect a state guarantee for all the firms that manage those accounts.

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<sup>28</sup> It should be emphasized that the discussion of military rule applies only to their economic policies and no other inferences should be drawn from it. Many of the economic reforms were also refined and made sustainable following the return to democracy.

<sup>29</sup> For further information, see Vial Ruiz-Tagle, J and F. Castro. *The Chilean Pension System*. OECD Journal on Budgeting. Volume 1, N° 1. 2001.

### 2.2.2. Structural Budget Surplus Rule

6. Starting in 2001, Chile adopted the fiscal rule that it would operate each year with a one-percent of GDP structural budget surplus<sup>30</sup>. This is not enshrined in legislation but is rather a political commitment of the current government.

7. A structural budget balance aims to eliminate the effects of cyclical fluctuations of economic activity on the budget balance<sup>31 32</sup>. When the economy is performing above its long-term potential, the government should return a nominal surplus. When the economy is performing below potential, the government should return a nominal deficit. Over the cycle, these should even each other out.

8. There were several reasons advanced in Chile for the introduction of this rule.

- First, it wanted to formalize the fiscal prudence that has characterized the management of government finances. There was a view that fiscal discipline had depended excessively on the commitment of a relatively small group of actors and this sought to institutionalize it.
- Second, a formal rule served to increase transparency and predictability in the conduct of fiscal policy.
- Third, this allowed Chile to operate a counter-cyclical fiscal policy within an overall framework of fiscal responsibility.

#### **Box 2. Why One Percent?**

The decision to target a 1% of GDP surplus – as opposed to a zero balance – was taken in order to offset a perennial 1% of GDP deficit at the Central Bank of Chile. When the two are consolidated, the public sector has an approximately zero balance.

The Central Bank was the vehicle used to bail out the banking system in the early 1980s and this deficit represents largely the interest rate differential on the debt assumed from the banking system and the loans used to finance them. There are on-going discussions in Chile of recapitalizing the Central Bank.

<sup>30</sup> This rule applies to the national government only. It should, however, be noted that the sub-national level of government is small in Chile.

<sup>31</sup> For further information on calculating structural budget balances, see *Structural Budget Balances: A Methodological Note* in OECD Economic Outlook – Sources & Methods.

<sup>32</sup> For a technical description of Chile's fiscal rule, see Marcel, M. et al: *Structural Budget Balances: A Methodology and Estimation for the Chilean Central Government* and Report on Fiscal Finance (2003).

9. It should be emphasized that calculating structural balances is, at best, an uncertain science and frequent ex post revisions are generally made to their calculations. They should be considered an approximation because of their inherent uncertainty.

10. In Chile, all calculations of the structural balance are performed by adjusting the revenue side of the budget as no expenditures are judged to have a significant automatic cyclical component. These adjustments estimate what the revenues would be if the economy was operating at full potential and copper prices at their long-term average. There are two separate exercises done for this purpose. The first one is to calculate the output gap to measure the effect of the economic cycle on tax revenues. The second is to calculate the long-term price of copper and the effect of deviations from that. (See *Box 3* for further discussion of the role of copper in Chile's economy and fiscal finances.)

11. During the first year of the use of the structural balance rule, these calculations were performed in-house by the Ministry of Finance. There was some skepticism voiced by the opposition and other commentators on this procedure, especially since it was difficult for non-specialists to understand the process.

12. To limit the possibility of irresponsible fiscal behavior through the calculation of these reference levels, and to increase the credibility of the new policy framework, the Ministry of Finance established after the first year two independent panels to carry out the forecasts. As is discussed later in the chapter, this takes place about two months prior to the presentation of the budget proposal to Congress.

13. The "output gap" panel consists of 14 economists appointed by the Minister of Finance for one year at a time. The same economists are generally re-appointed. The panel members are most often well-known economists from academia and research bodies, and a balance is kept between economists identified with the opposition political parties and with the ruling parties. The panel meets twice during the budget season. At the first meeting, the panel discusses methodological aspects of the model used. At the second meeting, each member of the panel submits his forecast for the various inputs required by the model. Each of the 14 estimates is published anonymously so that the each forecaster recognizes their own. The two extremes on either side are discarded and then a simple average of the remaining 12 forecasts is used. There is no discussion to achieve a consensus among panel members.

14. The copper price panel also consists of 14 individuals appointed in the same fashion by the Minister of Finance. They are employees of mining companies and related enterprises, as well as financial analysts

in this sector. This committee estimates the average long-term (10-year) price for copper as the reference price. Again, the panel meets twice during the budget season. Each panel member submits his estimate which is published anonymously. The two extremes are discarded and a simple average of the 12 remaining forecasts is used. No consensus is sought.

15. The establishment of these independent panels seems to have successfully alleviated fears about the impartiality of the calculations underlying the structural budget surplus.

### ***Box 3. Copper Stabilization Fund***

Chile's fiscal finances are heavily dependent on the volatile price of copper, Chile's leading export. About 4 percent of total government revenue comes from copper, but copper feeds through the entire economy so economic growth is correlated with the price of copper.

The volatility of the price of copper has had a very negative impact on fiscal finances as expenditures would generally shift upwards when the price was high whereas a downward shift when the price was low did not occur and deficits resulted. In 1987, the Copper Stabilization Fund was established. It was designed to partially isolate the available fiscal revenues from the cyclical fluctuations in the price of copper. When the price of copper goes above a certain target, the extra revenue is deposited in the Fund and is not available to the budget. Similarly, when the price of copper falls below a certain target, the revenue shortfall in the budget is compensated for by making withdrawals from the Fund.

The structural budget surplus rule has effectively superseded the functions of the Fund, and it can now be viewed as redundant to a large degree.

16. The structural budget surplus rule would appear to have performed well since its inception and has definitely served to set a hard budget constraint for the aggregate level of expenditures. In fact, opposition political parties supported the fiscal rule primarily as a vehicle to put a break on spending growth. In this context, it should be noted that it is extremely difficult to secure Congressional approval for increases in taxation in Chile.

17. The fiscal rule requires adjustments within the year in order to keep to the target. The fact that the Chilean government has in fact done so has greatly enhanced its credibility. For example, tariffs were reduced significantly in 2003 following the signing of Free Trade Agreement with the European Union. In order to compensate for the loss of revenue, measures were immediately taken to reduce expenditures

within the year<sup>33</sup>. Again, it should be emphasized that this refers to the performance of actual revenue and expenditures against the calculated structural balance. Errors in the calculation of the structural balance itself would not be known until well after the fact when more information is available to judge the structural-cyclical components of the budget.

18. Finally, it is appropriate to note a comment from a leading participant in the Chilean financial market. He stated emphatically that the markets did not pay great attention to the structural fiscal rule. The markets focused on the conventional deficit and viewed a conventional deficit of 1-2% of GDP as acceptable. The structural surplus rule, however, serves to set boundaries for the actual deficit, so the two can be said to work in tandem in that respect.

### 2.2.3. Annual Budget Cycle

19. The Chilean budget cycle is divided into two very distinct phases. The first one focuses on a critical examination of on-going programs and updating baselines. The second focuses on funding new programs and expansion of on-going programs through a central *Bidding Fund*. This is, however, subject to the availability of resources. For example, there was no second phase at all in the formulation of the 2004 budget.

#### **Box 4. The Budget Office**

The Budget Office is an agency of the Ministry of Finance and is headed by the budget director. Although formally reporting to the Minister of Finance, the budget director is appointed directly by the President and he may dismiss him at any time. The position of budget director is generally viewed as the equivalent of a senior ministerial position in the Chilean government. See *Chapter III* for further information on the government's organizational structure.

The budget office has a staff of around 200. In addition to the classic structure of having sectoral divisions shadowing respective spending ministries, the Budget Office has special units dealing with performance and results information, long-term budget studies, and financial management issues.

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<sup>33</sup> In addition, the rate of value-added tax was raised from 18 to 19 percent to compensate for the loss of revenue.

### *Phase I: Updating Baselines for Existing Programs*

20. The budget season starts in Chile in April following the end of the Southern Hemisphere summer. The Budget Office would then embark on an internal process of reviewing the execution of last year's budget and will also evaluate the implementation of the budget so far during the current year. As part of these reviews, the Budget Office will call meetings with the respective line ministries in order to exchange information.

21. These reviews include a systematic assessment of the performance and results of programs. These assessments are carried out by a special unit within the Budget Office and are discussed in detail in *Chapter IV* of this report.

22. Following these reviews, the Budget Office updates the baselines for on-going programs which then serve as their expenditure ceilings. This amount includes all expenditures that are mandated by law or contracts, and discretionary spending that is judged as continual by its nature. This may include increased expenditures for initiatives that have been established in previous years and are being phased in. An across-the-board cut ("efficiency dividend") is then deducted from this amount although some programs are exempted from this provision. The review of performance and results may also alter the level of funding for certain programs. The objective is to free up resources for the second phase of the budget formulation process.

23. These expenditure ceilings are formulated by the Budget Office in early June and are then officially communicated to line ministries at the end of June.

24. As is discussed in *Chapter III*, the Chilean government is divided into ministries and agencies. The maximum amounts are set for each ministry and each agency at the same level of detail as the budget. The maximums are, however, sent to the minister responsible and he/she can make any adjustments to them – i.e. reallocate between organizations – before forwarding them on to the agencies. Practices in this field vary across ministries, but in most cases the ministries simply pass the maximums on directly to the agencies without any adjustments.

25. Ministries and agencies can challenge the maximum amounts that they are issued but as this is very rarely successful such challenges are exceptional. This indicates the power of the budget office, and the

support it has from the Minister of Finance and the President. It is also important to bear in mind that these maximums only refer to on-going programs, not to new programs.

#### ***Box 5. Role of Medium-Term Projections***

In 2000, the Budget Office started maintaining baseline projections of government revenue and expenditures for the next three years. The aim is to keep these projections constantly up to date and they are reviewed twice a year: in May, when information on the execution of the previous year's budget is available, and in late September, when the budget bill and the official macro-economic projections are incorporated into the projections for the following year.

This is an internal document of the Budget Office and is only released to the public (or to other ministries) at a very aggregate level. There is no reconciliation between the projections from year to year in the public documents.

The document is not used as a tool for resource allocation. The Budget Office uses it to evaluate the overall trend in public revenue and expenditure to see how it is compatible with the over-reaching goal of maintaining the structural fiscal rule. As such, it assists in determining the availability of total resources. The May update provides guidance on resource availability until the independent panels on the structural balance meet in August to finalize the level of resources available.

#### ***Phase II: The Bidding Fund***

26. The second phase of the budget formulation process focuses on the Bidding Fund for new initiatives. As noted, the size of the Fund varies with the economic cycle and there was no Fund used for the 2004 budget. In general however, the Budget Office strives that the Fund be sufficiently large to be relevant in political terms. This has meant a fund that is about 2½ percent of total spending on average in recent years. Again, the Bidding Fund is financed by a critical examination of existing programs in the first phase and the added resources provided by a growing economy. The discussion below refers to the years when the Fund is in operation.

**Box 6. Budget Formulation Timetable**

<b>April-May</b>	Updating baselines. Initial bilateral meeting between budget office and line ministries.
<b>June</b>	Maximum amounts for on-going programs established.
<b>Early August</b>	Bilateral meetings between Budget Office and line ministries.
<b>Early August</b>	Meetings of panels on economic assumptions.
<b>End August /</b>	Line ministries submit proposals to “Bidding Fund”.
<b>Early September</b>	
<b>2<sup>nd</sup> week of</b>	Draft budget discussed with President.
<b>September</b>	
<b>3<sup>rd</sup> week of</b>	Bilateral ministerial meetings between Minister of Finance and
<b>September</b>	line ministers.
<b>4<sup>th</sup> week of</b>	Final preparation of documentation and pricing.
<b>September</b>	
<b>Last day of</b>	Budget proposal presented to Congress.
<b>September</b>	

**Fiscal Year = Calendar Year**

27. The launch of the Bidding Fund in 2000 was an effort to improve the quality of budget submissions from line ministries. First, it was designed to counter the incremental nature of the traditional budget process by having line ministries prioritize (rank) their requests for funding new initiatives. Second, it was designed to improve the technical quality of the funding requests which had varied greatly from ministry to ministry and were often lacking. This was accomplished by giving the Ministry of Planning the role of assisting line ministries in completing their bids in accordance with standards set by the Budget Office. This is discussed further in *Chapter IV* of this report. The reason for this arrangement is that the Budget Office found it incompatible with its role to assist line ministries in submitting requests for new funds. It should be emphasized that the Ministry of Planning has no decision-making authority over the bids.

28. This second phase of the budget formulation process starts in the first half of August with bilateral meetings are held between the budget office and line ministries. At these meeting, the submissions to the Bidding Fund are presented and discussed but no decisions are taken. These meetings are led by the relevant sectoral analyst from the Budget Office, and include the under-secretary of the line ministries and

the directors-general of the ministry's agencies together with their finance staff. The length of the meetings varies but they often last two-three days per ministry, depending on the number of agencies it has.

29. At the same time, the independent panels that calculate the structural budget balance meet. Following their conclusions, the Budget Office is in a position to finalize the overall level of resources available for the coming year. This in turn sets the ceiling for the amount of funds available in the Bidding Fund.

30. The Budget Office analyzes the various bids that have been submitted based on two criteria. The first is the technical quality of the bid. The second is the consistency of the bid with the political priorities of the President.

31. The consistency with the political priorities of the President is ensured (promoted) by an explicit system for communicating those priorities. First, the President will communicate these in his annual State of the National address to Congress in each year. Second, the staff of the President (Presidential Secretariat Ministry) will have bilateral meetings with each minister to discuss the President's priorities for the budget. These will first have been discussed thoroughly with the Minister of Finance and the budget director.

32. Based on these two criteria, the Budget Office proposes a list of new initiatives to be funded. The Minister of Finance and the Budget Director will then have one-on-one bilateral meetings with line ministers to discuss the proposals. The Minister of Finance and the budget director then have a meeting with the President to go over the proposal. As the proposals already take account of the President's priorities, the President generally accepts them with minor adjustments only.

33. The last step of the budget formulation process is for the Budget Office to finalize the budget documentation and to put the budget on the appropriate price level as all discussions will have taken place in the previous year's budget price levels. The budget document itself is a streamlined input orientated document. The budget office also produces supplementary documents presenting additional information on performance and results for each of the 18 "sectors" of the government. See *Chapter III* for a discussion of sectors.

### ***Box 7. Budgeting for the Military***

One of the legacies of military rule in Chile is that the military receives 10% of the gross revenue of the government-owned copper mining company (CODELCO) for equipment purchases. This amounts to about 0,4% of GDP. This is treated as an off-budget transaction. In fact, it was only in 2003 that a new law required for the first time the publication of how the military spends this money. The military may also borrow directly in order to finance equipment purchases. The Budget Office limits the amount of borrowing to what can be serviced with the proceeds of the 10% copper revenues. This borrowing is, however, not publicly reported.

