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Budget Reform in OECD Member Countries: Common Trends

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1. Introduction

From the early 1990s, the fiscal position of OECD member countries improved steadily each year, from a deficit of 5% of GDP for member countries as whole in 1993 to a perfect balance in the year 2000, *i.e.* neither a deficit nor a surplus. In 2001, member countries experienced a deficit of 1% of GDP. Table 1 depicts the general government financial balances of selected OECD member countries. This goes to show the historical pattern in member countries: achieving fiscal consolidation is a slow process and successes in fiscal consolidation can quickly dissipate. A very short time ago, several OECD member countries believed that they were on a long-term track for fiscal surpluses; the era of deficits had been overcome. This did not turn out to be the case; surpluses turned out to be a very short-lived phenomenon for many countries.

We at the OECD believe there are three major causes for the fiscal outcomes in member countries. The first is the general performance of the economy. There is no factor more responsible for the fiscal outcome as this. Table 2 shows a clear linkage between rates of economic growth and fiscal performance in selected member countries.

Table 1. **General government financial balance**

Surplus (+) or deficit (–) as a percentage of nominal GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001
OECD	–5.0	–4.2	–3.9	–3.2	–1.8	–1.4	–0.9	0.0	–1.0
EU	–6.4	–5.6	–5.3	–4.3	–2.5	–1.7	–0.8	0.5	–0.8
United States	–5.0	–3.6	–3.1	–2.2	–0.9	0.3	0.8	1.7	0.5
Japan	–2.4	–2.8	–4.2	–4.9	–3.7	–5.5	–7.1	–7.4	–7.1
Germany	–3.1	–2.4	–3.3	–3.4	–2.7	–2.2	–1.6	1.2	–2.7
France	–6.0	–5.5	–5.5	–4.1	–3.0	–2.7	–1.6	–1.4	–1.4
United Kingdom	–7.9	–6.7	–5.8	–4.4	–2.2	0.4	1.1	1.6	1.0
Italy	–10.3	–9.3	–7.6	–7.1	–2.7	–3.1	–1.8	–0.6	–1.5
Canada	–8.7	–6.7	–5.3	–2.8	0.2	0.5	1.6	3.2	2.4
Australia	–5.6	–4.6	–3.7	–2.2	–0.5	0.6	1.6	0.1	0.0
New Zealand	–0.4	3.1	2.9	2.9	1.6	–0.2	0.9	1.9	0.9
Netherlands	–3.6	–4.2	–4.2	–1.8	–1.1	–0.8	0.4	2.2	0.3
Finland	–7.3	–5.7	–3.7	–3.2	–1.5	1.3	1.9	7.0	4.9
Sweden	–11.9	–10.8	–7.7	–3.1	–1.6	2.1	1.3	3.7	4.8

Source: OECD.

The second major cause is the political commitment to fiscal discipline. This is best exemplified by the single common currency for Europe, the Euro, and the self-imposed Maastricht fiscal criteria that countries had to fulfil in order to qualify for it. Although it is certainly debatable whether an annual deficit of 3% of GDP and a 60% level of outstanding debt are especially challenging criteria, it is clear that they played the leading role in achieving fiscal consolidation efforts in Europe. It should also be borne in mind that the European Union's Growth and Stability Pact calls for member countries to aim for a budgetary balance over the business cycle and that many individual European Union member countries have a more challenging fiscal target in their national settings. The Budget Enforcement Act in the United States and its predecessor are manifestations of the political will for fiscal consolidation in the United States. Switzerland recently enacted a constitutional amendment mandating a balanced budget. Australia and New Zealand have experience with their Charter of Budget Honesty Act and Fiscal Responsibility Act, respectively, which manifest the political commitment to fiscal discipline in those countries.

