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Performance Budgeting and Accrual Budgeting: Decision Rules or Analytic Tools?

by
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Performance budgeting and accrual budgeting are analytic tools that provide information and insights which are not available through conventional approaches. But neither innovation is ready for widespread application as a decision rule in the budget process. This article urges fuller understanding of these innovations and their implications, and more systematic use of performance and accrual information for policy makers.

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Budgeting is a process that transforms information into decision. Requests submitted by spending units or generated by central budget staffs are inputted into the process, and allocations to entities, projects and other recipients are outputted. The quality of these decisions depends on the data available to decision makers, as well as on the analytic tools they use to process the information. One of the perennial aims of budget innovation has been to influence the decisions that flow from the process by modifying the classification or content of budget data and by introducing new analytic methods. At one time, most countries classified expenditures by organisation units and items to be purchased. Nowadays, most have economic and functional classifications, and many also classify expenditure by programmes, activities or outputs. As the stockpile of budget information has grown, the means of analysis have multiplied. Innovative countries strive to measure performance, medium-term fiscal impacts, exposure to contingent liabilities and other financial risks, the unit cost of producing government services, the long-term sustainability of the government's fiscal position, the revenue forgone through tax preferences, the distribution of expenditure by region, social class and gender, and other contemporary issues in budgeting.

The surge of data has spurred budget innovators to devise new rules for shaping the decisions that emerge from the process. They want information to be more than available: they want it to transform the way governments go about budget work. They want different information to produce different outcomes. This article focuses on two contemporary efforts to convert information into rules. One is performance budgeting, which seeks to base spending decisions on actual or projected results; the other is accrual budgeting, which calculates expenditure in terms of resources used or liabilities incurred. The first shifts budget decisions from inputs to outputs or outcomes; the second shifts them from disbursements to cost. Performance budgeting and the accrual basis are among the most prominent reforms on the budget agenda. Neither is new, and neither has made as much headway as reformers would like, but both are likely to be promoted within governments and by some international organisations in the years ahead.

Performance budgeting and accrual budgeting are analytic tools that provide information and insights which are not available through conventional approaches. Both can also be framed into decision rules that dictate the way governments allocate resources. One decision rule might specify that government should spend money to purchase outputs; another might require that government appropriate funds to cover the cost of goods consumed or liabilities incurred. Although both may seem to rationalise budget choice, this article argues that governments should move cautiously in codifying performance and accrual budgeting into decision rules. It is essential to develop a fuller understanding of these innovations and their implications before mandating that they be the basis of budget decisions. The article also urges, however, that governments incorporate performance and accrual information into the mainstream of data available to policy makers.

The critical difference between analytic tools and decision rules lies in the discretion permitted to politicians and officials when they make allocations. When information is only an aid for analysis, governments may opt to apply or disregard the proffered data, and they may interpret the data as they deem appropriate. For example, armed with data showing that one entity's unit costs are lower than another's, governments may nevertheless provide more money to the high-cost operation. Or, presented with accrual information, they may appropriate funds to cover cash outflows rather than incurred liabilities. However, when information is codified into decision rules, budget makers are required to base allocations on it. To put the difference simply: analytic tools empower budget makers, whereas decision rules constrain them. The former allow full scope for judgment and subjectivity, the latter make budgeting less judgmental and more objective.

The distinction between analytic tools and decision rules may be explained by considering the approaches taken by national governments in incorporating medium-term projections into budget work. As recently as two decades ago, few governments formally projected the future budget impacts of the decisions they made for the fiscal year immediately ahead. Nowadays, however, many governments construct forward estimates or baselines that project expenditures and other budget elements for each of the next three or more years. These projections typically assume that current policies will be continued without change; they thereby provide a basis for government to forecast the fiscal situation that will ensue if the budget policies already in place are maintained. With this information at hand, governments can estimate the impact of proposed or approved policy changes on future budgets. Using information in this way gives government a powerful analytic tool to take account of future implications before it acts.

Some governments have gone further by constructing medium-term expenditure frameworks (MTEF) that limit spending in each of the next three or more fiscal years. This "hard constraint" bars government from taking actions that would cause estimated future spending to rise above the preset limit. When it is used effectively, the MTEF converts projections from analytic tools into decision rules. The MTEF greatly increases the probability that medium-term projections will be used, but it also limits the budget options of government.

Experience with budget projections and the MTEF suggests the rationale for converting analytic information into budget rules. It also indicates why doing so may not be a good idea. Medium-term projections tend to be ignored by politicians who are pressured by the exigencies of budgeting to focus on the year immediately ahead, even when their decisions adversely affect future budgets. In response, reformers (including international organisations) have campaigned for governments to adopt MTEF-type arrangements that compel them to take account of future impacts before they decide spending levels. The MTEF thus becomes a decision rule that limits the freedom of cross-pressured politicians. But just imposing a decision rule may not suffice to change budgetary behaviour or outcomes. Many – probably most – countries that have a formal MTEF regard it as a technical exercise that is separate from the annual budget process. The rule exists on paper, but is breached in practice. Disappointing experience with medium-term expenditure frameworks and other budget reforms has led this writer to conclude that changing budget rules may not suffice to change budget behaviour.

Over the years, budgeting has evolved through innovations that have introduced new types of information and/or have prescribed new rules. One obvious consequence is that both information and rules have accreted. But this evolution has generated informational overload and decisional complexities. The more information that is provided, the greater the likelihood that some of it will get in the way of completing budget tasks on schedule; and the more rules that are in place, the greater the likelihood that some will be in conflict or be treated as technicalities. Those who would add to tools and rules should be cognisant of a fundamental limitation of budgeting: it is a time-pressured, deadline-saturated process in which making decisions on schedule often is more urgent that getting the analysis right.

With this limitation in mind, Section 1 of this article traces the evolution of budget tools and rules. The key development has been modification in the classification of expenditure data which has transformed budgeting from an insular process whose main task was to finance ongoing operations into an expanded process that contributes to economic stabilisation, programme planning and efficient management. Section 2 seeks to identify criteria for determining when new types of information should form the basis of new decision rules. This is a difficult assignment because budgeting lacks generally accepted standards for estimating and reporting public expenditures. Significant progress has been made in the past decade in devising codes of good budgetary practice, but most of the standards pertain to matters that have long been recognised as essential to good budgeting. Recent codes, such as those developed by the OECD and the IMF, are generally indicative rather than prescriptive with respect to the types of innovative practices discussed in this article. Section 3 discusses performance measurement as an input into budgeting, and concludes that it would be premature to base decision rules on these data. Much more work has to be done on linking resources and results before performance measurements can be turned into rules for allocating money. Section 4 concludes that shifting the budget to a full accrual basis would be inappropriate at this time, but that governments should be encouraged to deepen their experience with accruals, especially in balance sheets and other financial reports. The final section briefly points the way to future development of analytic tools and decision rules in budgeting.

1. Classification is the most important decision rule

The history of budgeting is the history of reform. The two cannot be disentangled, because practitioners are basically always tinkering with the machinery of budgeting. They do so by modifying either the classification or the informational content of the budget – that is, they change either the way information is structured for decision or the information available to decision makers. In general, reforms that merely add to the stockpile of data tend to be more successful than those which aim to establish new decision modes. The evolution of budgeting teaches that it is much easier to increase the flow of information than to change the way resource decisions are made.