#### **2.2.4. Conclusions**

34. Chile has an outstanding record of fiscal responsibility and a sophisticated budget formulation process.

35. The structural budget surplus rule appears to function well in Chile's political environment although it is too early to draw any firm conclusions regarding its sustainability. All the early indications are however positive. The independent panels used for calculating it are especially noteworthy, although the inherent uncertainty of such calculations is surprisingly little discussed in Chile.

36. Similarly, the Bidding Fund system appears to perform well. The process for deciding bids is understood well and the explicit linkages with the political priorities of the President are exemplary in operation. Framing discussion on new initiatives in the context of this notional Bidding Fund would appear to have increased the quality of submissions from line ministries.

37. Line ministries do not play a pro-active role in the budget formulation process. Internal reallocations between different components (agencies) of ministries are extremely rare. This is a legacy of a very centralized budgeting system. This is being redressed with the Budget Office now focusing its discussions solely on ministries, rather than talking directly with agencies. The needed culture change in line ministries will likely take an extended time to achieve.

38. Chile does not have a medium-term expenditure framework in the same sense as applied in OECD Member countries. Chile already has the foundation for such a system with the internal documents

currently used for macroeconomic purposes. It would be relatively simple to use it more actively for resource allocation purposes. This would greatly aid in the transparency of fiscal finances as well as promoting accountability.

39. Performance and results information is extensively used in the budget formulation process and it would appear to be well integrated with resource allocation decisions. The supplementary budget documentation on each sector presents this information in a very user-friendly manner.

40. The military is a special case in Chile's budget formulation system. The current state of affairs is highly inappropriate from a budgetary point of view. This is recognized in Chile and is slowly being rectified. This is, however, a very sensitive area.

## 2.3. Role of the Legislature

### 2.3.1. Introduction

41. Historically, Congress enjoyed a very strong role in the budget process in Chile. Starting in the 1830s, the Congress began to exert an ever-greater role and when the president tried to circumvent the budgetary powers of the Congress in the late 19<sup>th</sup> century a civil war ensued. Those allied with the Congress emerged victorious in the Civil War of 1891 and the primacy of the Congress was confirmed in budgetary affairs, and in general vis-à-vis the executive. The Congress, however, did not use its powers in a responsible manner and a general state of malaise ensued. Its role diminished steadily, starting with the 1925 Constitution. Today, the Congress enjoys very limited powers in the budget process. It simply appears to be accepted across the political spectrum that Congress would act irresponsibly in the budget arena if it were given any substantive power.

42. Congress was completely closed during the military take-over in 1973 and did not re-open until 1990 with the return to democracy. All accountability mechanisms were suspended during this time and no comprehensive budgetary information was made publicly available. The current government has made improved accountability to the Congress a priority. For example, a formal agreement was signed in 2002 between the executive and the Congress for the government to conform to the *OECD Best Practices for Budget Transparency*.

43. This chapter reviews the current congressional budget process. It concludes by discussing possible avenues for the future development of the role of Congress in the budget process.

#### **Box 8. The National Congress**

Chile's *National Congress*, located not in the capital Santiago but in the coastal town of Valparaiso, is a bicameral institution with a Chamber of Deputies and a Senate

The Chamber of Deputies has 120 members. They are elected from 60 two-member electoral districts and serve a four-year term. The Senate has 38 elected members. They are elected from 19 two-member electoral districts and serve an eight-year term. Half of the Senate's electoral districts are up for elections at each election to the Chamber of Deputies.

In addition to the elected members, the Constitution provides for former presidents to serve in the Senate for life after they leave office, as well as for nine other members to be appointed to the Senate for eight-year terms on an "institutional" basis, including four nominated by the military.

Chile's congressional elections are governed by a unique binomial system that rewards coalition slates. Each coalition can have two candidates for the two Senate seats and the two Chamber of Deputies seats in each electoral district. Typically, the two largest coalitions split the seats in a district. Only if the leading coalition ticket out-polls the second-place coalition by a margin of more than 2-to-1 does the winning coalition take both seats.

#### **2.3.2. Current Congressional Budget Process**

44. The budget is presented to Congress on the last day of September. This is not an important moment in the political calendar in Chile. In fact, the Budget Office has purchased advertisements in newspapers in order to provide information on the contents of the budget proposal.

45. There is no discussion of the budget in plenary session of either chamber of the Congress upon its introduction. The budget is automatically referred to the Budget Committee. The Budget Committee is unique in that it is a joint committee of both chambers of the Congress. In the past, this committee was a temporary *ad hoc* committee formed each year and operating only for a short period of time immediately following the introduction of the government's budget proposal. Effective in 2003, the Budget Committee has become institutionalised as one of the permanent committees of the Congress and will therefore

operate year-round. The Budget Committee consists of 26 members, drawn equally from the Senate and the Chamber of Deputies.

**Box 9. Constitutional Restrictions on the Role of Congress**

The Congress may only decrease expenditures for any program the government proposes. It may not increase expenditures, and it may not reallocate expenditures between programs.

The Congress cannot amend the economic assumptions or the revenue forecasts used in the budget proposal.

If the Congress does not approve a budget (either the original proposal from the government or one amended by Congress) by 30 November, the original government proposal becomes law.

The Congress may not scrutinize arms purchases by the military. This applies to the 10% of the gross revenue of the government-owned copper mining company (CODELCO) which must be transferred to the military.

The President sets the agenda of the Congress by giving priority status to bills that he desires and gives Congress a given number of days to consider them.

46. As noted, the budget is referred automatically to this committee without prior action in either house in plenary session. During the first week of October, the minister of finance introduces the budget by making an address to the Budget Committee highlighting the state of the economy and major policy decisions contained in the budget. The following day the budget director makes an address to the Budget Committee highlighting the various technical aspects of the budget. Each of these meetings lasts for approximately a half-day with members of the Committee asking the minister and the budget director questions following their presentations. The budget director will also have had meetings with the budget committee and informal meetings with each political party represented in Congress to provide information ahead of the introduction of the budget.

47. After receiving the minister of finance and the budget director in plenary session, the Budget Committee divides into five sub-committees each focusing on a different set of ministries. Each committee has five members (except one that has six). The scrutiny of the budget proposal takes place in these sub-committees. Each ministry and agency is examined during a four-week period. The length of examinations differs, but generally take two or three days for each ministry. The sectoral minister and the heads of every agency that he's responsible for attend the examination.

48. Following these examinations in sub-committees, the Committee reconvenes in plenary session and the conclusions of each sub-committee are discussed. As a rule, the Committee endorses the findings of the sub-committees.

49. The budget is then referred to both the Chamber of Deputies and the Senate where it is discussed very briefly and then approved in a series of ministry-by-ministry votes. Numerous amendments are still proposed at this stage by members of Congress, but some are dismissed as out of order (inelligible) and others are voted down by the government’s majority. If the votes from both chambers do not coincide a special committee of both houses is formed. This special committee would make a proposal which must be voted without amendment in both chambers. The budget is generally passed in late November. It would appear to be a matter of pride for the Budget Committee to have enacted the budget in as short a period of time as possible.

***Box 10. Congressional budget timetable***

<b>Last day of September</b>	Budget presented to Congress Budget referred automatically to the Budget Committee
<b>First week of October</b>	Minister of Finance makes policy address to Budget Committee
<b>First week of October</b>	Director of the Budget makes technical address to Budget Committee
<b>October-November</b>	Budget Committee forms five sectoral subcommittees to scrutinize the budget proposal
<b>Mid-November</b>	Budget committee finalizes report on the budget proposal
<b>Mid-November</b>	Budget approved by Congress
<b>November</b>	Protocol signed between Budget Committee and Budget Office
<b>1 January</b>	Start of fiscal year.

50. As noted above, even if the government’s budget proposal (or one amended in accordance with the restrictions noted above) was not approved by 30 November, the government’s original proposal would nonetheless become law according to the Constitution. This has, however, never happened and would appear today to be considered politically unacceptable. This opens the way to behind-the-scenes negotiations whereby the government itself decides to introduce amendments to the budget that are desired by Congress. Similarly, members of Congress have made their vote on unrelated legislation – the Free Trade Agreements were cited as an outstanding example – conditional upon desired changes in the budget. The frequency of such behind-the-scenes interventions is, however, said to be rare.

51. The Congress can also place restrictions on individual appropriations, for example by mandating that a certain part of the total appropriation be spent on a specified activity. This respects the constitutional provision that the total appropriation not be increased and at the same demonstrates the will of Congress. These are, however, also rare. (These restrictions are further discussed in *Chapter III*.)

52. The Budget Committee is assisted by a secretary, who is mainly responsible for ensuring that the rules of procedure in the Congress are adhered to in the discussion of the budget. An embryonic budget research office has also recently been established with a professional staff of three analysts. It should also be noted that think-tanks associated with political parties are very active in policy research and that each member of Congress gets a stipend to purchase technical assistance.

53. Since 1997, the Budget Committee and the Budget Office have agreed on a “protocol” at the end of each budgetary cycle. This is not legislated but is rather a signed and formalised political document between the legislative and executive branches. These protocols have become more elaborate in each year and are commitments by the executive to provide information to Congress on budget-related matters throughout the year. For example, a recent protocol commits the government to conform to the *OECD Best Practices for Budget Transparency*.

54. In formal terms, Congress can be described as having very limited impact on the budget policy of the government. The current budget process is designed for Congress to swiftly approve the government’s proposal with no changes. The influence of Congress in informal terms would also appear to be small, despite the instances mentioned above. The introduction of the structural budget surplus rule was, for example, not even discussed with Congress before being introduced. Whether this passive role for Congress is sustainable – or desirable – is certainly open to debate. The role of the legislature in OECD Member countries is certainly greater, and increasing in many cases.

### **Box 11. Audit**

The *Comptroller-General of the Republic* is Chile's supreme audit institution. In constitutional terms, it is not an office of the legislature but is rather considered a co-equal branch of government. The Comptroller-General is nominated by the President and confirmed by the Senate and his term of office is until he reaches 75 years of age. He can only be removed before then by being impeached for gross misappropriations of duties. He sets his own budget, level of staff, and salary in consultation with the President and the Senate.

It is a most unusual body in that it acts not only as an audit office but also pre-approves all expenditures and staff actions in order to ensure their legality. The case for modernizing this office and re-launching it as a modern auditor-general body appears appealing. As an office of the legislature, it would also assist the legislature with its oversight duties in holding the government accountable. In such a reformed model, the pre-approval of expenditures and staff actions would no longer be performed by the body.

### **2.3.3. Conclusion**

55. As noted in the introduction, Chile's *National Congress* had once a strong role in the budget process. Although there appears to be general satisfaction with the very limited role of Congress at present, it is worthwhile to consider that this may change in the future and that the Congress would take a more active role in the budget process. Despite their rarity, the behind-the-scenes negotiations on the budget and the restrictions placed by Congress on individual appropriations point in this direction.

56. Congress at present has a limited institutional capacity to consider the budget, as shown by the fact that a permanent budget commission is only being established this year. By not further developing its institutional capacity, the long-term risk may be that Congress would regain a stronger role in the budget process but without the institutional features to promote fiscal discipline and responsibility in its use.

57. The efforts to provide improved budgetary information to Congress are commendable, including the commitment to conform to the OECD Best Practices for Budget Transparency. Accountability of the government to the legislature could also be improved by re-launching the *Comptroller-General of the Republic* as a modern audit office and as an office of parliament.

### ***Box 12. The Swedish Parliamentary Budget Process***<sup>34</sup>

During 1996 and 1997, fundamental changes were made to the manner in which the Swedish Parliament approves the budget. There are no restrictions on parliament's ability to amend the budget but a rigorous institutional process has been put in place to promote budget discipline. It is one of the most modern parliamentary budget processes in OECD Member countries.

The key reform focused on introducing a top-down budgetary process where aggregate levels of expenditure are approved before individual appropriations. This operates on several cascading levels. A Spring Fiscal Policy Bill is presented to parliament in April, five months before the budget is submitted to parliament. The Bill proposes limits on the aggregate level of government expenditures and government revenues. Parliament debates these aggregate limits and enacts them into law in early June. Again, there are no restrictions on parliament's ability to amend the government's proposal. The Bill has created a vehicle whereby debate in Parliament can focus on the appropriate size of the public sector and the economic impact of various combinations of aggregate revenues and aggregate expenditures. The Budget – which is presented in September - must be in conformity with the aggregate level of revenue and expenditures as approved in the Spring Fiscal Policy Bill. The Budget as presented to parliament is divided into 27 Expenditure Areas. Parliament debates and approves by late November the level of aggregate expenditure for each of the 27 Expenditure Areas. Again, there are no restrictions on changes as long as the total voted in the Spring Fiscal Policy Bill is respected. Finally, parliament decides in late December on the level of individual appropriations within each of the 27 Expenditure Areas. Parliament can make any changes to individual appropriations within the aggregate level of expenditure for each of the 27 Expenditure Areas.

A strong division of labor among the committees of parliament accompanied these reforms. The Finance Committee is concerned mainly with the aggregate level of expenditures and revenue as contained in the Spring Fiscal Policy Bill and in the level of total expenditure for each of the 27 Expenditure Areas. It has essentially been given the role of 'policeman' of the parliamentary budget process. Individual appropriations within an Expenditure Area are the concern of the relevant sectoral committee of parliament. For example, the health committee would recommend the allocation within the relevant Expenditure Area for health. (The 27 Expenditure Areas reflect the committee structure of parliament.) Involving the sectoral committees like this also supports the use of performance information by parliament.

Chile may wish to consider aspects of the Swedish system as it strengthens the institutional framework for the congressional treatment of the budget.

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<sup>34</sup> For a description of such a system in operation, see Blöndal, J.: *Budgeting in Sweden*, OECD Journal on Budgeting.

## 2.4. Management

### 2.4.1. Introduction

58. Management practices in Chile are presently being modernized at a very rapid pace.

59. This chapter reviews reforms undertaken in the area of organizational structures, human resource management, and financial management. A special emphasis is placed on managerial flexibility in Chile.

### 2.4.2. Ministries and Agencies

60. Chile has a presidential system of government with executive power radiating from the presidency to ministers. In addition to ministries, Chile has a long history of other types of organizations – known collectively as *services*. This organizational model dates back to the early 1800s. Currently, there are 18 ministries and 165 *services*. Both the ministries and services vary greatly in staff size.

61. In legal terms, all of the services report directly to the minister as equals. The fact that the President appointed the heads of the services in the same manner as ministers, and he could dismiss them at any time, has however served to muddle this relationship. In fact, the relationship between ministries and services in general has been unclear in many instances.

62. Reforms to re-launch this organizational structure as a modern ministry-agency structure along the lines of the Scandinavian countries are being implemented. The term *agencies* will be used hereafter to refer to the various services.

63. First, the notion of *sectors* was introduced. This entails formalizing the groupings of organizations around a minister into a ministry and agencies. There are 18 sectors, matching the number of ministries. This was largely a presentational issue but the implication was clear. Ministries were to be responsible for policy-making and coordination, whereas the agencies would be responsible for policy implementation. The results of this reform vary greatly between sectors as they depend on how the minister himself has decided to operationalize it.