The third major reason – and the focus of this paper – is the institutional arrangements for budgeting. There are many examples of countries that have had a combination of economic growth and a degree of political commitment to fiscal discipline but have not had successful fiscal outcomes. If we look at the OECD member countries which are experiencing budgetary surpluses, these are generally the same countries that have been the most active in reforming and modernising their budget processes. The ones that started

Table 2. **Real GDP**

Percentage change from previous period

	1993	1994	1995	1996	1997	1998	1999	2000	2001
OECD	1.4	3.2	2.5	3.0	3.5	2.7	3.1	3.9	1.0
EU	–0.3	2.8	2.5	1.7	2.6	2.9	2.6	3.4	1.7
United States	2.7	4.0	2.7	3.6	4.4	4.3	4.1	4.1	1.2
Japan	0.4	1.0	1.6	3.5	1.8	–1.1	0.7	2.4	–0.4
Germany	–1.1	2.3	1.7	0.8	1.4	2.0	1.8	3.0	0.6
France	–0.9	1.9	1.8	1.1	1.9	3.5	3.0	3.6	2.0
United Kingdom	2.5	4.7	2.9	2.6	3.4	3.0	2.1	3.0	2.2
Italy	–0.9	2.2	2.9	1.1	2.0	1.8	1.6	2.9	1.8
Canada	2.4	4.7	2.8	1.6	4.3	3.9	5.1	4.4	1.5
Australia	3.8	4.6	3.9	4.0	3.5	5.4	4.5	3.4	2.4
New Zealand	4.7	6.1	4.0	3.3	3.1	–0.7	4.2	3.6	1.8
Netherlands	0.8	3.2	2.3	3.0	3.8	4.3	3.7	3.5	1.1
Finland	–1.1	4.0	3.8	4.0	6.3	5.3	4.1	5.6	0.7
Sweden	–1.8	4.1	3.7	1.1	2.1	3.6	4.5	3.6	1.2

Source: OECD.

earliest were the first to experience surpluses; the ones that did the most comprehensive reforms are the ones that have the most sustainable surpluses.

We at the OECD identify seven key institutional features that we believe play a key role in order to effectively control public expenditures. The remainder of this paper is devoted to a discussion of them.

2. Institutional arrangements for budgeting

The seven institutional features that the OECD believes are necessary to effectively control public expenditure are as follows:

- medium-term budget frameworks;
- prudent economic assumptions;
- top-down budgeting techniques;
- relaxing central input controls;
- focus on results;
- budget transparency;
- modern financial management practices.

Although they are identified as seven separate features, they do in fact build on each other and must be seen as a package. Each of these features is discussed below in detail.

2.1. Medium-term budget frameworks

Medium-term budget frameworks form the basis for achieving fiscal consolidation. They need to clearly state the government's medium-term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus, and debt. They then need to operationalise these high-level targets by establishing hard budget constraints for individual ministries and programmes over a number of years. This lends stability and credibility to the government's fiscal objectives.

By their very nature, high-level fiscal targets are set in a medium-term context. They aim to achieve a certain fiscal outcome over a number of years. Budgets are however enacted for a time period of one year, and are notorious for their short-term focus. This short-term time horizon is often criticised for impeding effective expenditure management; decisions on resource allocation are said to be made on an *ad hoc* or piecemeal basis with the implications of past and present decisions beyond the next year being neglected. This is not a new criticism. Medium-term budget frameworks aim to bridge this gap. Their successful implementation has been nothing short of a "cultural revolution" in governments.

Although the level of detail of such frameworks varies from country to country, they generally mirror the format of the budget, *i.e.* the medium-term frameworks are at the same level of detail as the annual budget. This means that a formal framework (or hard budget constraint) exists for each and every appropriation, most often for three years beyond the current fiscal year. These are rolling frameworks that are presented with the budget each year; year-1 in the previous year's framework becomes the basis for the budget and a new year-3 is added. This has greatly increased the effectiveness of planning and eased the annual budget process. These frameworks are not, however, enacted into legislation; they are planning documents that reflect the political commitment to fiscal discipline.