Changing classifications is hard work that has a high failure rate. But it is essential work because budgeting operates through classifications which both organise information and shape decisions. Half a century ago, Jesse Burkhead observed that "there is an almost infinite variety of ways in which budgetary data may be classified" (Burkhead, 1956, p. 112), and he argued that the search for the ideal classification is mistaken and fruitless because classifications serve multiple purposes in budgeting. In this writer's view, Burkhead's comment is valid only to the extent that classification is a means of presenting budget information; it is not valid, however, when classification serves as the structure for budget decisions. There are many ways to tell the budget's story, but there can be only one way to decide the budget. The government cannot allocate money one day on the basis of organisational units, the next day on the basis of programmes, the day after to regions, and so on. It cannot first set spending levels in terms of the items to be purchased and afterwards in terms of the outputs to be produced. Each of these methods is an appropriate means of displaying the budget, but only one can be the means of deciding the budget.

In almost all countries, the organisation chart is the decision structure. Spending units bid for resources, budget ministers and officials negotiate with those who have political or managerial responsibility for the spending organisations, funds are appropriated to organisations, these organisations spend the money, and financial reports are structured by organisation. Within organisational units, funds may be sub-allocated to particular items of expenditure such as personnel, supplies, equipment, travel, and so on. Over the years, as public expenditures grew, most governments consolidated these "line items" into broad categories. Instead of itemising each type of equipment, the budget lumped all equipment into a single category. Nevertheless, spending units have remained the central decision structure, and their budgets are still compiled by adding up estimated expenditure for personnel, supplies and other items.

Two paths are open to challenge organisations as the key unit of decision. One is to establish specialised classifications for particular types of decisions; the other is to replace organisations as the basic structure. The first is often successful, the second rarely succeeds. The first one works because it retains the organisational structure; the second fails because it attempts to uproot that structure. The most prominent example of a specialised decision classification is the capital or investment budget which allocates resources to projects rather than organisational units. It is important to note that the capital budget coexists alongside the budget for current expenditure, which is still decided by spending units. Another widespread approach is to segregate the budget by source of revenue (general fund, trust funds, and other earmarked revenue) with somewhat different decision rules for each source. In effect, government has multiple budgets, each with its own classification and decision rules.

Over the years, governments have added many classifications. It is quite common to classify expenditure by economic category (consumption, transfers, subsidies, investment, etc.) as well as by function (agriculture, health, education, transportation, and so on). Some governments classify expenditure by geographic units or by socio-economic groups. The common feature of these classifications is that they provide supplemental information; they do not displace classification by spending units. They are a means of displaying data, not of making expenditure decisions. After the budget has been decided, the government disaggregates spending by these supplemental schedules. The United States government publishes more than two dozen special classifications in a budget document that is aptly called *Analytical Perspectives*.[1] The document provides data on federal grants to states and cities, spending on research and development, tax expenditures, and other special categories. Many national governments have similar presentations which supplement the main decision structure. In the language of this article, they are analytic tools, not decision rules.

In contrast to these specialised classifications, some reforms have taken the second path: they have sought to establish an entirely new decision structure in place of organisation-centred budgeting. The most important of these initiatives has been programme budgeting, which was first introduced in the United States during the 1950s and has been attempted in many developed and developing countries. Although programme budgeting comes in many versions, its core idea is that expenditures should be grouped and decided in terms of governmental objectives, not according to the organisations spending the money. All activities contributing to the same objective should be placed in the same programme, regardless of the organisational entity to which they are assigned. To do so, governments seeking to budget by objectives construct a programme structure, which is supposed to serve as the basis for formulating the budget. For example, to safeguard citizens against crime, many governments maintain a police force, a prosecutor's office, a court system, a parole or probation agency, and prisons. Each of these is managed by a different entity, but all would be grouped in the same programme because they share a common objective. A programme structure would enable government to analyse the budgetary impact of more vigorous law enforcement on the courts and prisons. It also would enable government to trade-off among the different elements of the law enforcement programme. The government might decide that allocating more funds for police patrols would reduce the incidence of crime and thereby enable it to spend less on prisons.

Because it groups similar activities together, programme budgeting would seem to be a sensible means of decision, superior to systems that allocate resources on the basis of organisational structure and items of expenditure. In fact, however, governments have had great difficulty implanting a true programme budget. With few exceptions, governments that claim to have a programme budget use it to display spending decisions that have already been made. Having decided how much each spending unit should be allocated, they reclassify expenditures by programmes. Quite often governments label organisational units as programmes and pretend to have programme budgets. When this occurs, the only thing that is programmatic is the label.

The disappointing record of programme budgeting is due to many factors. Arguably, the most important is that it stirs up conflict over government objectives, generating protracted strife over the objectives of programmes. To take one example of many: suppose schools have nurses on duty to deal with routine medical problems and to teach students proper hygiene. This activity may legitimately be classified as serving both health and education objectives. Government ministries fight over the proper classification because it affects the resources they receive and their control over the activity. To mitigate conflict, governments either abandon programme budgeting or turn it into a supplemental presentation.

In line with the argument advanced here, programme budgeting also fails because it cannot dislodge organisations as the basic decision units in budgeting. Organisations and programmes are fundamentally antagonistic bases for structuring budget allocations. In the former, similar functions are grouped together regardless of the objectives they serve; in the latter, activities that serve the same objective are grouped together regardless of the organisation in which they are located. The former are structured for efficient provision of goods and services, the latter to facilitate the analysis of policy options. As sensible as it is to budget for objectives, governments cannot disregard the financial needs of the organisations that provide public services.

Organisations have another important advantage: they are a means of accounting for public funds. One of the difficulties faced by governments when they try to implement programme budgeting is determining who is responsible for the use of public funds. Governments usually solve this problem by classifying programmes within organisations, which robs programme budgeting of its essential purpose.

Organisations and programmes are compatible classifications when the latter serve only as instruments of analysis. Programme budgeting and other innovations have provided many national governments with much more information on objectives and policies than they had a generation ago. They have more data on the effectiveness of programmes and on the outcomes ensuing from them. Often, however, available data are not used in budgeting. The underutilisation of analytic data has more to do with the time compression and rigidities of budgeting than with the failure to implement programme budgeting. When decisions have to be made under tight deadlines, and almost all budgeted resources are claimed by past commitments and ongoing activities, there is not much space in the process for analytic work.

The survival of organisations as the basic decision unit imparts a vital message for performance budgeting. The path to better performance in government runs through the departments and agencies that produce public services. If they are mobilised to perform, performance budgeting has a foothold to spawn better results – more output and improved outcomes. The essential task of performance budgeting is not to produce better measurement but better organisations. Information is an instrument of analysis; organisations and those who work in them are the wielders of these instruments.

2. Criteria for establishing new budget rules

Budget rules determine how spending decisions are made and reported. Some rules, such as annuality and comprehensiveness, have been accepted practice since the emergence of modern budgeting more than a century ago.