64. Second, the Ministry of Finance has used the budget process to promote the ministry-and-agencies system. This is done by the Ministry of Finance communicating with the ministry as representing all the agencies in the sector – and not communicating with the agencies directly. The Ministry of Finance also encourages ministries to reallocate resources between agencies in the sector. Although the actual level of reallocations is low, the operation of the budget process has greatly aided in the “culture shift” in the sectors and the role of ministries as coordinators for the whole sector.

65. Third, and most recently, it was recognized that some of the agencies were actually policy-making in nature, rather than simply engaged in policy implementation. This resulted in 25 agencies being classified as policy making (or “centralized”) and 140 agencies as policy implementators (or “decentralized”). The former category includes the budget office, the latter category includes general service delivery, enforcement activities, and regulatory commissions. By recognizing the 25 agencies as being special, it will relieve tensions from the overall system and allow for the remaining 140 agencies to fit better into the modern ministry-and-agency structure being developed in Chile.

66. The management of all agencies is vested in a director-general<sup>35</sup>. Previously, all directors-general were selected by the President. Now, the president will only nominate the directors-general of the 25 policy-making agencies. For other directors-general, the positions will be advertised and an elaborate nominating process will operate. This reform is effective 2004.

67. A special nominations committee for directors-general will be created. It will consist of the head of a new human resource management agency and four other members who are appointed by the President upon confirmation by a 4/7 vote of the Senate. This nominations committee must present a list of no less than 3 and no more than 5 qualified people for all vacant positions of directors-general of agencies. The President may only appoint persons from that list; he can also reject them all and the whole process will start again. The President also enjoys the right to dismiss a director-general at any time. The appointments are for three years. They can be extended without advertisement twice for a total of nine years. After that, the competitive process must be opened again.

68. As part of this new reform, directors-general will sign contracts with their ministers concerning the goals of the agencies. This is discussed further in the *Chapter IV*.

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<sup>35</sup> In exceptional circumstances, the management of an agency vested with a collegium, or in a board of directors.

### 2.4.3. Managerial Flexibility

69. There are two aspects to managerial flexibility. The first is the legal detail of budget appropriations. The second is the various central management rules on implementing the budget, notably in the field of human resource management. This section will review Chile's position in these areas.

#### *Budget Appropriations*

70. For operating expenditures, each ministry and agency in Chile receives one appropriation for human resource and one appropriation for the purchase of goods and services. These are global amounts with no subdivisions among individual items of expenditures. The appropriations are considered maximums, i.e. there is not an obligation to spend appropriated funds. Some large organizations with a nationwide network have their appropriations divided among several regions, i.e. each region is treated as a separate agency.

71. In addition, there are a number of *restrictions* for each account. There are two types of restrictions. The first are common to all accounts and includes a maximum amount that can be spent on four items of expenditure: overtime, travel, training and on consultants. The amount of the restrictions originates with the Ministry of Finance in the budget proposal presented to Congress. The budget also contains a ceiling on the number of staff (posts) and the number of vehicles that each ministry and agency may have.

72. The second type is restrictions for specific appropriations. These generally earmark parts of a larger appropriation for specific projects. This can be viewed as simply a pragmatic approach to program budgeting. These restrictions generally originate in the Ministry of Finance as well. In other cases, they originate in Congress. As detailed in *Chapter II*, Congress cannot increase spending for any program, but they can use their power to reduce spending to force agreement with the Executive to mandate that a certain amount within a larger appropriation be spent on a certain project using this form of restrictions. It should be noted that these are relatively few at present.

73. A noteworthy feature of the Chilean system is that the all expenditures -- each and every transactions -- must be pre-approved by the *Comptroller-General of the Republic* in order to ensure their "legality." Certain other administrative acts must also be approved similarly. Even though the Comptroller-General has the authority to waive this procedure to whole categories of operations, for those not benefiting from such waivers, this can be a very cumbersome and time-consuming procedure.

74. As a general statement, however, the level of detail of appropriations allows quite wide managerial flexibility.

### ***Box 13. The Contingency Reserve***

The budget contains a contingency reserve. The amount of this reserve has been as high as 7.8% of total expenditures, but is now equivalent to 1.8% of total expenditures. The purpose of the contingency reserve is to fund legislation that Congress may enact after the introduction of the budget. The outstanding example of this is that the Congress approves salary increases for government employees in a special legislation in late December each year.

### ***Human Resource Management***

75. Chile has two types of human resource management systems operating side by side. The traditional system, known as *planta*, is highly inflexible. About sixty per cent of government workers are in this system. The remaining 40% are hired on contracts, the *contrata* system, which is flexible. The formal system is concentrated with older workers. Over 50% of public employees have less than 10 years experience and most of these are contract employees. It should be noted that the numerical ceilings on staff (posts) apply for both the traditional and contractual workers.

76. The employees in the traditional system are hired for life. They are classified into one of 28 pay categories and progression from one pay category to the next based on seniority only. There is also a fixed number of people in each category. By contrast, contract employees are hired on one year contracts, which are renewable. In fact, they are generally renewed and it is common for employees to spend their entire career in the government on such renewable contracts. They can be placed in the equivalent of any of the 28 pay categories, i.e. a person who would be classified into pay category 4 in the traditional system could be paid the equivalent of category 15 as contract employees. The contract system is generally used in Chile's private sector. Contract employees in the private sector receive one month's severance payment for each year worked (up to a maximum). Contract employees in the public sector, however, receive no such payments.

77. Similar to the reformed process for appointing directors-general, the government is introducing reforms to the hiring and promotion of staff in the *planta* system. Promotions are to be competitive with

positions being advertised and an independent panel reviewing the candidates. If no suitable persons are available within the organization, the position may be re-advertised and opened to persons from outside the organization. At the same time, the government launched an incentive package for the early retirement of older employees. This applies to the *planta* system. The government intends that a reformed *planta* system will reduce the reliance on the *contrata* system.

78. There is a further category of employees, which can be termed “consultants.” They give an invoice for their services and are paid with no reference to the 28 pay categories at all. These positions were traditionally used for special ministerial advisers and persons with exceptional skills for a certain project on a short-term basis. However, this system began to be used in order to pay higher salaries to people in occupations of high demand, such as computer specialists. This system was also abused and as a result has been reformed. A ministry or agency (through its ministry) can apply to the Ministry of Finance to have certain positions designated as “critical.” Such designations can allow an increase in salary of up to 100% to be paid on an on-going basis. At the same time, the restrictions in the budget on the total amount that can be paid to consultants was introduced as noted above.

79. The public sector is heavily unionized in Chile. There is, however, no formal collective bargaining permitted and salaries are set by an act of Congress each year. Since the return to democratic rule, however, the government and trade unions have regularly carried out informal negotiations over salaries and working conditions in the public sector.

80. A new Personnel Agency is being created in the Ministry of Finance. Its primary role is to assist the nominations committee for directors-general of agencies and the selection panels for positions within organizations. However, its mandate is quite wide for implementing human resource management policy in general. Previously, this had been a function of a unit within the Budget Office.

#### **2.4.4. Financial Management**

81. A number of reforms are underway to improve financial management in the Chilean government.

82. At present, all government accounts are maintained in a government-owned commercial bank, the *Banco del Estado*. Taxes to the government can be paid in any commercial bank which then has 3 days to forward it to the government’s account with the *Banco del Estado*. All government ministries, agencies and

regional offices maintain their own bank accounts at the *Banco del Estado*. There are some 5,000 accounts in all as separate accounts are often opened for individual projects. Each entity makes its own payments from this account following approval from the *Comptroller-General of the Republic*. There is no central payment system. A daily statement is prepared by the *Banco del Estado* showing the revenues deposited and payments disbursed each day. This statement is not made publicly available.

83. The balances of these accounts are not swept overnight and invested by the government. The Bank invests these balances overnight for its own gain. Regardless of the fact that the bank is government-owned, this is highly inappropriate and reforms to this practice are under discussion.

84. Significantly, the Ministry of Finance does not have access to information on the balances in the accounts. Other ministries and agencies delay their responses to such questions and the *Banco del Estado* claims that bank secrecy laws prevent it from giving the information to the Ministry of Finance.

85. The Ministry of Finance transfers money from its main account to the 5,000 accounts in accordance with an official monthly schedule of revenues and expenditures (apportionment) for each government ministry and agency. This schedule is prepared in January, but is revised frequently in response to the development of fiscal revenues and the timing of capital projects. It is not publicly available.

86. A monthly report is prepared on the revenues and expenditures of the government. This is audited and is available 45 days from the close of each month. The report specifies revenues and expenditures at a highly aggregated level. For example, expenditures are not classified by government organizations which are only published on a semi-annual basis. On a quarterly basis, additional summary information on the government's financial assets and liabilities is presented. These reports are publicly available.

87. An annual financial report is prepared and is available 3 months following the close of the fiscal year. As it is based on the audited monthly reports, this document is not specifically audited by the Supreme Audit Institute. It is publicly available.

88. A capital charging system is being implemented in three phases. In phase 1, a comprehensive asset register is being assembled. Phase 2 will see the valuations of those assets and Phase 3 will see the levying of a capital charge. This is expected to be implemented in 2005-2006.

89. The government's budgeting and financial reporting system are presently on cash basis. Chile is adopting *GFS / Government Finance Statistics* as the basis for its budgeting and financial reporting which

is on accrual basis. This is, however, a statistical framework and not an accounting framework and poses important conceptual challenges<sup>36</sup>.

#### 2.4.5. Conclusion

90. It is clear that Chile is undertaking a large number of initiatives in order to modernize the management of the public sector.

91. Chile is very well placed to re-launch the government's organizational structure as a modern ministry-and-agencies model. Managers enjoy a high degree of flexibility in the operation of their institutions and this flexibility would appear to be exercised in a responsible manner.

92. The depoliticisation of the appointments for directors-general of agencies and the move to a merit based system -- rather than a seniority based system - for the promotion and hiring of officials are reforms of huge importance. The government's apparent objective of increasing the reliance on the *planta* system – at the expense of the *contrata* system -- need however to be implemented with caution. The *contrata* system has served the government well and is a very established part of the Chilean government. A more urgent reform would appear to be the need to improve the conditions of contract employees if their contracts are not renewed, i.e. by giving them severance payments in line with private sector practices.

93. The financial management reform agenda is especially ambitious. The reform to the cash management system – especially the activities of the *Banco del Estado* – are urgent. The introduction of a capital charging system will improve asset management as well.

94. Chile needs to be careful in relying on a statistical framework, rather than an accounting framework, as the basis for its budgeting and financial management. Although international efforts to harmonize them are underway, there are at present large conceptual gaps between the two.

95. Finally, the role of the *Comptroller-General of the Republic* in pre-approving all expenditures should be reviewed. Effective internal controls and audit should be sufficient to assure the legality of transactions.

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<sup>36</sup> See *Catalogue of Issues – Comparisons of GFS, IPSAS and ESA* for a detailed listing of these differences [GOV/PGC/SBO(2004)1].

## 2.5. Accountability for Performance

### 2.5.1. Introduction

96. This chapter examines the development and use of performance information in the budget process. It is divided into four sections: 1) describes the four different approaches used by the Ministry of Finance to assess the performance of agencies and programs, 2) examines the integration and use of performance information in the budget process, 3) assess the methods for reporting on performance and 4) discusses the mechanisms used to report on performance to the legislature.

### 2.5.2. Performance Programs of the Ministry of Finance

97. The Ministry of Finance has a highly developed albeit complex system for obtaining information on agencies' and programs' performance, which combines performance measurement with evaluations. It first began experimenting with performance indicators in the budget process in 1994. A decade later, there are five different tools used by the Ministry to focus its public sector on performance. A special unit called the Management and Control Division within the Budget Office of the Ministry of Finance works on designing and implementing performance systems and on the subsequent monitoring of line ministries' results. The table below sets out the different performance information tools and their date of introduction. Each of these tools will be discussed in more detail.

**Table II. 1. Performance Information Tools**

<b>Name of Tools</b>	<b>Year</b>
Performance Indicators	1994
Evaluations	1997
Comprehensive Management reports	1997 <sup>37</sup>
Management Improvement Programs	1998
Bidding Fund	2001

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<sup>37</sup> This tool will be discussed in Section 3.

### *Performance Indicators*

98. This program was initially launched in 1994 on a volunteer basis. Line ministries that participated in the program developed performance goals or targets and indicators that were included in the budget process. In 1998, the program was removed from the budget process. The main reason for this change was the introduction of the Management Improvement Programs (MIPs) which incorporated indicators and targets linked to salary bonuses without relating these to the budget. However, MIPs encountered problems the agreed targets were low and the results difficult to verify. In 2001, as a result of these difficulties, MIPs were reformulated and performance indicators were removed from this program and re-introduced into the budget process.

99. Initially after this re-introduction into the budget process, agencies prepared the performance indicators, goals and targets and presented them along with their budget proposal to the Ministry of Finance. Since 2002, the Ministry of Finance has sent proposals for performance indicators to the agencies, which they can alter before submitting them to the Ministry of Finance.

100. The Budget Office reviews these submitted indicators and goals to evaluate technical standards and to ensure that targets and goals are consistent with budget appropriations. Then the Budget Office and the relevant ministry discuss the performance indicators and targets that will be included in the supporting budget documentation. The selected performance indicators and goals are incorporated in the information reports which accompany the Budget Bill presented to Congress.

101. The number of agencies taking part in this program has gradually increased. By the 2004 budget 132 agencies were participating and they produced a total of 1684 performance indicators (averaging 12.8 per agency). See Table 2 below for details on the total number of performance indicators produced between 2001-2004.

**Table II. 2. Number of Performance Indicators: 2001-2004<sup>38</sup>**

Functions	2001		2002		2003		2004	
	N°	%	N°	%	N°	%	N°	%
General	53	19%	82	15%	215	21%	318	19%
Social	113	41%	266	50%	500	48%	803	48%
Economic	109	40%	189	35%	324	31%	563	33%
<b>Total indicators</b>	<b>275</b>	<b>100%</b>	<b>537</b>	<b>100%</b>	<b>1039</b>	<b>100%</b>	<b>1684</b>	<b>100%</b>
<b>N° agencies</b>	<b>72</b>		<b>109</b>			<b>111</b>		<b>132</b>

102. These measures seek to evaluate performance on different dimensions include economy, efficiency, and effectiveness. They include process, output, intermediate outcomes, and outcome indicators. However, the vast majority of indicators are processes and outputs measures. (See Tables 3 and 4 below for details).

**Table II. 3. Performance Indicators 2004: Function and Evaluation Dimensions<sup>39</sup>**

Functions	Effectiveness	Efficiency	Economy	Service Quality	Total	(%)
General	170	45	56	47	318	19 %
Social	405	118	123	157	803	48 %
Economic	273	70	96	124	563	33 %
<b>TOTAL N°</b>	<b>848</b>	<b>233</b>	<b>275</b>	<b>328</b>	<b>1684</b>	<b>100 %</b>
<b>%</b>	<b>50%</b>	<b>14%</b>	<b>16%</b>	<b>20%</b>	<b>100%</b>	

<sup>38</sup> Classified according to the Functional classification of Expenditure, Estadísticas de las Finanzas Públicas, Dirección de Presupuestos, Ministerio de Hacienda.