It should also be emphasised that these are living documents. The fact that a three-year budget framework is in place does not mean that no changes can be made to the document. In fact, shifting appropriations within ministries is key to successful fiscal discipline as is depicted in a later section of this paper. It is, however, imperative that all such changes be clearly depicted and explained, *i.e.* whether the changes are the results of changed economic circumstances or new policy decisions. Most countries publish detailed reconciliations between year-1 in the previous year's framework and the current budget proposal.

The frameworks also serve to deter expenditures by illuminating the budget implications of decisions in next year's budget whose expenditure may not be fully reflected in the budget. This can refer to: *i)* the operating costs of various capital projects being launched; *ii)* programmes that come into effect late in the budget year thus not exposing their full costs in the initial year; *iii)* programmes whose spending implications may not be fully reflected under the circumstance prevailing during the budget year but will become more actual in out-years. These are all classic examples of budgeting games in member countries, which the medium-term frameworks aim to end.

From the point of view of agency managers, medium-term frameworks enable them to be in a better position to plan their operations as they have some indicative level of funding beyond the next budget. This is especially relevant when resources are being reduced. Many downsizing options involve more than one year in order to reap the full benefits. Prior to the advent of medium-term frameworks, such options were often not considered as the time horizon only extended to the next budget year.

2.1.1. Problems with medium-term budget frameworks

Medium-term budget frameworks themselves are, however, not without their own problems. It is worth noting these. The United Kingdom was a pioneer in the area of multi-year budget forecasts in the 1960s and 1970s and encountered significant problems. These problems can be divided into three groups. Most of these problems have been experienced by other member countries as well.

- First, there was a tendency to overestimate the growth potential of the economy when making the multi-year budget forecasts. This made excessive resources available in the forecast period and created an upward pressure on public expenditure.
- Second, 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.
- Third, the multi-year budget forecasts were made in real terms rather than in nominal terms. In the 1970s, when economic growth subsided and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically for increases in prices while revenues suffered. This created further pressure on public finances.

The above experience caused many to view medium-term budget frameworks with some suspicion. It must, however, be observed that the early medium-term budget frameworks took place in an environment of rapid expenditure growth, not expenditure retrenchment as is the case today. Regardless, action has been taken to rectify the specific problems identified above. First, member countries are systematically making use of more “prudent” economic assumptions in order to avoid having excessive resources made available (this is discussed in the next section of this paper). This has tended to eliminate the second problem identified above. Third, medium-term budget frameworks are now invariably made in nominal terms, not real terms.

2.2. Prudent economic assumptions

Deviations from the forecast of the key economic assumption underlying the budget are the government’s key fiscal risk. There is no single factor more responsible for “de-railing” fiscal consolidation programmes than the use of incorrect economic assumptions. Great care must be taken in making them and all key economic assumptions should be disclosed explicitly. Sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget. Furthermore, a comparison should be made between the economic assumptions used in the budget and what private sector forecasters are applying for the same time period where practicable. The establishment of an independent body to recommend the economic assumptions to be used in the budget may be considered as well. All this serves to place safeguards against the use of unrealistic, or “optimistic”, economic assumptions.