Some are of recent vintage and rely on new techniques such as the medium-term expenditure framework (MTEF). In general, the older the rule, the more widely it is applied. Some rules are inherently country-specific and include the forms and schedules on which spending units bid for money. Many rules are formal and are codified in budget law and manuals, but some of the most important ones are informal, such as the conduct of negotiations between the finance ministry and spending entities. In every country, a vast body of rules dictates the compilation of the budget by the government and its review by the legislature. Many rules pertain to the implementation of the budget and determine the scope for virement and other modifications of the purposes and amounts of expenditure. Most rules are procedural but some, such as those which constrain fiscal aggregates, are substantive.

Although rules have accreted, stability is important in budget procedure. Having routine procedures that recur with little or no change year after year stabilises budgetary roles and relationships and drains the process of much of the conflict that inheres in the competition for limited resources. Frequent changes in procedure complicate the tasks of calculating expenditures and resolving conflict. Nevertheless, changing circumstances and the development of new techniques make it appropriate for governments to modify budget practices from time to time. The two innovations discussed in Sections 3 and 4 have the potential to introduce new budget rules. The case for performance budgeting and for accrual budgeting rests in part on new forms of information processing – performance measurement and accrual accounting – as well as on new conditions facing budget makers, such as rising expectations and fiscal pressures. Before examining these reforms, it would be useful to specify criteria for assessing the appropriateness of proposed changes in budget rules.

One seemingly logical criterion must be discarded. While it might seem sensible to reject proposed rules that would bias budget decisions, it should be apparent that all significant changes in budget rules have the potential to alter budget outcomes. Rules matter because they affect the behaviour of those who exercise authority in budgeting. The essential purpose of new decision rules is to produce allocations that differ from those that would otherwise occur. Performance budgeting aims to give more money to activities that produce wanted results and less to those that do not. Accrual budgeting intends to make governments more cautious in taking on long-term commitments that may have a negligible impact on the current budget but would adversely affect future ones.

Occasionally new rules are substantive: they purposely change the decisions that emerge from the process. Europe's Stability and Growth Pact is of this sort, as are rules that require a balanced budget or some other predetermined fiscal outcome. Most new rules, however, are procedural: they modify the way decisions are made, but do not dictate any particular outcome.

Performance budgeting changes the focus from inputs to outputs; accrual budgeting requires that spending be measured on a cost basis rather than on a cash basis. The following paragraphs specify a number of criteria for assessing these and other procedural changes.

2.1. Government's ability to complete its budget responsibilities

Formulating the budget is one of the few tasks that every government must complete, regardless of how difficult the choices or deep the conflicts. Often, new procedures are introduced in disregard of their effect on budget work. They overload the process, require more information than can be handled in the confined timetable, and ultimately fall into disuse because they get in the way of formulating the budget. Zero-based budgeting (ZBB), which was popular in the United States and some other countries a few decades ago, illustrates this problem. It multiplied the number of decision points for government, requiring additional information and analysis for each decision. While ZBB had laudable intentions, it was unworkable and had to be discarded by governments that made earnest efforts to implement it.

Formulation of the budget may also be impeded by reforms that stir up budget conflict. This appears to be one of the unavoidable side effects of programme budgeting, for it requires that policy makers agree on objectives in addition to deciding the amounts to be spent. It also impels them to review a broader range of options than is normally considered in formulating the budget. Politicians and managers often fight harder over the purposes of expenditure than on the amounts allocated. Friction over the programme structure retards efforts to budget on the basis of objectives. A similar problem sometimes besets governments which embrace performance budgeting and become entangled in protracted argument over the definition of outputs and outcomes. Getting the definitions right becomes more important than getting the government to perform.

2.2. Availability and use of information

Effective implementation of budget rules depends on information. If the government is called upon to budget for tax expenditures or contingent liabilities, it must have reliable data on these transactions. Many governments do not. In this writer's experience, reformers have rarely taken account of the cost, availability or use of the requisite data. They assume that once the requirement is in place, the government will take appropriate steps to inform itself. Things do not always work out this way. Quite a few governments that have been pressured to maintain an MTEF lack reliable projections of future revenue, spending or economic conditions. Similarly, governments that nominally have a performance budget may have insufficient data on the outputs they produce or the social outcomes deriving from public policy. It is not reasonable to expect a government that accounts for public finances on a cash basis or lacks timely, audited financial statements to produce credible accrual-based budgets.

In building robust budget institutions, it would be logical to prepare the way by developing necessary information resources first and establishing rules afterwards. Would-be reformers should study the sequence by which Australia made forward estimates the centrepiece of budget policy. As recounted by John Wanna and associates (Wanna *et al.*, 2000, pp. 319-322), development of forward estimates as a decision rule proceeded in a series of steps over several years. At first, the estimates were internal projections used exclusively by the Department of Finance and Administration in its budget work. They were not deemed sufficiently reliable for public dissemination. However, before long, the Department realised that it would have a stronger case for budgetary discipline if others had access to the forward estimates, and it upgraded them for publication. Once they were public, government leaders decided to use them to frame medium-term expenditure decisions.

The high cost and limited availability of new data are serious impediments to budget innovation in developing countries. But the issue affects all countries because major reforms add to the informational burdens of those who bid for or allocate resources. Far-reaching reforms may be more successful when the government purges some old informational requirements to make room for new ones than when it layers new data on the old. When Australia made forward estimates the basis for policy and fiscal decisions, it eliminated much of the line-item detail that previously dominated budget decisions. And when New Zealand adopted output-based budgeting, it removed almost all mention of inputs from the budget, appropriations act, and supporting documents. In many countries, by contrast, budgeting is an amalgamation of multiple waves of reform, each of which has deposited its residue of informational requirements.

When governments add budget rules, they facilely assume that the new information will be used. This assumption leads to the overproduction and underutilisation of budgetary data. For example, requiring governments to compile data on contingent liabilities does not itself assure that they will regulate these financial risks. Even if they were required to publish the data in the budget, governments may lack the incentive or the opportunity to make effective use of the data.

2.3. Relevance of budget rules

New budget rules must make sense to those who are supposed to produce the data or use them. Often they do not make sense and they come to be regarded as a technical exercise, one of the many chores that must be done to get through the annual budget cycle. This has been the fate of many of the reforms prescribed by international financial institutions for developing countries. It is highly likely that this fate will befall accrual budgeting if it is adopted by governments that do not understand it and have no plans to use the information in managing public finances.

Innovative rules acquire relevance when they are integrated into ongoing budget practices and are not hived off to the periphery of the process. Australia made a success of forward estimates when they became the central instrument for setting budget policy. In many countries, however, an MTEF is irrelevant because it stands apart from the annual budget. Relevance is promoted when governments decide in advance how new rules and the resulting information will be applied. It is often assumed that requiring a particular practice or report suffices. Innovations in budget practice that are not viewed by practitioners as useful do not survive.

2.4. Enforcing the rules

Budget rules are not self-enforcing. Just because a procedure is mandated in law or regulation does not mean that it will be applied. In budgeting, as in other activities, there are numerous ways to sabotage unwanted innovations. When budget rules are deemed important, the means of enforcement should be built in from the outset. In some countries, enforcement is assigned to the audit office or to a legislative committee, such as the Public Accounts Committee in the United Kingdom. In other countries, courts have become involved in enforcing budget rules.