<sup>39</sup> Ibid.

**Table II. 4. Types of Performance Indicators in 2004**

Functions	Process	Output	Result			Total
			Intermediate	outcome	Total	
General	116	124	48	30	78	318
Social	224	394	122	63	185	803
Economic	173	261	117	12	129	563
<b>Total</b>	<b>513</b> <b>30%</b>	<b>779</b> <b>46%</b>	<b>287</b> <b>17%</b>	<b>105</b> <b>6%</b>	<b>392</b> <b>23%</b>	<b>1684</b> <b>100%</b>

103. The 2002 budget included 537 performance indicators; these were reported on in the first quarter of 2003. In this second round of evaluating performance results the agencies reported on 73% of them, with a 69% compliance rate within a range of 95%-100% (See Tables 5 and 6).

**Table II. 5. Performance Indicators Reported on and Fulfilled in 2002**

Functions	Number of Indicators				(%)	
	Reported	Agreed Not reported	Total	Fulfilled	Reported/total	Fulfilled/Reported
General	52	27	79	37	66%	71%
Social	187	79	266	134	70%	72%
Economic	155	37	192	99	81%	64%
<b>Total</b>	<b>394</b>	<b>143</b>	<b>537</b>	<b>270</b>	<b>73%</b>	<b>69%</b>

**Table II. 6. Degree of Compliance, by Functions Classification 2002**

Degree of Compliance	Economic	General	Social	Total	%
95% - 100%	99	37	134	270	69
90% - 94%	14	6	16	36	9
89% - 80%	15	3	12	30	8
< 80%	27	6	25	58	15
<b>Total</b>	<b>155</b>	<b>52</b>	<b>187</b>	<b>394</b>	<b>100%</b>
<b>Percentage</b>	<b>39%</b>	<b>13%</b>	<b>47%</b>	<b>100%</b>	

### *Evaluations*

104. The Budget Office makes use of evaluations as an important tool for stimulating performance and assisting in resource allocation. Currently there are three types of evaluations, desk evaluations, impact evaluations, and comprehensive spending reviews. Since the establishment of the program in 1997, a total of 151 evaluations have been conducted, 145 desk evaluations and 10 impact evaluations. The annual public expenditure of programs that have been evaluated is approximately 27% of total governing spending. In addition, three Comprehensive Expenditure Reviews have been completed. The annual spending of these agencies is 4.5% of total governing expenditure.

105. An inter-ministerial committee oversees all evaluations. The members of this committee include representatives from the Ministries of the Presidency, Planning, and Finance. The National Budget Office is accountable for the execution of all evaluations.

106. The following process is used to conduct desk evaluations. The Ministry of Finance submits a proposal to Congress with the names of the programs and agencies it wishes to evaluate in the coming year. After the programs have been agreed with Congress, external consultants are chosen to conduct the evaluations through a process of public bidding. The consultants carry out evaluations based on a logical framework methodology and procedural guidelines established by the Management and Control Division. The evaluation reports contain results and recommendations which can vary from advice to eliminate the program to requests to introduce minor changes. Since the establishment of the program in 1997 the agencies being evaluated have participate in the process by commenting on the intermediate and final

reports, including the recommendations. Additionally, since 2000 the relevant agency and the Budget Office have officially agreed commitments to improve performance based on these recommendations.

107. The process is similar for impact evaluations with two notable differences. Another methodological approach is used and these evaluations are contracted out either to research institutions or universities rather than external consultancies. Since it involves more field research and data collection this type of evaluation is expensive and time consuming. Given these cost implications it tends to be used for programs which represent a large amount of public spending that have not been evaluated or for programs where previous desk evaluations have failed to reach conclusions on outcomes.

108. A comprehensive spending review evaluates a ministry or agency. This evaluation examines, the structure, functions, mission statement, objectives and strategic management and planning framework of the relevant ministry. It also examines if the ministry used resources in an economic, efficient, and effective manner.

109. All final evaluation reports are sent to Congress, publicized on the internet site and available in the Budget Office. The recommendations of the evaluations are discussed with the relevant ministry. The ministry agrees with the Budget Office commitments to implement these recommendations. These commitments are then incorporated into a formal agreement between the Ministry of Finance and the relevant ministry. They are monitored in subsequent years to ensure that they have been implemented.

110. The recommendations from the 71 programs evaluated between 2000-2003 have resulted in 25% of these programs introducing a major redesign of their programs or institutional changes, 38% underwent substantial design modifications to some components and/or internal management procedures and 26% have had to improve their information systems and make minor changes to management processes. In addition 11% of these programs were eliminated in the light of their results and/or because their objectives no longer responded to new requirements (see Table 7 for more details).

**Table II.7. Implementation of Evaluation Recommendations 2000-2003**

<b>Categories</b>	<b>Percentage of programs</b>
<p><i>Minors Modifications</i></p> <p>Programs requiring minor adjustments such as improvements of information, follow up and monitoring systems, fine-tuning some aspects of design and or internal management process.</p>	26%
<p><i>Design Modifications of Some Components and/or Internal Management Procedures</i></p> <p>Programs needing mainly design modifications to some components or activities and/or internal management processes. Among the most important are: review of focalisation criteria or methodological tools; improvements of information, follow up and monitoring systems; improvements of internal and external coordination among staff and/or agencies involved; improvements of management procedures in relation to financial transfers within the different level of responsibility with respect to the execution.</p>	38%
<p><i>Major Program Reformulations and/or Institutional Re-location</i></p> <p>Programs needing substantial reformulation or deep changes in design, internal management processes and/or re-location to other agencies, with the aim of adapting to new elements of diagnostic and or ensuring more coherence and better integration among lines of action.</p>	25%
<p><i>Program Cuts</i></p> <p>Programs which have finished their execution period, previously defined, or whose results no longer justify their budget allocation.</p>	11%
<b>Total</b>	100%

111. In addition to the evaluation programs discussed above, the Ministry of Planning is responsible for Capital Projects Evaluations, formally known as the National Investment System. Since 1988 it has been a mandatory requirement that all investment projects must have an ex-ante evaluation. The Ministry involved in the investment project must submit an evaluation report to the Ministry of Planning for technical examination. Only if the evaluation is technically approved by the Ministry of Planning can the project be introduced into the budget proposal in the formulation stage.

### *Management Improvement Program (MIP)*

112. This program started in 1998 from an agreement with the public sector unions. It establishes a reward system for central government employees in which bonuses are determined by organizational performance. The program is similar to ISO in that it focuses on improving management processes within agencies against a pre-established benchmark. It seeks to contribute to enhancing performance by improving the internal management processes of ministries thus assisting agencies to achieve their wider objectives and targets.

113. In 2001, when performance indicators were removed from the MIP and re-introduction into the budget, the MIP changed to focus on assessing progress in managerial systems. By 2004 these managerial systems included Human Resources, Quality of Customer Services, Planning, Control and Territorial Management, Financial Management, and Gender Focus. Each of these areas is divided into systems and progress against every system is measured in stages 1 through 4 or 1 through 6. By 2004, MIP functioned in 88 centralized agencies and 89 decentralized agencies.

114. This program operates in the following way: the Ministry of Finance prepares a general framework program including areas, systems and stages. This is discussed and approved by the inter-ministerial committee. This is sent to each agency who prepare their proposal according to the framework program, stating the overall stage in each system they wish to achieve by the end of the year. These proposed systems are submitted to the Ministry of Finance, where they are reviewed by a specialist network. The systems are then sent to the Inter-Ministerial Committee for approval. This committee consists of members from the Ministry of Interior, Presidency, and Finance. If the proposal is approved by the committee, agencies will issue a decree that sets out their new commitments for the coming year. This decree is issued by the relevant Ministry and approved by the committee.

115. In the following year, agencies produce an MIP report detailing their progress against management objectives. The report is certified by a specialist network and each agency's internal auditors check the results and. In 2002, 79% of agencies achieved 90-100% compliance with MIP objectives and total compliance with objectives reached 93%. When the agency meets 90-100% of its organizational objectives staff will receive 3% salary increase for the following year and achieving 75%-89% of objectives results in a 1.5% salary increase for the following year.

### *Bidding Fund*

116. As discussed in Chapter 1, the bidding fund is a pool of unallocated resources to which ministries can submit bids either for new programs or to substantially extend or reformulate existing programs. Essentially the fund is a device for allocating new funds however, it is designed in a way that provides incentives for agencies to introduce formal performance indicators and targets.

117. Ministries submit bids in a standard format, which is based on a logical framework matrix. It incorporates the program's objective, main components, performance indicators, targets, target population, expected results, spending request, and its contribution to the relevant agency's overall strategic goals and outputs. The Ministry of Planning provides technical assistance to agencies in developing their matrix.

118. These bids are sent to the Ministry of Planning where they are reviewed and graded. They are then included in the relevant ministry's formal budget proposal. The Ministry of Finance makes a short list of programs taking into account the technical criteria and most importantly their relevance to government priorities. This list is sent to the President and it is part of the discussion on the total budget proposal. The President makes the final decision on which programs will receive funding. This process is described in more detail in Chapter I.

119. In the 2002 budget, 138 million US dollars was allocated to 126 programs. In 2003 budget, 116 programs received funding amounting to a total of 130.4 million US dollar, 90% of these resources were allocated to existing programs. Since the fund has been established, the number of new programs decreased from 61% in 2001 to 27% in 2003. This trend is explained by the fact that 2001 was the first budget of the new government who introduced its program priorities in this period. In all years more than 50% of resources were allocated to social functions.

120. Once programs have been selected, the Management and Control Division enters into discussions with the relevant agencies to decide which of the performance indicators and targets contained in their logical framework will be included in the information reports that accompany the budget bill. If the performance indicators are not of high enough standard to be included, the agency is required to work on developing satisfactory indicators during the course of the year.

121. In the subsequent financial years, if a program remains a high priority and performs well in terms of achieving results and developing relevant new indicators it will generally be included in the agency's

baseline. As discussed in Chapter I, there was no bidding fund for the 2004 budget due to lack of resources. In terms of performance, the bidding fund helped to motivate agencies to introduce indicators for new programs, to extend indicators to existing programs, and when indicators already existed to attempt to improve them.

### 2.5.3. Performance Information in the Budget Process

122. If performance information is to improve accountability and performance it is important that it be integrated into the budget process and used in decision making. This provides the opportunity to hold agencies accountable for results and to push them to achieve improvements in performance. In Chile, performance information is integrated into two stages of the budget cycle, the internal evaluation stage and the preparation stage.

123. Since 2001, performance information has been incorporated into the internal evaluation stage of the budget cycle. During this stage of the budget process, within the Ministry of Finance, the Budget Director, staffs from the Management Control Division and the relevant Budget Sector division, meet to assess each agency's annual progress. For each agency they discuss all financial and also performance information including progress against targets, results of evaluations, and the MIP. These meetings set the foundation and framework for the next stage of the budget cycle.

124. There are also separate meetings within the Ministry of Finance to discuss the results of evaluations. If the results and recommendations of these evaluations have consequences for allocation; decisions are taken in these meetings and discussed with agency heads at the preparation stage of the budget. If there are no implications for allocation, the results and recommendations are discussed with agencies after the Budget Bill has been sent to Congress. These discussions aim to develop a formal agreement on how the agency will implement the recommendations.

125. The preparation stage of the budget process, takes place after ministries have received their baseline and submitted their proposals to the Ministry of Finance. At this stage one on one technical committee bilateral meetings are held with the ministerial under-secretary, the head of each agency and relevant Budget sectoral division and staff from Management Control Division also participate. In each meeting, the relevant agency's budget proposal is discussed along with its past performance, proposed performance goals, and targets. There are several smaller meetings to examine the details of goals and targets.

126. The Ministry of Finance has developed a system, which integrates the results of evaluations and performance measures into the budget process. However, OECD experience demonstrates that the integration of the performance information into the budget cycle does not guarantee that it will be used in decision-making. It is a necessary rather than a sufficient condition for improving accountability for results and performance. In some OECD countries, this information has simply been ignored when it came to making decision about allocations.

127. The Chilean system of performance budgeting does not automatically and directly link performance to appropriations. It does not mechanically cut funding to programs that fail to meet targets or increase the funding of programs that achieve results. The Ministry of Finance has in fact sought to avoid the mechanical association of budget allocations to performance measures.

128. Rather performance information is used in the budget cycle along with financial and other information as a starting point for discussions with agencies. Resulting from these discussions performance data has been used to confirm existing allocations or when results were poor various actions have been taken to push agencies to improve performance. These include new performance conditions being established and incorporated into the Budget law and/or agencies agreeing to modifications in their programs. These promises are reviewed in subsequent years to see if performance has been improved. Furthermore, in some cases funding to programs has been reduced due to continuous failure to achieve improvements and in a few instances programs have been eliminated.

129. In our view the Chilean approach to performance budgeting is a sensible one. It recognizes that it is often not possible to routinely reward good performance through the budget allocation process, but performance motivation is achieved through a carrot and stick incentive structures. The carrot comes from the MIP system discussed in section one it provides pay incentives for employees and teams to improve processes which will assist in achieving goals.

130. The stick comes from the view, expressed by line ministries interviewed for this study that the Ministry of Finance would reduce funding or even possibly eliminate programs if performance did not improve. In practice the elimination of programs is a rare course of action. However, the fact that this has happened in a few cases and that the Ministry of Finance has both the power and the willingness to take this action or to reduce funding, serves as an incentive for ministries to improve performance.

131. The Ministry of Finance has developed a high-quality system for integrating performance information into the budget process and successfully combined this with a realistic use of this information in decision-making.

#### **2.5.4. Reporting on Performance to the Ministry of Finance**

132. The main mechanism used by line ministries to report to the Ministry of Finance on their performance is the Comprehensive Management Report. The 1997 Budget Law requires all agencies in central government to present information on their objectives, management targets, and results. This information is provided through the Comprehensive Management Reports, which all agencies are obligated to produce each year for presentation to Congress.

133. These reports are very wide-ranging and encompass the major activities and functions of the relevant agency. Each report includes the following items: a letter from the agency head, the laws and regulations that govern the agency, information on the agency's financial and human resources, and a detailed presentation of agency's performance results, this includes among others achievements against performance indicators, results of MIP goals and progress in implementing evaluation recommendations. Agencies' progress in implementing evaluation recommendations are reported on twice a year; in the Comprehensive Management report and also in July of each year.

134. The Comprehensive Management Report is produced in the first quarter of every year. The Management and Control Division, designs and sends to each ministry a standard format and structure for the report along with instructions. These instructions are produced by the Budget Office and the Ministry of the Presidency. Each ministry produces its report and sends it to the Budget Office, where it is reviewed and analyzed. The Ministry of the Presidency also reviews sections of these reports, which are relevant to its goals and priorities.

135. These results are analyzed, verified, and audited. Meetings are held with the Budget Office and the agencies for verification of the data and review of performance measures. Also the information databases and systems within ministries are audited by the Government General Internal Audit Committee. These audits are conducted on programs/agencies with a high public profile or on a random basis.

136. Since the re-introduction of performance indicators into the budget process there have only been two rounds of reviewing performance against targets. There are positive signs of improvement; however, there still are concerns about the quality of information provided, the linking of outputs to strategic goals, the provision of data against targets, and the timely provision of data. Given that agencies compete against their own past performance record it will take time to gather the necessary historical data to be able to gauge if the goals set are too high or too low and to monitor progress overtime.

137. There are also concerns about the technical capacities of individual ministries to develop performance indicators especially outcome measures and to monitoring progress against targets. Each ministry has to monitor and collect information from at least three if not four different performance programs and additionally provide information to the Ministry of the President on progress against goals. This gives rise to concerns about the ability of the ministries to co-ordinate the information from these different programs and to obtain and maintain the necessary data systems. Furthermore, it is unclear if managers and/or agencies use this performance information internally in making decisions on their programs or if it is just a reporting mechanism to the Ministry of Finance.

138. In the end the bounded nature of ministerial and managerial attention sets strict limits on the volume and complexity of performance information that will be properly utilized in decision-making. Having launched the performance reform, Chile like many OECD countries, will have to wrestle with how to select and prioritise the performance indicators and targets that most matter.

139. These issues are prevalent in OECD countries, where concerns have been expressed that performance management and budgeting runs the risk of becoming nothing more than a paper exercise. The Budget Office has sought to address some of these problems by including the development of management and planning system as one of the areas in the MIP program. It remains to be seen how this will progress.

140. It is too soon to predict if this revised system of performance indicators will prove effective however, despite the above issues the early signs are positive. The combination of evaluations and performance measurement provides strong mechanisms that enable the Ministry of Finance to hold agencies accountable for results, and provide instruments to motivate agencies to improve performance.

### 2.5.5. Reporting on Performance to the Legislature

141. The legislature receives information on the performance of agencies and programs from the Ministry of Finance in three different forms, the Comprehensive Management Reports, information on performance indicators, and reports from program evaluations.

142. Annually the Ministry of Finance sends a Comprehensive Management Report on each agency to the Budget Committee in Congress and relevant sub-committees. Performance indicators, targets, and goals are incorporated into the information reports sent with the Budget Bill to Congress. Progress against these targets and goals are included in the Comprehensive Management Report. The Budget Committee also receives final program and agency evaluation reports.

143. If the provision of this information is to improve accountability to the legislature it is important that Congress use it to hold the executive to account. The presentation of these reports is scheduled to ensure that the information is provided on time to be included in congressional debates on the budget.

144. Nevertheless, Congress has proven largely uninterested in examining performance information and using it in decision-making. It has demonstrated some limited interest in specific program evaluations. This is partly because Congress plays a role in the selection of programs to be evaluated. However, even in this area the attention given to the reports is sporadic and dependent on the political and media interest in the program evaluated.

145. Parliamentarians' lack of interest in performance information is common in OECD countries. The information executives consider important for management, is not necessarily the same that parliamentarians want for oversight control.

146. However, in the Chilean context this problem of lack of interest has been compounded by two factors. First, up until recently the Budget Committee was only in session for two months in the year and therefore, had little time to examine this information. Second the dominance of the Executive limits the ability of Congress to make decisions and to play any significant role in the budget process.

147. The first issue has been partly addressed, since July 2003 the Budget Committee has been running throughout the year. This provides more time to examine performance information and during interviews for this study the Budget Committee expressed an interest in doing this. The second factor reflects

constitutional features, which are difficult to alter, although some internal process adjustments may prove useful.

#### **2.5.6. Conclusion**

148. The Chilean Ministry of Finance has a highly advanced system for obtaining information on agency and program performance. Over a ten-year period, this system has been developed and adjusted to take account of lessons learned and changing demands. The Ministry has adapted performance systems to address problems, many of which are common within OECD countries and do not have easy or obvious solutions. Most importantly, the Ministry has proven willing to take a long time approach and to persist with performance programs.

149. Overall the Chilean performance system compares favorably with OECD countries especially in terms of the attention and priority given to performance information in the budget process. This system has combined the integration of performance information in the budget process with the sensible use of this information in decision-making.

150. If there is a weakness in the Chilean system, compared with the best of OECD systems, it is that the performance system is so heavily centralized. As a long term aim it would be desirable for agencies capacity to be built up so that they are a more equal partner in the decisions on indicators and measures.

151. Nevertheless, to date this is a success story. The key factor is the attention given by the Budget Director to performance information. This is reflected in his establishment of a separate unit, the Management and Control Division, the priority given to the use of performance information in the budget process, and the variety of different instruments reinforcing the performance idea. This strong role reflects the relatively unchallenged power of the Executive in the Chilean budget process. In an OECD context where, legislatures generally have a more powerful role, such a centrally directed process would not be feasible.

## 3. Korea

### 3.1. Overview of the Top-Down Process and Fiscal Rules

- *What were the original goals for introducing a top-down budgeting process? When was top-down budgeting introduced? How has it evolved (changed) since its inception? What is the general assessment of the top-down process at present?*

Korea adopted top-down budgeting in 2004 for the 2005 budget, following a pilot run involving 4 ministries for the 2004 budget. This means we have yet to complete a single complete budget cycle under a top-down framework. Currently, the second top-down budget proposal (for FY 2006) is under review at the legislature.

The budgeting process before the introduction of the top-down framework can be characterized as unproductive iterations of excessive requests from spending ministries being met by excessive cuts by the budget office. The process was not able to overcome the gaps in information asymmetries that existed on both ends, and the resulting inefficiency was exacerbated by unnecessary conflicts between the budget authority and line ministries. Increasing complexity in both public administration and budgeting finally forced the budget office to realize that scrutinizing and adjusting every individual program was no longer feasible.

The decision to switch to top-down budgeting aimed to eliminate inefficiencies due to asymmetric information by allowing line ministries to formulate their budgets within their respective predetermined ceilings. Line ministries are expected to take advantage of the greater discretion allowed to them to fully utilise their expertise in their respective areas. For its part, the central budget authority would be free to concentrate on the allocation of overall resources among the line ministries.

Concurrently with top-down budgeting, a medium-term expenditure framework (the 5-year National Fiscal Management Plan) has been introduced to bring resource allocation in better alignment with national policy priorities. Other fiscal reforms have been initiated as well, including performance-oriented budgeting, a comprehensive budget information system, and a program budget structure.

The introduction of top-down budgeting has significantly reduced the practice of “excessive requests-excessive cuts.” Before, the budget requests by line ministries averaged about a 25% increase over the

previous budget. With top-down budgeting, the increase rates have dropped to 5% and 7% for FY 2005 and FY 2006, respectively. This has dramatically reduced the need for the budget office to scrutinise and pare down budget submissions from spending ministries, which has also eliminated most of the time-consuming efforts by ministries to explain or justify their requests for individual programs and activities.

The new top-down system puts significant weight on ensuring that line ministries, experts from the private sector, and other interest groups have ample opportunity to contribute their input into the budgeting process. Nevertheless, there are still demands on the budget office to allow more time for substantive consultations with line ministries, and to further rationalize procedures for setting expenditure ceilings.

- *Is the expenditure ceiling linked to a formal fiscal rule, either in terms of deficits, debt and/or expenditures? If so, please describe the fiscal rule and how it is “operationalised” in the annual budget process.*

No formal fiscal rules are applied in setting expenditure ceilings. However, macroeconomic indicators such as the size of budget deficits and GDP growth serve as important factors in settings the overall envelope, i.e., the total available resources. In particular, the indicative National Fiscal Management Plan serves as an important basis for determining the annual expenditure ceilings.

### **3.2. Determining Expenditure Ceilings**

- *When are the expenditure ceilings set? For how long are they set? If multi-annual, are the ceilings adjusted every year?*

Between January and March, working groups meet to update their respective sectoral targets for the medium-term National Fiscal Management Plan. Public hearings and consultations are subsequently held between March and May to solicit feedback from various interest groups. The plan and ceilings are finalized at a Resource Allocation Meeting attended by all cabinet members, held usually between April 30<sup>th</sup> and May 1<sup>st</sup>, after which line ministries are notified of their respective ceilings on May 4<sup>th</sup>.

While the National Fiscal Management Plan is a rolling plan, and is revised and updated every year to reflect socioeconomic changes, the expenditure ceilings apply only to the upcoming year’s budget.

- *How are the annual ceilings determined? Do spending ministries submit bottom-up proposals ahead of the top-down ceilings being established, i.e. in order to inform the top-down decision? Or, are they required to submit proposals that do not exceed the ceiling in the first instance? In practice, do the annual ceilings usually end up as incremental adjustments to the previous year's ceilings?*

Expenditure ceilings are annually determined, and therefore are revised every year. The medium-term program plans, submitted by line ministries to the central budget authority in late January, serve as bases for setting the annual expenditure ceilings. Generally, the annual expenditure ceilings show an increase from the previous year's ceilings.

- *Please describe the political aspects of determining the expenditure ceilings. What is the role of the Minister of Budget vis-à-vis the Presidency / Prime Minister & Cabinet, and other spending ministers? When do most changes typically take place in the relative amounts of the ceilings? When a new government takes office? When a crisis takes place? Are there other "politically opportune" moments to affect significant changes?*

Despite the fact that Korea's political system is a Presidential system, the National Assembly, Korea's parliament, generally respects the expenditure ceilings set by the administration. Recently, however, there have been increased demands for ex-ante consultations with the legislative branch or submission of reports.

- *Are the ceilings made public? If so, when and how?*

Expenditure ceilings are not made public in Korea.

- *If there are changes between the initial economic assumptions (revenue forecasts) used as the basis for calculating expenditure ceilings and revised final ones, how are the ceilings adjusted to take account of this? How is the difference allocated among the ministries?*

In Korea, there have not been any cases where expenditure ceilings have been revised after they have been determined. Nevertheless, there are cases of supplementary budgets, as in this year, for cases of revenue shortfalls. For clarification, ceilings have not been changed during the budget formulation process, i.e., before a budget has been approved. However, after a budget has been approved, a subsequent, supplementary budget may alter the ceilings.

- *At what level of detail are the expenditure ceilings set? One global amount per ministry, or separate ceilings for sub-components, such as salary, other operating expenditure, transfers and investments? If so, what is the rationale? Are there different mechanisms in how the ceilings are decided for each category? Is there any possibility to transfer amounts between the various sub-categories?*

Once expenditure ceilings are determined for major programs of line ministries, current expenses are collectively adjusted to fit a certain level. Other expenses are adjusted for average yearly increase rates by using the remaining resources for adjustment, i.e. the budget margin.

- *Are any specific items in a ministry's overall ceiling, "ring-fenced," so that a spending ministry cannot allocate that money to other uses?*

If changes need to be made, most of the adjustments are carried out by restructuring spending items within the expenditure ceilings for the respective spending areas. To make additional changes in resource allocation, the budget margin, or resources which have been set aside for making adjustments, is used.

### **3.3. Interactions between the Central Budget Office and Spending Ministries**

- *Do ministries have an opportunity to appeal their given expenditure ceilings? Are ministries given feedback on why their ceilings were adjusted from the initial, bottom-up figures they gave (assuming there is a bottom-up component)? If so, in what form?*

In the preliminary stages of determining expenditure ceilings, there are procedures to solicit the opinions of line ministries and to consult with them on basic directions and principles for resource allocation. However, once the expenditure ceilings have been notified to the line ministries, there are no official mechanisms to allow feedback to and from the line ministries on these ceilings.

This is one of the factors responsible for the discontent among line ministries and their demands the procedures for setting expenditure ceilings be further rationalized. There are also demands that the consultations before the expenditure ceilings are determined should be more substantive.

- *How have ministries performed their role in making final allocation decisions within their respective spending ceilings? Do spending ministries have the capacity to make such decisions? Have there been*

*significant reallocations, or has it been largely incremental from the previous year? What is the overall assessment of spending ministries taking on this role?*

Currently, it is a fact that line ministries lack the experience in making allocative decisions. Furthermore, a key issue that needs to be addressed is how to ensure accountability of line ministries to balance the greater discretion allowed to them. Accordingly, in order to support the autonomous budget formulation and expenditure restructuring by line ministries, officials responsible for budgeting in 12 line ministries have been promoted in status from Budget Managers to Fiscal Planning Officers.

In addition, the Budget Advisory Committee in each spending ministry, chaired by its Deputy Minister for Policy and Public Relations Management, is taking on a more active role. A similar committee, chaired by the Minister of Planning and Budget, exists at the inter-ministerial level to help share the knowledge and expertise of the central budget authority.

- *What kind of “assistance” does the Budget Office provide to spending ministries in this respect, if any? Does the Budget Office provide guidelines to each spending ministry for their internal allocation decisions?*

The Ministry of Planning and Budget prepares detailed Budget Formulation Guidelines by line items and program types, and sends these guidelines to line ministries to support their autonomous budget formulation process. The Guidelines have been augmented after the introduction of top-down budgeting, and now contain more detailed and specific guidelines than the previous guidelines used under the bottom-up process.

- *What can the central budget office do if ministries' budgets (formulation/execution) violate its ceiling? Can the respective ministries be penalized? If so, how?*

A certain degree of resistance and disagreement is inevitable in allocating a limited amount of resources, and these challenges should be addressed by establishing an appropriate institutional mechanism for securing the consent of the line ministries. It would be necessary to reach agreements on fiscal discipline of line ministries and make efforts to ensure fiscal rules.

Furthermore, there is a need for detailed resource allocation criteria and principles that take into account the individual circumstances of the line ministries.

MPB “rewards” exemplary ministries with a 3% raise in personnel costs. So far we have not been able to devise effective penalties for non-compliant ministries. The latter typically violate their respective ceilings in two ways. First, there are ministries that submit budget requests in excess of their ceilings, leaving the hard final decisions in cuts to MPB. Second, some ministries have been found to deliberately omit parts of their statutory expenses—the reasoning being that the omitted expenses must be allowed later on in any case, while the approved discretionary spending will be easier to defend one way or another once it has passed muster.

- *Under what circumstances can the Budget Office overrule internal allocation decisions made by individual ministries? In practice, does this happen? In general, do ministries “worry” about defending their decisions to the Budget Office?*
- *Does the Budget Office have sufficient information in the top-down environment to effectively be able to second-guess and challenge the submission of spending ministries? At what level of detail does the Budget Office scrutinize the submissions by spending ministries?*

The central budget authority determines expenditure ceilings for line ministries, spending areas, and sub-areas, as well as for key budgetary programs. Therefore, it would be necessary, and agreeable, to scrutinize the budget requests up to a level which needs to be reviewed in order to set the expenditure ceilings.

However, exercising too much control over individual programs that are formulated autonomously by line ministries and meet the predetermined expenditure ceilings would encounter resistance from line ministries. If the program that is being reviewed follows the general resource allocation directions and principles, it would be desirable to respect the discretion of the line ministries in budgeting for individual programs.

### **3.4 Interactions between the Central Budget Office and the Legislature**

#### **3.4.1 General Background**

##### *Government*

Korea has a “Presidential” system of government, in which the President (elected every five years by direct popular vote) appoints his cabinet, albeit with the consent of the National Assembly (Korea’s unicameral legislature). The Korean system closely resembles that of the US in terms of relationships between the

administrative and legislative branches of government. Thus there may be less agreement between the two branches than in a parliamentary system, where the majority party in the legislature forms the cabinet.