The reforms discussed in Sections 3 and 4 diverge in terms of enforcement. When the accrual basis is embedded in accounting rules and auditors are armed with independence and resources, failure to comply with the rules may result in qualified financial statements and impaired access to capital markets. With rare exception, government pronouncements on performance are not systematically audited. Citizens and interest groups have little recourse when results are misstated or disregarded. For performance budgeting and accrual budgeting to take root, it is essential that governments have formal procedures for reviewing reported results, including accepted standards for measuring outputs and outcomes and for reporting costs and liabilities.

2.5. Learn from past efforts that failed

The spread of budget rules has been propelled by stories of successful innovations in *avant garde* countries. Relatively little attention is paid to how the reforms were introduced, the obstacles that had to be surmounted, the special conditions that enabled success, and the features that did not work out quite as expected and were discarded along the way. When it comes to emulating other countries, failure is usually a better teacher than success. But who knows or cares about reforms that were launched with much fanfare only to be abandoned with barely a notice? Australia's ambitious strategy to thoroughly evaluate all programmes was accorded much publicity, but no announcement was made when the strategy was terminated. Britain's "Next Steps" initiative, which led to the creation of more than 100 agencies with broad operating independence, is well-known around the world, but the retaking of managerial control by ministries and central agencies during the Blair regime is hardly known. Sweden is rightfully regarded as an innovative country, but it is hard to find information on why its results-budgeting initiative of the 1980s barely got off the ground. Even more important than absolute failure is the necessary tinkering to take a reform from blueprint to practice, to get a promising concept to work within the demanding realities of budgeting.

Performance budgeting is a case study of repeated failure. The concept was introduced in the United States shortly after World War II, but it disappeared with hardly a trace. Governments attempting performance budgeting today would learn much by studying why this American innovation, and many others like it, lapsed into obscurity. Why did a reform that is so sensible survive for no more than a few years, and why is a new version invented every decade or so? What are the political, organisational and informational prerequisites for making a success of performance budgeting? Addressing these types of questions would shed light on the conditions needed for performance-based innovations to work.

2.6. The architecture of reform matters

Governments that move to performance budgeting or accrual budgeting often have a broader reform agenda that may include lengthening the timeframe of budgeting, undertaking programme evaluation, changing the format of the budget, and other innovations. Quite often the various initiatives are disconnected from one another, giving rise to confusion and reform fatigue. Whether innovations are intended to be decision rules or analytic tools, it is important that the government link the pieces together so that those who have to make them work understand how they are connected.

The two reforms discussed in Sections 3 and 4 illustrate this problem. While they are typically depicted as separate innovations, both performance budgeting and accrual budgeting require reliable attribution of costs to activities, including apportionment of indirect and overhead costs. But when each reform is entrusted to a different entity, each entity may define and measure costs differently, leading to inconsistent rules and widespread confusion. The problem occurs when innovation is an analytic tool, but is significantly more damaging when it is promoted as a new decision rule. The solution, which is rarely achieved, is to pay attention to the overall architecture of reform, so that performance budgeting and accrual budgeting are designed as one set of innovations rather than as discrete changes.

2.7. The internationalisation of budget rules

Not long ago, budget rules were specific to each country. Although they were influenced by practices in other countries and there was an active exchange of ideas, governments charted their own course. This is now undergoing change, as international organisations recommend or dictate country practices. The rules are strongest with regard to fiscal outcomes, but they also pertain to other budget practices. The European Commission has an elaborate set of rules, including the close review of annual budgets and multi-year spending plans of member countries. The IMF has issued a "Code of Good Practices on Fiscal Transparency" and has converted its government finance statistics (GFS) to the accrual basis. Although it will take considerable time, one should not be surprised if international organisations were to devise rules for measuring and reporting programme results. Once rules are established to account for expenditure, it is only a short distance for them to migrate to the making of expenditure decisions. This has been the path taken by the accrual basis, which is moving from a rule that pertains to financial reporting to one that covers budget decisions as well.

It is important that international organisations be mindful of the distinction between analytic tools and decision rules and, except where there is compelling justification, that they leave rules to the discretion of national governments. It also is important that they distinguish between good and best practice, internationalising practices which have been implemented in a broad swath of countries, not only in the most advanced ones.

3. Performance budgeting

Performance budgeting is easy to explain but has been hard to implement. The basic idea is that governments should budget for actual or expected results (typically labelled as outputs and outcomes) rather than for inputs (personnel, supplies and other items). When deciding the budget, governments should be informed of the services that public agencies will provide and the expected benefits and social conditions that will derive from spending public funds. As appealing and sensible as this idea is, putting it into practice has been exceedingly difficult. Governments have many things on their minds when they allocate resources; performance is only one preoccupation and usually not the most urgent.

While it appears to be simple, performance budgeting comes in as many varieties as there are governments that have applied it. Each government has its own approach and each has distinctive definitions and methods for feeding performance data into the stream of budget work. The many approaches can be aligned along a spectrum ranging from the loosest concept to the most stringent, with numerous shadings in between. Loosely defined, any system that provides information on the volume of outputs, the activities of government agencies, their workload, indicators of demand or need for public serves, or the impact of expenditure qualifies as a performance budget. Strictly defined, only the budget systems which formally link increments in spending to increments in results would qualify. Under the first definition, many governments could claim to have performance budgets; under the second, few could. With such a wide range, one may justifiably argue either that performance budgeting has been truly successful or that it has dismally failed.

The difference between the two definitions corresponds precisely to the distinction drawn in this article between analytic tools and decision rules. If all that performance budgeting does is to inform policy makers, it serves as an aid to analysis, though like all analytic instruments, it risks falling into disuse. On the other hand, if it is deployed to decide budget allocations, performance budgeting functions as a rule that can be stated in the following form: the government should consistently allocate resources on the basis of evidence or reasoned expectations of results. To do so, each increment in expenditure should result in an increment in results, defined as a greater volume of output or additional improvement in social conditions.

Both versions of performance budgeting depend on information concerning the services or results of public expenditure. Their data requirements overlap but are not identical: those deriving from the stringent version are much more demanding. For most analytic purposes, it suffices to disaggregate data to the programme or activity level; for budget decisions on marginal results, data on cost and results must be attributed to discrete units of output or results. Lacking robust cost accounting systems, most governments cannot allocate costs so as to connect incremental resources and results.

For all versions, the dependence on information explains why governments have invested in measuring performance. It is not feasible to budget for performance without measuring it, but it is feasible to measure and not budget for performance. In many countries, defining and compiling data on performance is not only the first step, but the last one as well. As discussed below, analysts and managers often engage in heated and protracted argument over the definition of outputs and outcomes, leaving insufficient opportunity to apply the data in the budget practices.

It is technically feasible to measure and budget for incremental results, but few governments have actually done so. Although they may want to budget for performance, governments must take other considerations into account when they set spending levels. Foremost is the necessity to pay for past commitments as well as for ongoing activities and the operating costs of government departments and agencies. In drawing up the budget, policy makers must also be mindful of political promises, interest group demands, and the overriding need to complete budget work by curtailing conflict over objectives and resources. When all powerful claims on resources have been satisfied, not much is left over to allocate on the basis of results, and performance is crowded out altogether or recedes to the margins of the budget.

Progress has also been hindered by lack of a strong performance ethic in public management. To anticipate an argument that will be elaborated later in this section, the government cannot budget for performance if it does not manage for performance. Managers and rank-and-file civil servants must care about delivering good services and improving the efficiency of operations, and they must pay attention to the outcomes that flow from government policies. They must be willing to take a hard look at what works and what does not, and to reallocate resources from less effective to more effective activities. If they are not willing, no dose of performance data will make much of a dent in their agency's performance. This argument has far-reaching implications, for it portends that the reform of budgeting must be part of a larger transformation of government.

3.1. Analytic tool or decision rule?

The principal theme of this sub-section is that most governments would do well to deploy performance budgeting as an analytic tool because few have the capacity to ground budget decisions on it. Governments usually fail when they conceive of performance budgeting as the key instrument for allocating resources. Failure often leaves governments with a robust supply of relevant information that can enhance public policy. It is important, therefore, to consider both the opportunities and impediments for applying performance information to budget decisions.

The notion that the government should purposely spend money to purchase results has considerable appeal. It is reasonable to expect that the government is informed of the increase or decrease in outputs or of the changes in social conditions that are expected to flow from its decisions. For many budget issues, it is technically feasible to link incremental resources and results in the manner called for by the strict definition of performance budgeting. In fact, a small number of governments operate this type of budget, but it is definitely beyond the reach of all but the most innovative. Few governments have both the political will and the necessary data to link increments in resources to increments in results.

One government that has the requisite conditions is Sunnyvale, a small city in the state of California in the United States, which has operated a true performance budget for approximately two decades. Sunnyvale's approach, which in this writer's judgment is among the most advanced in the world, presents policy makers with a series of options in each major area of public activity. For example, in budgeting for fire services, the city allocates money so that response time from receipt of an emergency call to arrival of fire equipment on the scene should be no more than 7 minutes, 20 seconds. Before taking this decision, city officials consider alternatives that would lengthen or reduce response time by spending less or more money than the amount agreed in the budget. In this example, outputs have a qualitative dimension and are not defined solely in terms of volume.

Although it is two decades old, the Sunnyvale model lies at the cutting edge of performance budgeting. It illustrates the potential for deploying this reform as a decision rule that drives budget allocations. Doing so would transform budgeting into a process for allocating resources at the margins. Indeed, this is almost always the question that confronts budgeting: Should government spend a little more or a little less? But there is one big difference: Sunnyvale explicitly decides more or less in terms of marginal changes in outputs or outcomes. This has the effect of making performance budgeting the key rule for deciding how much to spend on each government activity.

Transforming performance budgeting into a decision rule would require at least the following capabilities: *i)* the government would need information and expertise to disaggregate activities or outputs into standardised units; *ii)* it would then allocate costs to these units; and *iii)* it would acquire capacity to measure results contributed by each unit. These are truly challenging tasks, for few governments have robust cost accounting systems that enable them to measure marginal costs by distinguishing between fixed and variable costs, as well as between marginal and average costs. It is also essential to allocate costs among the units producing outputs and other benefits. Without reliable cost measurement and assignment, Sunnyvale would have no legitimate basis for determining that the amount budgeted would enable the fire department to respond within 7 minutes, 20 seconds. Without more detailed knowledge, one can only imagine the large amount of analysis and measurement that underlies Sunnyvale's budget decisions. Inasmuch as the unit cost of producing the next increment in results usually differs from the unit cost of producing the previous increment, it has been necessary for Sunnyvale to develop tools of marginal analysis for government.

Governments which embrace performance budgeting as a decision rule face another handicap. When it appropriates money, the government usually acquires the entire output of each spending unit for a fixed sum. Except in entities financed by trading income, the amount spent by the government does not vary if fewer or more outputs are produced. The Sunnyvale fire department receives the same appropriation whether it responds to 50 fires or 500. This critical difference between public sector budgeting and commercial budgeting is one of the main reasons why it is not normally advisable to define performance budgeting as a decision rule. Most large businesses have variable budgets: the resources available to operating units vary automatically with the volume of goods and services they produce. If they produce more, they have more to spend. For innovative governments, such as Sunnyvale, it would be necessary to shift from fixed to variable budgeting. This poses difficult questions pertaining to appropriations as legal limits on expenditure.

Additional considerations weigh against deploying performance budgeting as the basis for budget allocations. One is that results are not a sufficient guide for spending decisions. In some situations, poor results may compel the government to spend more, while favourable results may enable them to spend less. In order to budget for results, governments require a deeper understanding of programmes and options than is provided by output and outcome measures. Moreover, when the government is the sole or dominant supplier of an essential service, it may be compelled to spend even when favourable results are not forthcoming. Few governments have the option to close low-performing public schools.

Sound budgeting is as much a matter of political and managerial judgment as of results measurement. These judgments are especially important when the concept of performance moves from outputs to outcomes. There is rarely a linear connection between the amounts spent and the outcomes that ensue. For this reason, the strict version of performance budgeting emphasises outputs, not outcomes. This was the path taken by New Zealand when it reformed public finance in the early 1990s, and it is the path taken by governments such as Sunnyvale.

In assessing the suitability of performance budgeting for decisions, it is essential to keep in mind that governments finance ongoing organisations, not just programmes and results. This is why organisational units have survived as the main classification scheme in budgeting. As will be elaborated below, organisational performance is defined not only by substantive results but also by its capacity to innovate, its responsiveness to clients, and the morale and skills of its workforce.

The foregoing arguments lead conclusively to the finding that, in all but exceptional circumstances, performance budgeting should be regarded as analytic input into the budget process. The impact of performance information on the budget will vary from one cycle to the next, as well as among programmes within each cycle. A sensible way of thinking about performance information comes from the United States Office of Management and Budget (OMB) which has made significant progress implementing the Program Assessment Rating Tool (PART) that evaluates approximately one-fifth of all federal programmes each year through a menu of questions covering four dimensions of performance: programme purpose and design, strategic capacity, programme management, and programme results. The responses are weighted into an aggregate score for each programme, which is then used together with other information by the OMB to recommend budget allocations. The OMB cautions in its guidelines that "program performance will not be the only factor in decisions about how much funding programs receive. However, the Congress and the President, equipped with information about program performance, can consider performance to a greater degree in their decision making…".[2] In sum, PART is an analytic tool, not a decision rule.

3.2. Measuring performance

Over the years, governments have invested more effort in measurement than in any other feature of performance budgeting. As already noted, measurement has been the only step in many countries. Efforts to measure the activities and results of government expenditure date back many years. One of the earliest was launched more than 70 years ago when Herbert Simon (a future Nobel Laureate in Economics) teamed with the head of the International City Managers Association to devise a measurement scheme based on the concept that "the result of an effort or performance indicates the effect of that effort or performance in accomplishing its objective" (Ridley and Simon, 1943, p. 2)[3]. Since then, thousands of articles and reports have been published, each providing its own language and approach. Perhaps because of the large volume of such studies, management guru Donald Kettl has observed that "measuring government performance is like the weather. Everybody talks about it…but there is no consensus on how to do it."[4]

Because definitions and measures have not been standardised, most governments invent their own, striving to produce the right measurement system for themselves. The novelty and inflated importance of the task often generates interminable argument over whether a particular measure is an output or an outcome, a target or an indicator, a goal or an objective, an end outcome or only an intermediate outcome. In this writer's view, something is amiss when, after decades of research and experience, governments struggle with basic concepts, as if ordinary words such as outputs and targets are so obscure that they need their own dictionary. Protracted argument conveys the impression that measurement is an end in itself; getting government to perform better is secondary to getting better measures.