Throughout most of Korea's history, the President's political party (the "ruling" party) also held the majority in the legislature. Recently, however, the opposition (parties other than the President's) occupies the majority of seats at the legislature.

### *Budgeting*

In budgeting, the US and Korean systems differ because of several factors. By law, the administrative branch has the mandate for budget formulation and execution. The legislature reviews and then approves the administration's budget proposal, as well as final account settlements at the end of the budget cycle. It should also be noted that the legislature was very limited in its analytical capacity until it established its own research arm very recently (NABO; National Assembly Budget Office).

The administration's budget proposal is formulated by the Ministry of Budget and Planning (MPB), which is the central budget office. MPB consults with the National Assembly, political parties, local governments, and interest parties periodically throughout the budget formulation process. The final budget proposal is transmitted in early October to the National Assembly, which has to approve the budget by the end of the year (the Korean fiscal year coincides with the calendar year).

During its budget reviews, the National Assembly may make reductions from the administration's budget proposal. It may also decide to increase parts of the budget, but only with the consent of the administration. In practice, the total result of all such adjustments are relatively small, which means the administration's budget proposal passes through the legislature's review and approval process more or less intact (see table below). This by no means implies, however, that the budget review sessions are comfortable formalities for Cabinet members or MPB officials. The fact that the ruling party is currently the minority in the National Assembly, and the general societal trends toward greater democracy and transparency ensure that the sessions are quite demanding for the administration.

**Table II. 8. Proposed vs. Final Budgets (1980–2003)**

(in billion won)

Year	Budget Proposal	Increments	Reductions	Final Budget	Adjustment (%)
1980	5,843	6.2	45.1	5,804	-0.7
1981	7,851	85.5	85.5	7,851	0.0
1982	9,596	104.4	121.9	9,578	-0.2
1983	10,517	33.2	133.5	10,417	-1.0
1984	10,967	39.1	39.1	10,967	0.0
1985	12,275	30.6	30.6	12,275	0.0
1986	13,815	52.5	67.3	13,801	-0.1
1987	15,582	56.8	78.7	15,560	-0.1
1988	17,542	59.9	137.9	17,464	-0.4
1989	19,371	307.4	450.2	19,228	-0.7
1990	23,025	230.8	566.8	22,689	-1.5
1991	27,183	142.6	345.3	26,980	-0.7
1992	33,505	0.0	305.0	33,200	-0.9
1993	38,050	200.7	200.7	38,050	0.0
1994	43,250	400.1	400.1	43,250	0.0
1995	50,141	204.1	357.3	49,988	-0.3
1996	50,003	150.7	191.7	57,962	-0.1
1997	67,780	307.0	508.4	67,579	-0.3
1998	70,360	295.0	391.8	70,264	-0.1
1999	80,570	839.7	1,271.9	80,139	-0.5
2000	86,736	500.6	763.0	86,474	-0.3
2001	94,930	20.0	825.4	94,125	-0.8
2002	106,480	1,612.1	1,008.8	105,877	-0.6
2003	111,658	617.8	792.7	111,483	-0.2

### 3.4.2 Responses to questions

- *Did the legislature make any changes in its own procedures for approving the budget once the top-down approach was adopted for budget formulation? If so, what?*

No. Introduction of the top-down approach in 2004 was entirely an initiative of the administration. The National Assembly is not involved in the budget formulation process, making it less urgent for it to adjust its procedures to a top-down framework. MPB's concern is that the absence of procedures that reflect the

top-down framework may open the possibility that the National Assembly's final budgets would undermine established top-down expenditure limits.

- *What is the legislature's role in determining the spending ceiling used in the budget formulation process? Is the legislature consulted? Does the legislature formally approve the ceilings?*

The legislature is consulted at the beginning of the budget cycle in March. It is also briefed on the general thrust and broader totals of the spending limits after MPB and the Cabinet finalize the annual ceilings (the expenditure ceilings are not multi-year) in May. Although formal approval is not required at that point, it is understood that the legislature may effectively reject the administration's ceilings.

- *Are there any mechanisms in place to ensure that the legislature honours the spending ceilings adopted by the government, either in aggregate or at a more detailed level? If not, is there a tradition for the relevant ministry to "volunteer" other offsetting savings so that the ministry's total will still come under its original ceiling notwithstanding the increases introduced by the legislature?*

So far there are no mechanisms to ensure that the legislature honours the government's spending ceilings. As a last resort, MPB may try to enforce the ceiling by persuading the relevant ministry to make offsetting savings in the relevant or subsequent budgets. This was not necessary at the first budget review after adopting top-down budgeting last year, as virtually all National Assembly committees took considerable care to honour the ceilings.

- *What are the respective roles of the Budget Office and spending ministries in defending the government's budget proposal before the legislature?*

Ministers and officials from MPB and other ministries appear before National Assembly committees to answer questions about spending estimates and whether specific projects/programs are justifiable. This is done at various standing committees which conduct preliminary reviews of spending in their respective areas, and also at subsequent sessions for comprehensive review at the Special Committee for Budget and Accounts.

In principle, questions on broader policy directions and expenditure totals are supposed to be fielded by MPB, leaving specific projects/programs to be defended by the relevant ministry. In practice, however, administration officials find it wiser to respond directly to questions rather than defer to other, more

appropriate sources. Thus MPB officials usually end up fielding most of the questions put by the legislature. In doing so MPB will call on the spending ministries to provide relevant material if necessary.

- *After the Government submits its proposal but before the legislature approves the budget, should any unforeseen development arise that requires additional spending, how will this be worked out between the two? Will the ceiling also be adjusted, or will other spending be reduced to keep it intact?*

Having been through only one budget cycle since adopting the top-down spending ceilings, Korea has not encountered this scenario yet, and there are no formal nor implicit rules governing such cases. Judging from past behaviour, the most likely decision would be to raise the ceiling to accommodate the new spending requirement, but still try to offset at least part of the cost by reducing other items in the budget, possibly from other spending categories, too.

- *How has the overall relationship between the Budget Office and spending ministries vis-à-vis the legislature changed overall, especially in terms of “tactics” employed.*

So far there have been no noticeable changes.

## 4. Norway

### 4.1. Overview of the Top-Down Process and Fiscal Rules

#### 4.1.1. Structural deficit and expected real return on petroleum fund

- The current fiscal rule was proposed by the government and discussed and settled by the parliament in 2001. One reason for this was that a change in the monetary policy also made it convenient to change the fiscal policy. The change in the fiscal policy was partly due to two other reasons;

1) The use of the petroleum revenue had been restricted in Norway in the previous years because of low unemployment and little spare capacity in the economy. Norway had once to start to use more of their petroleum revenues even if it would bring some structural changes to the mainland-economy.

2) Waiting to long and not building upon a strategic plan for slowly increasing the use of the petroleum revenues could possibly make the pressure for uncontrolled injections of petroleum revenues into the economy irresistible, the dam would break. There was an unrealistic view of the size of the petroleum wealth among the population. The parliament could in the right context decide to spend the petroleum revenues outside the budget for purposes that had not got priority in the ordinary budget process. There had been several proposals for investing the petroleum revenues into “extraordinary research and development for the future” and for financial investment in Norwegian private companies for building up “national” ownership.

The new fiscal rule said that the deficit could be 4 per cent of the estimated capital in the Government petroleum fund. This means a slowly increasing deficit in the coming years determined by the estimated real return of the capital in the petroleum fund in the beginning of the budget year. This deficit is of course cyclically adjusted and adjusted for special events. It is also adjusted for volatile changes in the level on the transfers from the central bank and net interest received. However, there is still flexibility to take into consideration the need for cyclical measures through the fiscal policy.

- The line in the overhead is the projected real return when the new fiscal rule was established. The white columns are observed and projected real return this fall. Adding the orange parts give you what the deficits have been and are projected to be in 2005 and 2006.

#### 4.1.2. The underlying real growth in government expenditure and growth in GDP mainland Norway

- The normal political situation in Norway has been minority governments, there are today eight parties in the parliament. Even if there has been since October this year, a majority government, it still consists of three different parties. It has been common that when a new government is settled the political parties negotiate in advance to make a political announcement for their coming politics in the next 4 years. This includes statements for the level of taxation. The former government, where the conservative party was a member, had as a part of their announcement that they should reduce the tax-level substantially and they did. The new government has in their statement that the tax-level should be raised back to the 2004-level but still keep the same deficit as the former government. It will not be possible in Norway to have a fixed ceiling for the expenditure level agreed on by all parties in the parliament.
- However in the internal annual budget process in the government the operational target is a total spending limit for the budget. As a starting point a full budget in nominal terms is calculated given the macroeconomic assumptions. Given political targets for changes in the tax-level and for a deficit, the implicit maximum level of the expenditures in real terms is estimated.
- A top-down budget approach in the government internal budget preparation was introduced in Norway in 1990 with the 1991 as the first budget year. The main focus was to get better control both over the expenditure level and the total priorities in the budget through making the line ministers more responsible for their own budgets. It was accepted that the knowledge of health politics should be in the Health Ministry and not in the Finance Ministry. It was also an attempt to move the responsibility for the overall priority in the budget up to a broader discussion in the cabinet. Introducing expenditure ceilings meant that the cabinet in plenary meetings decided each ministry's total spending limits. In a government where the ministers come from different parties it is necessary to have a process to give an overall priority which all parties can support. The results of the earlier process were too much dependent of each minister's ability to negotiate with civil servants from the Ministry of Finance.
- Looking at the calculation of the total expenditure ceiling it has changed very little since the beginning of this process. To calculate this total, the same procedure was used even before the introduction of expenditure limits for each ministry. There are of course pressure to change the calculations and making exemptions for special expenditure like money used abroad, self-financing investments etc.

from the ceilings. These changes are however not taken into the considerations. There are some exemptions but these are mostly expenditures with equivalent revenues. It seems that there is a general assessment of the top-down process at present.

## 4.2. Determining Expenditure Ceilings

- Since the expenditure ceilings in Norway are not formal objectives for the government's fiscal policy, rather an operational measure, it is settled at the beginning of the budget process each year. This is done in March. The expenditure ceiling is not published and the parliament is not involved in the process. The budget process in the government in Norway is mostly closed. The only exceptions may be a discussion with the government's own party group in the parliament at the end of the budget process.
- While the macroeconomic framework settles the total expenditure ceiling, the ceiling for each ministry is based on bottom-up information from the ministries. The ministries deliver information on:
  - A budget in real terms given unchanged politics from the previous year
  - Proposals for reducing the expenditure in their budget with 3-4 per cent. Some expenditures are protected and not included when the amount needed to reach 3-4 per cent is calculated.
  - Proposals for new priorities/reforms in the next year's budget.

Even if it always is some discussions of what unchanged politics are, the Ministry of Finance conservative view most commonly wins. If there are not an agreement between the spending ministries and the Ministry of Finance the decision is taken by the cabinet. When the cabinet meets for their first budget discussion in the beginning of March, they do not decide what will be the new priorities in the next year budget. They decide the total amount that will be spent on new priorities and they also shorten the list of proposals from the ministries. This shortened list will be considered later in the budget process to choose new priorities.

- The total amount distributed between the line ministries at the first conference is calculated as the total expenditure limit from the macro calculation minus reserves for new priorities. The difference between budget under unchanged policy and the amount to be distributed on the conference is the total reduction the government have to choice from the list of possibly reductions ("3-4 per cent list"). The relative portion of the total reductions for each ministry may differ. The spending limit for each

ministry is the spending under unchanged politics and the reductions chosen for each ministry by the cabinet. The resources for new priorities will be distributed between the ministries in a budget conference in August.

- There is normally one expenditure ceiling for each ministry. The reductions at the March-conference are “examples of possible reductions” and the ministry may choose other reductions than decided in the cabinet. The ministries are also free to redistribute the expenditures under the ceilings. However it is rather hypothetical that the ministries should choose other reductions after the process in advance of the cabinet-meeting.
- There are however some kind of expenditures that are “ring-fenced” in the process:
  - Since the total of the grants to the local government is decided by the cabinet, it is not allowed to take grants meant for the local government and use these amounts for other purposes. The ministries may however change the responsibilities between the central and the local government but that requires that the resources used on the programs also must be redistributed taken into account the local government’s own financing of the programs.
  - Changes in estimates for the costs of the beneficiary programs may not be used (or must not be financed) by the line ministries themselves, but are changing the individual ministry’s total expenditure ceiling. Changes in the total have to be handled by the government in the plenary cabinet-meeting in August.
  - Family allowances are regarded as a part of the tax-system and treated as such by ring-fencing it from the ministry’s disposal.
- In August the economic framework is updated. There may be different changes that influence on the total expenditure ceiling:
  - The estimated revenues from the petroleum sector for the present year may differ. It is however only 4 per cent of the change in the estimated revenues for the present year that can be spent, so the change in the amount may be limited.
  - Estimates for tax revenues from the mainland and unemployment insurance may be changed due to new economic assumptions. However the expenditure ceilings are based on cyclical adjusted tax revenues and unemployment insurance. The new revenue estimates only affects the ministry’s expenditure ceilings if the changes are not assumed to be cyclical. Cyclical change in the unemployment insurance is just added to the old spending limit.

- Changed estimates for the entitlement programs may be large and may require adjustments in the other expenditure or revenues to keep the total budget deficit. Lower estimates do not create problems and will just increase the possibility for new priorities.
  - The reserves for new priorities settled in March are often felt to be too low when it shall be distributed.
- If there is a need to finance extra expenditures, different sources may be looked upon:
    - Specified reductions in expenditures programs in some ministries.
    - One time income like selling buildings and withdraw on funds that are not previous formally owned by the government.
    - Adjust the proposed change in the level of taxation.
    - In the budget there is a central reserve for unforeseen expenditures during the budget year. This may be reduced. This amount is however usually rather small.
  - In Norway the Ministry of Finance is responsible for the budget, the tax-system, the fiscal and monetary policy and the private financial market. This highly centralisation of functions means that there is only one minister in the cabinet to defend the totality in the budget. This means that the Minister of Finance must have the support of the Prime Minister when the cabinet is determining the expenditure ceilings. When different parties form a cabinet the leaders of the parties will be ministers in the cabinet. Even if it is the prime minister that draws the conclusions he often discusses it with the party leaders in advance.

#### **4.3. Interactions between the Central Budget Office and Spending Ministries**

- The Budget Office provides timetables and guidelines for the budget process each year. Each ministry has however their own budget departments who are responsible for following up the internal process in the ministries. The common assumptions as interest rates, exchange rates etc. is given by the central budget office. The central budget office is also responsible for inflating the budget to nominal terms.
- There are however also technical groups with members from the spending ministries and from the Ministry of Finance to follow up specific areas in the budget:
  - The total economic situation for the local government
  - Estimates of expenditures under the entitlement programs
  - Health care expenditures

- There is also a restriction that every investment project larger than 500 mill. NOK (60 mill. €) shall be reviewed by a consultant firm before the project is presented to the cabinet. The Ministry of Finance is involved in these evaluations.
- These requirements mean that the Central Budget Office has a detailed knowledge of the proposals presented by the spending ministries.
- When there are disagreements between the Ministry of Finance and a spending ministry the disagreement is explained in the budget documents sent to the cabinet for decision. Most of the disagreements however are settled at a technical level before the documents are sent to the cabinet. One common problem is to define unchanged politics. Another reason for disagreement may be that the spending ministries propose reductions in expenditure programs the parliament probably will not agree on.