In the measurement industry, relatively little forethought has been invested in how the new data are to be used in managing government and allocating resources. It is assumed that once data are available, they will be used. Judging from past experience, this is an unwarranted assumption; the more likely action is that they will be ignored. Especially when the aim is to influence budgetary behaviour, it is important to think through the means by which such measures might be invested with greater relevance. To the extent that budgeting entails choices at the margins, it would be sensible to measure performance in terms of the different results that would ensue from different budget allocations. If this were done, the tools of analysis would be aligned with the structure of budget decisions. In fact, however, most performance measures are snapshots: they display outputs or outcomes under only one policy. Although they may yield useful insights, snapshots do not shed light on what budget makers need to know about performance. From the vantage point of politicians and managers, the key performance questions are: what difference will it make if governments adopt this policy option rather than another one? And what difference will it make if spending is raised or lowered? For example, how many more children might complete schooling because the budget is subsidising hot lunches? How many more would continue on to secondary education if the school were staffed with guidance counsellors? As these questions indicate, it is feasible to frame performance measures in terms of the differences in outputs or outcomes that would result from changing the amounts spent.

The next few paragraphs suggest one approach for focusing performance measures on the issues facing budget makers. It is not the only feasible approach, but it is set out here because it fits in well with budget practices in many countries, though the approach itself is not yet used in any country. The core idea is for the government to construct a baseline of the services that would be provided if current policies (including budget allocations) were continued without change. This services baseline would parallel the expenditure baseline that is widely used to prepare and analyse budgets. The expenditure baseline is an essential component of the MTEF; it enables governments to project future spending under current policy. The baseline is usually updated annually (or more frequently) for changes in prices and other economic and programme variables. Once these adjustments have been made, any change in spending – defined as a variance from the baseline – must be the result of policy change. A similar baseline would project the types and volumes of services for the next year or the medium term. Linking the two baselines would greatly enhance the utility of performance measurement as a tool of budget analysis by showing how changes in spending and services are linked.

Many technical issues would have to be resolved in constructing a services baseline, but these are not inherently more difficult than those that arise in estimating baseline expenditures. Both the expenditure and services baselines would rely on assumptions about prices, workload and other variables; both would require rules for estimating future amounts; and both would rely on procedures for adjusting the projections and measuring policy changes. In much the same way that it estimates the spending implications of policy changes, the government would estimate the service implications of these changes. In effect, this is what Sunnyvale must do to compile its annual budget. How else could it estimate the impact of spending levels on response time in the fire department?

The purpose of suggesting the services baseline is not to recommend a particular course of action, but to urge that much can be done to strengthen performance measurement as an analytic tool. Change-oriented performance measurement is relevant because it focuses on the issues governments deal with when the budget is being formulated. Some might object that a services baseline entrenches incrementalism – the tendency to consider only marginal changes – in budget work. The objection is valid, but half a century of warring against incrementalism has left budget reformers with nothing but failure. The most fruitful path to successfully deploying performance measurement is one that recognises and exploits incrementalism's hold on budget decisions.

3.3. Managing for performance

Both as a decision rule and as an analytic tool, performance budgeting is effective only when the managerial culture is supportive. Previous waves of reform assumed that budgeting drives management; if the budget is oriented to results, government entities will be managed for results. This premise was grounded on a simplistic notion: government entities need money to operate. Therefore, if the money they receive is conditioned on performance, they will be motivated to perform better. This reasoning is flawed in this writer's view, and dooms performance budgeting to failure, for it does not recognise that budgeting is shaped by the managerial context within which resources are spent and services provided. If managers do not care about results or if employees are indifferent to how well they perform, installing performance budgeting or similar techniques will hardly make a difference. One of the most important lessons from half a century of disappointment is that budgeting cannot be transformed in isolation from the management practices and culture in which it is embedded. Only when they manage for results will managers be able to budget for results.

One corollary of this theme is that it is necessary to measure or otherwise gauge the performance of public organisations. Good performance is not manna from heaven; in every instance, it has the fingerprints of organisations that are doing their job and producing results. Focusing only on outputs and outcomes ignores fundamental questions about how results materialise. Why do some organisations perform well and others poorly? What are the characteristics of high-performing organisations? How can organisations improve results? These and similar questions have a common answer: public agencies have to be organised, motivated, managed and financed to perform the tasks expected of them.

Some governments have attempted to build organisational characteristics into performance measurement. New Zealand has one of the most interesting systems, for it distinguishes between the government's role as a purchaser of the outputs of state entities and its role as owner of the agencies. There is a tension between the two roles that pulls the government in opposite directions. Its interest as a purchaser is short-term: the government aims to buy outputs for the current or next year at a low price. Its ownership interest is long term: the government is concerned with the capacity of public agencies to respond to future demands and changing conditions, and it is impelled to sell outputs at a sufficiently high price so that agencies can invest in training, research and development, and other actions that capacitate it.

In New Zealand, the purchaser role overwhelmed ownership, with the result that inadequate attention was given to organisational health. The balanced scorecard, which was in vogue a few years ago, attempted to redress this imbalance by treating outputs as only one of four sets of interdependent performance measures. The other three pertain to internal processes and practices, staff quality and morale, and customer needs and satisfaction. In calling attention to this approach, this writer's aim is to encourage governments to think in organisational terms when they invest in performance budgeting. As an analytic tool, performance budgeting works only when the tool is wielded by agencies that know how to use it and are motivated to perform.

4. Accrual budgeting

To assess the accrual basis, it is necessary to distinguish between *ex post* reporting of financial results and *ex ante* specification of revenue and expenditure policy. While it may be appropriate to prescribe the accrual basis in financial reporting, extension of this principle to budget statements raises critical questions that must be addressed by each country through its political-administrative machinery. It is essential to standardise financial statements, but it may still be appropriate for countries to establish their own budget conventions. Thus, the case for accrual budgeting must be made independently of arguments used in support of accrual accounting.

The recent development and dissemination of public sector accounting standards have impelled many national governments to accrue assets and liabilities on the balance sheet, as well as income and expenses on operating statements. However, few governments systematically accrue revenues and expenditures in the budget. The short list of countries that have full accrual budgets is Australia, New Zealand and the United Kingdom. Other countries have adopted accruals for certain types of transactions. These countries include Iceland, Sweden and the United States. All these countries differ from one another in applying accrual principles to the budget. Some of the countries set aside money for depreciation or a capital charge, others do not. Some book all taxes due as current revenue; others recognise revenue when it is received. These and other differences indicate that accrual budgeting is still in the testing stage, and that it would be premature for all but the most *avant garde* countries to shift their budgets to this basis.

All of the national governments that have implemented accrual budgeting have two distinguishing characteristics. They are regarded as among the best managed countries in the world, and they generally give public managers broad operating discretion. These characteristics may be necessary preconditions for accrual budgeting. Strong management is essential because the accrual basis adds to the complexity of financial management and requires both skill and probity in valuing assets and liabilities. Operational discretion is also important to enable managers to efficiently use available resources. Without appropriate discretion, managers are likely to regard accruals as technical entries that have no bearing on the resources available for expenditure.

4.1. Reporting and budgeting

The disparity between the wide application of accrual accounting and the limited implementation of accrual budgeting suggests that the factors which have induced governments to present their financial statements on the accrual basis are not as compelling in determining how governments go about estimating future revenue and expenditure flows in the budget. Financial statements are subject to audit, budgets are not, though it is possible that they will be in the future. Financial statements are a means of communicating the government's condition to interested outside parties; budgets traditionally have been a means of communicating within government. The fact that some cutting-edge governments have embraced accrual budgeting indicates that the traditional differences between the two types of statements may be narrowing. But the two types of statements still serve different purposes, and the methods suitable for one might not suit the other.

The distinction between financial reporting and budgeting bears directly on the central question of this article: When should a particular form of information be cast as an analytic rule or a decision tool? Prescribing the accrual basis for financial statements gives a government valuable insights that may enhance the formulation of budget policy. With current information on assets and liabilities, a government can more clearly assess how changes in budget policy would impact its future financial condition. But as long as the budget itself is not on the accrual basis, these insights are only analytic tools, even though they are mandated for financial reports. However, if the budget were put on an accrual basis, this would become a decision rule for estimating the receipts and expenditures expected for the next or subsequent financial periods.

The fact that many governments report but do not budget for accruals indicates a preference for treating information on assets and liabilities as aids to analysis rather than as categories for decision. This is exemplified by the latest reforms in France. Much of the literature on the accrual basis, however, ignores the differences between reporting and budgeting and assumes that what is appropriate for the former also suits the latter. For example, a report published in 2003 by the Asian Development Bank devoted more than three-quarters of its 85 pages to accrual accounting, but then argued that if it were applied only to financial reporting, accrual information may not be taken seriously. The budget is the key management document in the public sector, and accountability is based on implementing the budget as approved by the legislature. If the budget is on a cash basis, that is going to be the dominant basis on which politicians and senior civil servants work. Financial reporting on a different basis risks becoming a purely technical accounting exercise in these cases (Athukorala and Reid, 2003, p. 51).

No claim is made here that accruals add value to budgeting; rather, the case rests on the value that would be subtracted from financial reporting if the budget were on a cash basis.

It should be noted that even when both reporting and budgeting are on the accrual basis, they may show different financial results either because they apply different accounting rules or because they value things differently. For 2005, the State of Queensland in Australia reported a budget surplus of approximately AUD 3 billion, but the balance sheet reported an AUD 18 billion increase in net worth. This increase was due principally to revaluation of existing assets, not to the accumulation of additional assets during the financial year. The difference between the balance sheet and the budget is justified because one measures financial stocks and the other measures financial flows. A much stronger case can be made for applying accruals to stocks, because they provide a full accounting of an entity's assets and liabilities, rather than applying accruals to flows, which measure financial transactions during a fixed time period. The accrual basis would transform the budget from a statement of flows to a statement of fiscal impact. In fact, one of the aims of those who advocate accrual budgeting is to turn the budget into a fiscal impact statement.

Before endorsing this transformation, it would be useful to consider the evolution and purposes of budgeting and how accruals might affect budgetary practices. Modern budgeting emerged in Europe more than two centuries ago as a means of planning and regulating the cash flow of government during a fixed period, typically a single fiscal year. Budgeting supplemented appropriations, which were already on the cash basis and restricted the amounts that the government was authorised to spend. Because it is inherently a political statement, the budget had its own country-specific rules and conventions. The fiscal balance was calculated as the arithmetical difference between cash received and cash paid out during the financial year. This calculation only covered accounts and funds that were included in the budget; it did not include off-budget or extrabudgetary items.

Operating within their own rules, budgets were subject to manipulation, as opportunistic politicians sought to project or produce fiscal outcomes that suited their interests. In many countries, the manipulations were marginal, such as adding a bit to revenue by selling assets, or subtracting a little from expenditure by delaying certain payments. Although they were not good practice, the manipulations enabled cross-pressured politicians to muddle through from one budget year to the next. In some countries, however, manipulations became so common and significant as to undermine the integrity of budget accounts. Whether marginal or major, these practices highlighted deficiencies in cash-flow budgeting.

During the past two decades, several factors have converged to challenge cash-flow budgeting. One has been the internationalisation of accounting rules and the auditing of government financial reports. The IMF shifted its government finance statistics (GFS) to the accrual basis at the start of the 21st century, and the International Public Sector Accounting Standards Board (IPSASB) has been busy promulgating accrual-based rules for public entities. In addition, various international organisations have co-operated in shifting the system of national accounts (SNA) to a modified accrual basis. A second, related, influence has been the rapid spread of fiscal rules which constrain budget options and outcomes. Effective enforcement of these rules depends on objective information concerning the government's fiscal performance. Moreover, without accounting standards, these rules would provide politicians with fresh incentive to manipulate the timing or recognition of various transactions to make the government's fiscal position appear more favourable than it actually is. Finally, the successful conversion of pioneer countries such as New Zealand to the accrual basis has spurred other countries to follow suit.

In business firms, the budget is an internal document that is not bound by accounting rules. Each firm can prepare its budget in the format and on the basis that fits its interests. However, government budgets are not internal documents; they are presented to parliament for approval and are one of the major instruments for informing citizens of public policies and priorities. Arguably, citizens should have transparent, tamper-proof statements of the government's budget plans that comply with accepted accounting standards and are not manipulated for political advantage. Despite these considerations, cash-flow budgeting has several compelling advantages. It is better understood by citizens and the government than accrual budgeting; it may be less prone to manipulation; and it may provide a more reliable indicator of the government's near-term fiscal condition.

Shifting to the accrual basis transfers budgetary power from elected leaders to technical experts. Cash is the everyday currency of private and public transactions. Governments take in cash and spend cash, and the amounts reported are actual rather than assumed. Accruals are grounded on complex assumptions that can befuddle experienced politicians. One should not be surprised if technocrats get into the habit of soothing the concerns of ministers, assuring them that "these are only technical entries that do not affect the resources you really have to spend". One entry adds money to pay for depreciation or a capital charge; another entry withdraws an equivalent amount of money. In some instances, this new form of double-entry budgeting might change political or managerial behaviour. In most, it will not.

One of the reputed advantages of accruals is that they are less subject to manipulation than cash. Under accruals, the government does not increase its net worth by selling assets for cash, nor does it improve its fiscal position by accelerating tax collections or delaying bill payments. But under the accrual basis, governments can manipulate fiscal estimates or results by changing assumptions about interest rates or tax arrears, adjusting discount rates, revaluing assets, or altering some of the myriad assumptions made in the course of accruing revenues and expenditures. It is often much harder to detect manipulations that are buried under layers of assumptions than those linked to cash transactions.

Finally, cash is sometimes a more reliable indicator of an entity's current financial condition. As the accrual basis becomes embedded, accounting authorities produce more rules which increase the variance between cash flows and accrued results. In recent years, the International Public Sector Accounting Standards Board (IPSASB) has issued more than 20 accrual-based rules for public sector entities, and more can be expected in the years ahead as new financial instruments are devised or new conditions arise. In some circumstances, cash may be a more accurate indicator of fiscal performance. It is well known that the shares of companies whose reported earnings are depressed by negative accruals tend to outperform companies whose earnings are boosted by accruals. This "accruals anomaly" (the term applied to the phenomenon in finance studies) indicates that investors who pay attention to cash earnings will do much better than those who focus on reported earnings.[5] Although one should be wary of generalising from business accounting to government finance, the clear implication that cash is a useful measure of financial performance does pertain to public entities.