#### **4.4. Interactions between the Central Budget Office and the Legislature**

- The Norwegian parliament introduced a top-down approach to the budget in 1997 for the budget year 1998. These changes were induced by the parliament after a recommendation from a commission and without interference by the government.
- The parliament has 15 Standing Committees where the Standing Committee on Finance and Economic Affairs has the lead in the budget process. The budget proposal from the government is aggregated to 22 expenditure and 2 revenue groups, where the revenue groups are taxes and dividends. The Standing Committee on Finance and Economic Affairs discusses the ceilings and propose changes before all, the 22 expenditure and 2 revenue ceilings are settled in one plenary vote by the parliament. Alternative proposals must also include all ceilings and the total. After this vote the different expenditure aggregates are discussed in the different standing committees. They may change the priorities inside the ceilings but they can not exceed the spending limits.
- This means that the real budget discussion in the parliament is before the Standing Committee on Finance and Economic Affairs propose these spending limits. If a political party wants to prioritize

health before education, this has to be done before the parliament in the plenary vote settles the 22 expenditure levels and not in the Standing Committee on Health and Care Services.

- The normal situation in Norway has been that the government has had a support only from a minority of the delegates in the parliament. The parties in the parliament that support the government must then negotiate with the other parties to see if there is someone that may support the government proposal with some acceptable adjustments. There have been, and still is, nearly a common agreement in the parliament (except from the Progress Party) on the size of the deficit in the budget. The negotiations may however alter the composition between new reforms on the expenditure side and tax relief.
- Also new proposals from a new government may change the expenditure level. When there is a change of the government after an election, the old government presents their proposal for the next year's budget before the new government takes office. The new government will after a month present their proposals for changes in the original proposed budget. This year the Bondevik government, where the Conservative Party was an important part, left after several years with tax relief in the budget. A coalition, where the Socialist Left Party is a part, took office. As mentioned yesterday, the new government has announced that they will bring the tax level back to 2004-level, still having the same deficit.
- Normally the government will propose some supplementary spending to the budget before the expenditure ceilings is settled by the parliament. This is however usually small amounts financed by reserves for unforeseen expenditure in the budget and then not affecting the totals of the budget.
- After the proposal from the government has been sent to the parliament the discussion is mainly held in the standing committees in the parliament. The Budget Office and spending ministries are not involved in this discussion defending the government's budget proposal before the legislature. However the parliament in Norway has itself very little secretarial support. Statistics Norway may help them to estimate the revenues from new tax-proposals. The parties are also allowed to send questions with alternative proposals to the Ministry of Finance to calculate the cost of these proposals. The Ministry of Finance may seek help from the spending ministries to do so. The ministries have also given technical support to write bills. The experience from this system is mainly positive but one has seen two problems. First, because there is no cost in sending questions, the number of questions asked has increased dramatically. Some parties have also tried to trick officials into political discussions instead of seeking information.



## 5. Sweden

### 5.1. Overview of the Top-Down Process and Fiscal Rules

- *What were the original goals for introducing a top-down budgeting process? When was top-down budgeting introduced? How has it evolved (changed) since its inception? What is the general assessment of the top-down process at present?*

In the first half of the 1990's Swedish public finances seriously deteriorated and the deficit peaked at 12 per cent of GDP in 1993. At the same time increased attention was paid to the relation between the institutional structure of the budget process and the development of the public finances. In early December 1995 the Minister of Finance presented the intended reform of the budget process to Parliament. It was described as phase two of a programme with the objective to restore public finances. The first phase consisted of taking the concrete decisions to reduce public expenditure and increase revenue with some 7 per cent of GDP. The second phase consisted of institutional changes that would prevent a situation where the country once again got into similar budgetary problems. The fundamental features of the system, including a medium-term expenditure ceiling and a top-down process, still remain. The general assessment, and the reality, is that the top-down process, and explicitly the expenditure ceiling, has served the country well. A reference is made to the expenditure ceiling and the surplus target in the annual Government declaration presented to Parliament.

- *Is the expenditure ceiling linked to a formal fiscal rule, either in terms of deficits, debt and/or expenditures? If so, please describe the fiscal rule and how it is "operationalised" in the annual budget process.*

The expenditure ceiling covers all state expenditure and public pensions, except interest on the state debt. The ceiling is not linked to a formal fiscal rule in a sense that makes the ceiling subsidiary to another restriction. However, there is also a target for the public deficit/surplus for the general government sector (ESA 95). The expenditure ceiling is estimated so that it will make it possible to comply with the medium-term target for the public deficit/surplus without increasing the tax ratio to GDP. Presently, there is no objective related to the size of the public debt, other than what follows from the Stability and Growth Pact (the actual size is less than 50 per cent of GDP).

## 5.2. Determining Expenditure Ceilings

- *When are the expenditure ceilings set? For how long are they set? If multi-annual, are the ceilings adjusted every year?*

In the Budget Bill (t+1) submitted to Parliament in September the Government proposes an expenditure ceiling for year (t+3). With a few exceptions the Government has proposed and Parliament has approved an expenditure ceiling for the third additional year in the three-year period. The reason for approving the ceiling three years in advance it is that it is assumed that this distance will reduce the risk that the ceiling will be a function of the desirable expenditure. The ceilings are expressed in nominal terms and are not adjusted for inflation. An approved ceiling might be adjusted for technical reasons, e.g. when items are moved from the revenue side of the budget to the expenditure side or vice versa, or when there is transfer of tasks and funds between central and local government and the balance of the general government finances is unaffected. Technical changes do not allow increased overall public spending.

- *How are the annual ceilings determined? Do spending ministries submit bottom-up proposals ahead of the top-down ceilings being established, i.e. in order to inform the top-down decision? Or, are they required to submit proposals that do not exceed the ceiling in the first instance? In practice, do the annual ceilings usually end up as incremental adjustments to the previous year's ceilings?*

For a number of years the expenditure ceiling has, somewhat simplified, been calculated as an annual increase over last years expenditure with 4 per cent (2 % volume and 2 % price increases). Consequently, public expenditure remained at a more or less stable ratio to GDP. All budgeting and monitoring is performed in a medium-term perspective, i.e. estimates are always made for a three-or-four-year period (t, ... t+3). When spending ministries submit their proposals for the next fiscal year there is already an approved expenditure ceiling for that year. But this does not prevent spending ministries from submitting proposals that, added together, are incompatible with the ceiling. Spending ministries are also required to propose savings that can contribute to the financing of reforms. However, usually they do not comply with this requirement. The submitted proposals constitute the starting point for the negotiations. The important thing is that the Government, at least the Prime Minister and the Minister of Finance, are committed to the approved expenditure ceiling. The subsequent budget process/negotiations will make sure that the budget proposal submitted to Parliament stays under the approved ceiling.

- *Please describe the political aspects of determining the expenditure ceilings. What is the role of the Minister of Budget vis-à-vis the Presidency / Prime Minister & Cabinet, and other spending ministers? When do most changes typically take place in the relative amounts of the ceilings? When a new government takes office? When a crisis takes place? Are there other “politically opportune” moments to affect significant changes?*

The overall expenditure ceiling is in the first instance calculated within the MoF Budget Department and then presented to the Minister of Finance. The expenditure ceiling to be proposed to Parliament is then agreed between the PM and the Minister of Finance. Spending ministers seem to have little influence on this process. Sweden has had the same Government (a Social Democrat minority Government in an informal coalition with one party, the Centre Party 1994-1997, or two parties, the Left Party and the Green Party 1998-2005) since the reformed budget process was introduced. In the period 1997 – 1999 the expenditure ceiling was used as an instrument to reduce state expenditure. Since 2000, however, the expenditure ceiling has been used as an instrument to keep the ratio of expenditure to GDP more or less constant. This fact does not exclude that considerable relative changes between the 27 expenditure areas (COFOG related) under the ceiling may have occurred. The sums allocated to expenditure areas for the years t+2 and t+3 are for all practical purposes guidelines and adjustments due to changing priorities or revised forecasts are frequent and not looked upon as being dramatic.

- *Are the ceilings made public? If so, when and how?*

The overall expenditure ceiling for year t+3 is submitted to Parliament as a proposal and is voted on by Parliament, so obviously it is made public. The Government also proposes frames for each of the 27 expenditure areas for t+1 to be used by Parliament in the top-down procedure applied by Parliament when approving the state budget. These frames are also made public. The Government also requests that Parliament approves preliminary frames for the 27 expenditure areas to be used by the Government as guidelines when preparing the budget for t+2 (and t+3).

- *If there are changes between the initial economic assumptions (revenue forecasts) used as the basis for calculating expenditure ceilings and revised final ones, how are the ceilings adjusted to take account of this? How is the difference allocated among the ministries?*

When the overall expenditure ceiling is calculated allowance is made to uncertainties related to the macroeconomic development and the forecasting of expenditure. Practically, the issue is managed through

a “budget margin” that can absorb deviations. This is a small margin between the expenditure ceiling and the sum of the ceiling restricted expenditures. Originally the budget margin amounted to some two or three per cent of the ceiling. So far the expenditure ceiling has never been adjusted due to changed macroeconomic indicators. Usually, the margin has been sufficient to take care of deviations that occur during the budget preparation phase. If not, there is no rule for allocating the cuts. Money is taken where available.

- *At what level of detail are the expenditure ceilings set? One global amount per ministry, or separate ceilings for sub-components, such as salary, other operating expenditure, transfers and investments? If so, what is the rationale? Are there different mechanisms in how the ceilings are decided for each category? Is there any possibility to transfer amounts between the various sub-categories?*

The decisive expenditure ceiling is the overall expenditure ceiling for the central government (including public pensions) but excluding interest on public debt. The division into sub-ceilings, or frames, for the 27 expenditure areas are negotiable during the preparation of the budget proposal. There are no ceilings or restrictions for expenditure categories like salary, transfers, investments etc.

- *Are any specific items in a ministry’s overall ceiling, “ring-fenced,” so that a spending ministry cannot allocate that money to other uses?*

A spending minister has a substantial freedom to allocate funds to different purposes/appropriations within his/her expenditure area. However, the MoF Budget Department checks that the allocations are realistic and that the spending minister will not have to be bailed out during the implementation phase. There are a number of rules laid down by the Budget Department, meaning that in principle, a spending minister can only reallocate funds if they are released as the result of discretionary measures. This means that, e.g. funds freed due to diminished demand for an entitlement cannot be reallocated to another purpose by a spending minister; instead these funds are brought back to the central budget and used to finance any (new) expenditure in the whole budget. Although symmetry is not automatic, increased expenditure within existing rules is usually financed from general budget funds.

- *If applicable, how are programs run jointly by two or more ministries handled in the top-down budgeting process?*

Programmes are usually not so strict that the situation creates real problems. There are cases when two ministries negotiate their respective contributions to a “programme”.

- *Are differences made between mandatory (entitlement programs) and discretionary spending in calculating the top-down ceilings? In particular, are automatic stabiliser programs, such as unemployment insurance and other low-income social programs, subject to expenditure ceilings?*

One reason why the system with an expenditure ceiling has been so successful in Sweden is, no doubt, that it is comprehensive. In fact, an expenditure ceiling disregarding entitlements would be totally inefficient in the Swedish context where at least 60 per cent of the expenditure are entitlement programmes. Thus, all state expenditure except the interest on the state debt is included under the overall expenditure ceiling. The ceiling is not adjusted for changes occurring in e.g. entitlement programmes and labour market related programmes. The explicit purpose of the budget margin is to absorb changes of this kind. However, to create scope for additional, cyclically motivated labour market programmes, some of these programmes have been financed from the revenue side of the state budget, i.e. tax expenditures. The idea is that a fixed expenditure ceiling, that is not changed due to “normal” deviations, contributes to the credibility of the Government’s fiscal discipline. But, as mentioned above, the concerned expenditure area frame and appropriation is often more or less automatically compensated for effects of this kind. This is true both in the preparation and execution stages of the budget process.

- *If the budget contains a contingency fund for “routine” emergencies, are such funds allocated separately for different ministries in the first instance, or is there a single fund at the centre that ministries may apply to during the course of the year?*

There is a very small central contingency fund/appropriation (1 MEUR). Some ministries have separate appropriations for e.g. damages, fines.

- *How does the top-down budgeting process take account of major "non-routine" emergencies that require additional funding in excess of what is covered by "routine" contingency funds? Is it understood that these expenses are not bound by existing ceilings?*

A recent experience of this kind is the budgetary costs due to a major storm in January 2005. Government agencies, companies, forest owners and municipalities suffered large costs and losses which to some extent were compensated from the state budget. Increased payments were covered by reallocations within the

budget under the existing expenditure ceiling. However, some costs were compensated by means of tax reductions. The reallocations between expenditure area frames and appropriations in the state budget were submitted to Parliament in a supplementary budget.

- *Are there any other reasons for adjustments of the ceiling during the year?*

During the ten years the expenditure ceiling has been operational only technical changes have been carried out during the implementation stage.

### 5.3. Interactions between the Central Budget Office and Spending Ministries

- *Do ministries have an opportunity to appeal their given expenditure ceilings? Are ministries given feedback on why their ceilings were adjusted from the initial, bottom-up figures they gave (assuming there is a bottom-up component)? If so, in what form?*

The frames for the 27 expenditure areas are decided by the Cabinet in the middle of March. These ceilings are firm guidelines for the internal formulation of the detailed state budget. The ceilings are adjusted for changed macroeconomic indicators etc. However, it also occurs that reallocations are made rather late in the budget preparation process. It has also happened that the frame for one expenditure area has been increased in order to accommodate an important reform and that the corresponding financing has been provided from a reduction of the budget margin. Nevertheless, the expenditure area frames constitute an important part of the top-down procedure, and serve as an anchor for the budget formulation process.

- *How have ministries performed their role in making final allocation decisions within their respective spending ceilings? Do spending ministries have the capacity to make such decisions? Have there been significant reallocations, or has it been largely incremental from the previous year? What is the overall assessment of spending ministries taking on this role?*

No doubt, incrementalism is a fundamental weakness of public budgeting. Too little attention is paid to existing activities and resources. Probably at least 95 per cent of next year's budget is explained by the present budget. However, the experiences over the last ten years is that ministers *do* reallocate funds within their respective expenditure areas. The reallocations are marginal but they are made without any effort from the Budget Department. In a system without ceilings and delegation of authority spending ministries

would not make any reallocations at all, they would just ask for more funds, which the MoF in the end would be unable to resist. Ceilings are a Budget Department's best friends!