4.2. Accruals as an analytic tool

Accruals warrant a prominent place in financial reporting because they provide insights into government finance that are not yielded by cash alone. The three most salient claims for accruals are that they provide better measures of the government's current fiscal condition and of long-run sustainability, and they encourage managers to operate efficiently. Each is important, and each warrants close review.

When the government's **fiscal condition** is measured in cash, it is likely to be incomplete and subject to manipulation. Cash accounts do not include depreciation of assets and can be made to appear more favourable by manipulating the recognition of transactions. The shorter the timeframe, the greater the scope for manipulation. In a one-year budget cycle, the government need only defer expenditure or advance tax collections by a few days (or weeks) to produce more favourable outcomes. In a medium-term frame, shifting from one year to another may make little or no difference. Yet, even on an annual basis, there is often little difference between cash and accrual accounting. In New Zealand, for example, for the 2004 financial year, there was less than a 0.8% variance between revenues recognised on the cash and accrual bases. The variance was also very small for current expenditure, with expensing of depreciation under the accrual basis largely offset by deferring recognition of capital expenditure. In fact, in some circumstances, the accrual basis yields a lower deficit (or higher surplus) than in cash accounting.

It may be argued that New Zealand has an elevated degree of probity in public finance and does not purposely manipulate transactions to improve cash flows. Countries lacking this ethic are likely to show much larger variances between cash and accruals, as would countries which do not efficiently maintain public infrastructure or have significant leakages in tax collections. All this may be valid, but it leads this writer to the conclusion that countries (such as New Zealand) which are best prepared for accrual budgeting get rather little out of it; and countries that need it the most because they have the greatest variances between cash and accruals (such as those which finance deficits through asset sales) probably lack both the technical skill and the political will to operate accrual budgets.

Governments can guard against the manipulation of accounts in a cash system by establishing rules concerning certain types of transactions. Some governments treat income from asset sales as a means of financing rather than as a cash inflow, while some exclude savings due to timing adjustments from baseline projections. It may be argued that these rules introduce accrual-like rules into budgeting, yet they do so within a cash framework. In other words, the government avoids both the cost of moving to accrual budgeting and the principal distortions of cash budgeting.

The second claim shifts the focus from the short (or medium) term to long-term **fiscal sustainability**. The key concern is that governments that budget on a cash basis tend to ignore the accumulation of liabilities that will be paid in the distant future typically for pensions and health care. But accounting rules significantly diminish the utility of accruals as indicators of long-term fiscal soundness. While they provide for governments to recognise future payments for their own employees, accounting rules preclude the recognition of liabilities for social security and other non-employee benefits.[6] Whatever the rationale for including one type of liability and excluding the other, the result is that accrual-based statements do not provide sufficient insight into the government's future fiscal position. Some well-run national governments have supplemented official financial statements with long-term fiscal sustainability studies which do include social security and other liabilities excluded from accrual accounts. The United Kingdom Treasury publishes an annual long-term fiscal forecast, and the government of Australia publishes an intergenerational report every five years. These sustainability analyses can be conducted regardless of whether the budget is cash or accrual based.

The third claim is that accrual budgeting establishes conditions for **managerial efficiency and accountability** because it budgets all the costs associated with carrying out particular activities or services. Managers are accountable for all costs, including those paid out of other accounts (such as employee pensions and the imputed cost of accommodation in public buildings). Operating accounts are charged for the depreciation of physical assets and (in some countries) for the capital invested by the government in the entity. Capacity and incentive to manage costs depend on managers having broad discretion to spend operating funds as they deem appropriate. When managers lack operating freedom because the funds they spend are earmarked for designated purposes, making them responsible for full costs is counterproductive, for they are charged for matters over which they have no control.

At present, few national governments give managers sufficient operating discretion to make effective use of accruals. Those governments that do risk complications when managers take money appropriated for depreciation and spend it on other items instead. This has occurred in Australia which, in contrast to some other countries that have accrual budgets, makes cash appropriations for depreciation. In the countries that do not, depreciation and some other accrued charges are regarded as technical matters that have little bearing on how public funds are managed.

Thus far, there is little evidence that accrual budgeting has made much difference in managerial behaviour. It can be argued that accrual accounting and budgeting work only when they are accompanied by performance management and budgeting. Without these management capacities, it is prudent for countries to continue to upgrade their existing cash-based systems. In other words, accrual budgeting may only be ripe for the small cohort of best managed governments. Many countries would achieve greater progress by improving cost allocation and measurement systems, broadening managerial discretion, and enhancing the quality of performance measurements than by moving to accrual budgeting.

In line with the earlier discussion, countries that have adopted accrual budgeting claim that it has strengthened short-term fiscal performance. But programme managers rarely use accrual budgeting to manage operations. Although it has strongly endorsed accrual budgeting, the Asian Development Bank has also concluded that accrual "information does not necessarily change results". Drawing on New Zealand's experience, the ADB found that the improvements achieved by government were primarily due to political will. A less sophisticated system could have achieved a great deal in the presence of that political will, and an even more sophisticated system would achieve very little if the political will to use it were not present (Athukorala and Reid, 2003, p. 51).

This conclusion has profound implications for the central issue of this article. The essential purpose of new decision rules is to compel changes in budgetary behaviour. But if the changes sought depend on the will of those who manage the budget, the new techniques serve only as analytic tools.

5. Concluding remarks

Neither performance budgeting nor accrual budgeting is ready for widespread application as a decision rule. Both have unresolved issues and are costly to implement. In performance budgeting, the key issue is the extent to which resources should be linked to results; in accrual budgeting, the issues are much more complex and pertain to the valuation of assets, recognition of revenues, treatment of depreciation and capital charges, and other unresolved questions.[7] The few countries that have adopted accrual budgeting have taken different approaches; their experiences should provide a firmer basis for assessing accruals in the future.

Although they are distinct innovations, performance budgeting and accrual budgeting share a dependence on robust, results-oriented management and full cost attribution. Because these qualities are absent in most countries, the suitability of performance and accrual systems is limited. It is not surprising, therefore, that the countries which have good performance-based management are most likely to have adopted features of accrual budgeting. For the vast majority of countries, performance budgeting and accrual budgeting suffice as analytic tools. This is a second-best solution that promises greater gains in budgeting than would be forthcoming from the pursuit of cutting-edge innovations.

Notes

1. The *Analytical Perspectives* for the fiscal 2007 budget is a document of 400 pages. It is published by the United States Government Printing Office together with the main budget documents.
2. PART instructions and results are published on website of the Office of Management and Budget, *www.omb.gov*.
3. This book was drawn from monthly articles published in 1937 and 1938.
4. Quoted in Osborne and Plastrik (2000), p. 249.
5. The seminal study on this subject is Sloan (1996).
6. Under generally accepted accounting principles, a liability is recognised when an event has already occurred, a future payment is probable, and the amount can be reliably estimated.
7. The main issues are presented in Blöndal (2004).

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