- *What kind of "assistance" does the Budget Office provide to spending ministries in this respect, if any? Does the Budget Office provide guidelines to each spending ministry for their internal allocation decisions?*

There are financing rules laid down by the MoF Budget Department in a circular describing what kind of reallocations are allowed or not allowed. E.g. that money may not be transferred from an entitlement appropriation to a discretionary investment appropriation or that new permanent expenditure may not be financed from temporary savings.

- *What can the central budget office do if ministries' budgets (formulation/execution) violate its ceiling? Can the respective ministries be penalized? If so, how?*

During the *formulation* stage part of the process is that spending ministers try to obtain more resources for projects or programmes, but these requests are denied by the Budget Department or, exceptionally, accepted in the final round. It must be understood that expenditure area frames do not rule out negotiations! In the end of the formulation process there is identity between the a sum of the appropriations within an expenditure area and the frame for that area. During the *execution* stage close monitoring is carried out by the Budget Department and spending ministries in order to avoid that appropriations and the overall expenditure ceiling are exceeded. In contrast rather little attention is paid to the expenditure area frames during the implementation of the budget. It is a joint responsibility for the Cabinet to avoid that the approved expenditure ceiling is not exceeded or that appropriations are not exceeded more than the organic budget law allows.

- *Under what circumstances can the Budget Office overrule internal allocation decisions made by individual ministries? In practice, does this happen? In general, do ministries "worry" about defending their decisions to the Budget Office?*

Even when a system with frames for expenditure areas is well established the core of the budget process is still focused on the individual appropriations (some 490). The figure for each appropriation/purpose is what, in the end, is negotiated between the Budget Department and the concerned spending ministry. Only a figure agreed with the Budget Department can appear in the draft budget submitted to Parliament. It

occurs that the Budget Department refuses to accept a suggested allocation (or reallocation) and that this position is strongly contested by the spending ministry. As a rule, however, spending ministries have a large mandate to allocate funds between appropriations under an expenditure area, provided the expenditure area frame, set earlier in the process, is not violated. Then Budget Department intervenes when financing rules are not respected or if the effectiveness or efficiency of the reallocation is questionable.

- *Does the Budget Office have sufficient information in the top-down environment to effectively be able to second-guess and challenge the submission of spending ministries? At what level of detail does the Budget Office scrutinize the submissions by spending ministries?*

In the beginning there might have been an idea that the work of the Budget Department would be drastically facilitated and changed by the introduction of an overall expenditure ceiling and expenditure area frames for the 27 expenditure areas. The idea was, perhaps, that it would be sufficient to focus on the overall quantitative restrictions. If that was the case, reality quickly made it clear that the Budget Department must have enough subject-matter knowledge for all parts of the state budget to match the spending ministries. Financial restrictions must be well founded and based on the operations in the respective field. Restrictions provide support in the negotiations, but the thrust of the negotiations is always subject-matter related or policy based. The desk-officer organisation in the Budget Department today is as large (some 30 persons) as it was before the introduction of top-down budgeting. The desk officers have the capability to make their own forecasts of the expenditure, given present policy. They can analyse the costs of suggested reforms and also make the analyses required to propose savings in the different policy areas. The submissions of spending ministries are scrutinized down to the expenditure driving elements (rules, objectives, numbers etc.). The expansion of the number of staff of the Budget Department is explained by the substantial increase of the resources for consolidation, monitoring, reporting and forecasting. The IT-support provided to the desk officers has also been strongly enhanced.

#### **5.4. Interactions between the Central Budget Office and the Legislature**

- *Did the legislature make any changes in its own procedures for approving the budget once the top-down approach was adopted for budget formulation? If so, what?*

As a matter of fact, it was the other way around! After investigations carried out by a working party in Parliament in the beginning of the 1990's, Parliament decided in 1993 and 1994 to introduce a separate procedure for the preparation and approval of the Budget Bill in Parliament. The process has all the

characteristics of a top-down procedure; first one vote on the frames for all the 27 expenditure areas *and* on the estimate of the revenues, and then votes (27) on the appropriations within each expenditure area. First the aggregate is approved, then the details. During the second stage Parliament is allowed to reallocate funds between appropriations within an expenditure area, provided the frame for the area is not violated. The procedure was first used in 1996 for the preparation and approval of the 1997 budget. The Government also used its new top-down procedure in 1996 preparing the 1997 budget. Obviously, the reform efforts were well coordinated.

- *What is the legislature's role in determining the spending ceiling used in the budget formulation process? Is the legislature consulted? Does the legislature formally approve the ceilings?*

The legislature approves the overall expenditure ceiling three years in advance. The legislature also decides on preliminary frames for each expenditure area to be used as guidelines by the Government when formulating the budgets for the years  $t+2$  and  $t+3$ . The Government also proposes firm financial frames for each of the expenditure areas for  $t+1$ , i.e. the next fiscal year, to be used by Parliament in the approval process of the next year's budget.

- *Are there any mechanisms in place to ensure that the legislature honours the spending ceilings adopted by the government, either in aggregate or at a more detailed level? If not, is there a tradition for the relevant ministry to "volunteer" other offsetting savings so that the ministry's total will still come under its original ceiling notwithstanding the increases introduced by the legislature?*

Ever since the reformed budget process was introduced Sweden has had a minority Government. This Government has formed an informal coalition with one or two other parties. The main area for collaboration has been the state budget. As a result, the budget submitted to Parliament is based on an agreement between the Government and supporting parties, together forming a majority in Parliament. Consequently, over the last ten years there have been extremely few changes made in Parliament regarding the sums for each of the 27 expenditure areas. However, more frequently there are changes made between appropriations within an expenditure area leaving the financial frame unchanged.

- *What are the respective roles of the Budget Office and spending ministries in defending the government's budget proposal before the legislature?*

Once the draft budget has been submitted to Parliament the role of the Government is relatively small. Ministers never appear before committees, but state secretaries/deputy ministers and senior officials are invited to explain details etc. At this stage it is the responsibility of the parties in Parliament to discuss and approve a budget. However, there are close links (weekly meetings) between the Social Democrat party group in the Finance Committee, and also in the Tax Committee, and the political leadership in the Ministry of Finance. Probably there are similar links between spending ministries and “their” committees in Parliament.

- *After the Government submits its proposal but before the legislature approves the budget, should any unforeseen development arise that requires additional spending, how will this be worked out between the two? Will the ceiling also be adjusted, or will other spending be reduced to keep it intact?*

If a situation of this kind arises the Government is not allowed to submit new proposals with budgetary consequences, except in an extreme situation. The purpose of this rule is to make sure that the submitted budget is complete. But if an unforeseen development arises within 14 days after the submission of the draft budget it can be handled by means of a private member bill presented by a “friendly” MP. If the issue surfaces later it can be brought on the agenda by means of an initiative in a committee. Such an initiative is usually based on information in a document drafted by government officials, put into the hands of a representative of the majority. If the issue is of a technical nature the ceiling might be adjusted. If, on the other hand, the issue involves new expenditure for a reform, the extra expenditure will probably just reduce the budget margin. Then, of course, there is always the possibility to wait and bring up the issue in a supplementary budget during the next year.

- *How has the overall relationship between the Budget Office and spending ministries vis-à-vis the legislature changed with the introduction of top-down budgeting, especially in terms of “tactics” employed.*

In all budgetary systems or procedures where there is an effective restriction the players will try to find ways to circumvent that restriction. In a system where e.g. the deficit/surplus is a firm restriction the escape route offered for increased expenditure is a balancing increase of taxes. This approach leads to a steadily increasing expenditure ratio and tax ratio to GDP. If an expenditure ceiling is the effective restriction the players will after some time learn how they can dodge it. One obvious method is crediting more revenue, e.g. user charges, to the expenditure side of the budget, thus providing more room for expenditure to be charged to the budget with unchanged net expenditure. A similar method is to charge

expenditure to the revenue side of the budget, e.g. tax expenditure. In other words, you could expect a move from gross budgeting in the direction of net budgeting. There are several observations of these kinds in the development of the budgetary practices in Sweden, especially during the last few years. It should be stressed that the described practices, when they are used, are carried out openly and in a fully legal way and are approved by Parliament.



## Appendix

*N.b. The agenda for the SBO special session on top-down budgeting and questions for discussion that were circulated in advance of the meeting are reproduced in this appendix.*

**working party of Senior Budget Officials**

**special session on top-down budgeting**

**PARIS, 15-16 NOVEMBER 2004**

### **ANNOTATED AGENDA**

**Chairman:**

**Mr. Barry Anderson, Head, Budgeting and Public Expenditures, OECD**

#### **Monday, 14 November 2005**

10:00	Opening by Chairman
<b>10:00-13:00</b>	<b>Overview of the Top-Down Process &amp; Determining Expenditure Ceilings</b>
13:00-15:00	No-Host Lunch
<b>15:00-18:00</b>	<b>Interactions between the Central Budget Office and Spending Ministries</b>
18:00-20:00	Cocktail

#### **Tuesday, 15 November 2005**

<b>10:00-13:00</b>	<b>Interactions between the Central Budget Office and the Legislature</b>
13:00-15:00	No-Host Luncheon
<b>15:00-16:30</b>	<b>Wrap-Up and Conclusions</b>
16:30	Closing by Chairman

*A coffee-break will be called during each session.*

## **GENERAL MEETING INFORMATION**

### ***Format of discussions***

Only a limited number of countries have been invited to participate in this special session of the Working Party of Senior Budget Officials. As such, the meeting is designed to be highly interactive and informal. The meeting will be strictly off-the-record.

Each session will be divided into two parts. In the first part, each country will be asked to briefly (10 minutes) highlight their national experiences in the area under consideration. The second part of each session will consist of a general discussion of the topic under consideration.

The annotations on the following pages for each session can act as a guide in preparing the country presentations. They should, however, in no way limit countries from presenting additional relevant information.

### ***Meeting location***

The meeting will take place at OECD Headquarters which is located at 19 rue de Franqueville in the 16th *arrondissement* (district) of Paris. The closest metro station is “La Muette”.

### ***Registration form***

All participants need to complete the attached registration form and return it to the Secretariat ahead of the meeting.

### ***Security***

Please be advised that OECD Headquarters is a secure complex. Entry passes can only be issued to registered delegates and a passport or national identity card needs to be presented in order to receive an entry pass. Delegates will also be required to clear a security checkpoint for entry. Please allow 15 minutes to finish these security formalities.

### ***Documentation***

Other than this annotated agenda, no specific documentation is being distributed ahead of this meeting.

**Cocktail**

All delegates are invited to attend a cocktail reception hosted by the Secretariat at the conclusion of the first day of the meeting.

**No-Host Luncheons**

All delegates are invited to attend a no-host luncheon on both days of the meeting. Each person is responsible for settling their own bill.

## SUMMARY ANNOTATIONS FOR AGENDA ITEMS

### Questions for Discussion during Each Session

#### Overview of the Top-Down Process

- What were the original goals for introducing a top-down budgeting process? When was top-down budgeting introduced? How has it evolved (changed) since its inception? What is the general assessment of the top-down process at present?

#### Determining Expenditure Ceilings

- Is the expenditure ceiling linked to a formal fiscal rule, either in terms of deficits, debt and/or expenditures? If so, please describe the general fiscal rule and how it is “operationalised” in the annual budget process.
- When are the expenditure ceilings set? For how long are they set? If multi-annual, are the ceilings adjusted every year?
- How are the annual ceilings determined? Do spending ministries submit bottom-up proposals ahead of the top-down ceilings being established, i.e. in order to inform the top-down decision? In practice, do the annual ceilings usually end up as incremental adjustments to the previous year's ceilings?
- Please describe the political aspects of determining the expenditure ceilings. What is the role of the Minister of Budget vis-à-vis the Presidency / Prime Minister & Cabinet, and other spending ministers? When do most changes typically take place in the relative amounts of the ceilings? When a new government takes office? When a crisis takes place? Are there other “politically opportune” moments to affect significant changes?
- Are the ceilings made public? If so, when and how?
- If there are changes between the initial economic assumptions (revenue forecasts) used as the basis for calculating expenditure ceilings and revised final ones, how are the ceilings adjusted to take account of this? How is the difference allocated among the ministries?

- At what level of detail are the expenditure ceilings set? One global amount per ministry, or separate ceilings for sub-components, such as salary, other operating expenditure, transfers and investments? If so, what is the rationale? Are there different mechanisms in how the ceilings are decided for each category?
- Are any specific items in a ministry's overall ceiling, "ring-fenced," so that a spending ministry cannot allocate that money to other uses?
- If applicable, how are programs run jointly by two or more ministries handled in the top-down budgeting process?
- Are differences made between mandatory (entitlement programs) and discretionary spending in calculating the top-down ceilings?
- If the budget contains a contingency fund for "routine" emergencies, are such funds allocated separately for different ministries in the first instance, or is there a single fund at the centre that ministries may apply to during the course of the year?
- How does the top-down budgeting process take account of major "non-routine" emergencies that require additional funding in excess of what is covered by "routine" contingency funds? Is it understood that these expenses are not bound by existing ceilings?

### **Interactions between the Central Budget Office and Spending Ministries**

- Do ministries have an opportunity to appeal their given expenditure ceilings? Are ministries given feedback on why their ceilings were adjusted from the initial, bottom-up figures they gave (assuming there is a bottom-up component)? If so, in what form?
- How have ministries performed their role in making final allocation decisions within their respective spending ceilings? Do spending ministry's have the capacity to make such decisions? Have there been significant reallocations, or has it been largely incremental from the previous year? What is the overall assessment of spending ministries taking on this role?

- What kind of “assistance” does the Budget Office provide to spending ministries in this respect, if any? Does the Budget Office provide guidelines to each spending ministry for their internal allocation decisions?
- What can the central budget office do if ministries' budgets (formulation/execution) violate its ceiling? Can the respective ministries be penalized? If so, how?
- Under what circumstances can the Budget Office overrule internal allocation decisions made by individual ministries? In practice, does this happen? In general, do ministries worry about defending their decisions to the Budget Office?
- Does the Budget Office have sufficient information in the top-down environment to effectively be able to second guess and challenge the submission of spending ministries? At what level of detail does the Budget Office scrutinize the submissions by spending ministries?

### **Interactions between the Central Budget Office and the Legislature**

- Did the legislature make any changes in its own procedures for approving the budget once the top-down approach was adopted for budget formulation? If so, what?
- What is the legislature’s role in determining the spending ceiling used in the budget formulation process? Is the legislature consulted? Does the legislature formally approve the ceilings?
- Are there any mechanisms in place to ensure that the legislature honours the spending ceilings adopted by the government, either in aggregate or at a more detailed level? If not, is there a tradition for the relevant ministry to “volunteer” other offsetting savings so that the ministry's total will still come under its original ceiling notwithstanding the increases introduced by the legislature?
- What are the respective roles of the Budget Office and spending ministries in defending the government’s budget proposal before the legislature?

- After the Government submits its proposal but before the legislature approves the budget, should any unforeseen development arise that requires additional spending, how will this be worked out between the two? Will the ceiling also be adjusted, or will other spending be reduced to keep it intact?
- How has the overall relationship between the Budget Office and spending ministries vis-à-vis the legislature changed overall, especially in terms of “tactics” employed.