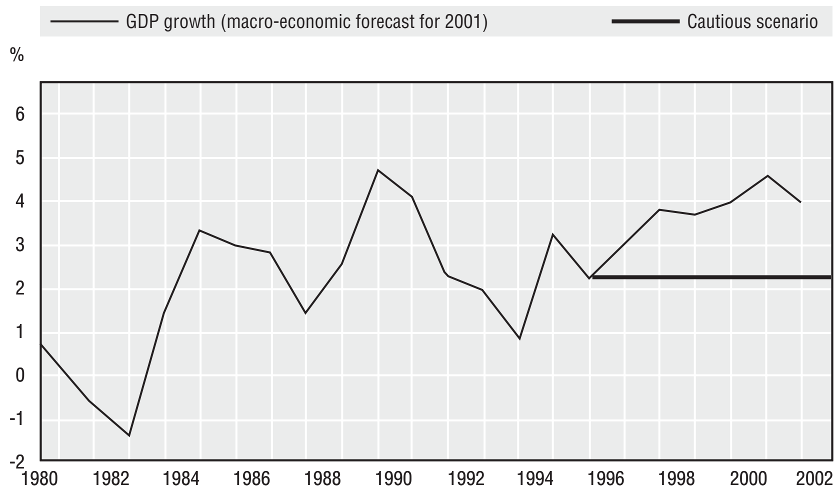
Two member countries, Canada and the Netherlands, have had especially harrowing experiences with the use of economic assumptions and have established safeguard features that are leading-edge practices among member countries.

In Canada, the government started using systematically-biased “prudent” economic assumptions and incorporating a contingency reserve. The previous perception of “optimistic” economic assumptions being used in the budget had significantly downgraded the believability of government-generated economic forecasts. Rather than relying on internally generated economic forecasts to be used in the budget, the government started employing the average of forecasts made by private sector economic forecasters – and then adjusting them downwards. This was done in order to achieve credibility, both in the eyes of the public and in the eyes of financial markets.

The Canadian Department of Finance systematically revises the private sector forecasts downwards as a further measure of prudence. This takes the form of the government adding 50-100 basis points (0.5-1.0 percentage point) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower forecast economic activity. This provides a buffer in order to maintain the government’s fiscal objectives. As a further buffer, the government established a significant contingency reserve fund – 2.5-3.0 billion Canadian dollars each year. This fund can only be used to compensate for forecasting errors and unpredictable events. It cannot be used for any new policy initiatives. Recourse has never had to be made to the contingency reserve funds and they have been applied to deficit reduction (surplus) in their entirety in each year.

In the Netherlands, the government shifted its focus from controlling the level of deficits to controlling the level of expenditures. These expenditure caps were based on cautious economic assumptions for the economy. This was viewed as an “insurance policy” for shifting the focus from the deficit to expenditures, *i.e.* the risk of the budget out-turn being worse than expected is mitigated. Any “surprises” are likely to be positive. The economic assumptions are made by the independent Central Planning Bureau (CPB). The CPB will present two economic scenarios to the government. The first one is what it considers to be the most likely level of economic growth. The second one is what it considers to be a cautious level of economic growth that should be used for budget policy purposes. The government then applies the cautious scenario. The differences between the two are shown in Figure 1. In political terms, the government would rather be faced with “good surprises” rather than with “bad surprises”.

Figure 1. **Actual economic growth between 1980 and 2001 and cautious economic assumptions used for budgetary policy in the Netherlands**



Source: Ministry of Finance, Netherlands.

2.3. Top-down budgeting techniques

Budgeting has traditionally operated on a bottom-up principle. This means that all agencies and all ministries send requests for funding to the Finance Ministry. These requests greatly exceed what they realistically believe they will get. Budgeting then consists of the Finance Ministry negotiating with these ministries and agencies until some common point is found. This bottom-up system has; several disadvantages to it. First, it is very time consuming and it is essentially a game; all participants know that the initial requests are not realistic. Second, this process has an inherent bias for increasing expenditures; all new programmes, or expansion of existing programmes, are financed by new requests; there is no system for reallocation within spending ministries and there are no pre-set spending limits. Third, it is difficult to reflect political priorities in this system as it is a bottom-up exercise with the budget "emerging" at the end of this process. This manner of budgeting is now being abandoned and replaced with a new top-down approach to budget formulation. This has been of great assistance in achieving fiscal consolidation.

The starting point for the new system is for the government to make a binding political decision as to the total level of expenditures and to divide them among individual spending ministries. This decision is made possible by the medium-term expenditure frameworks which contain baseline expenditure information, *i.e.* what the budget would look like if no new policy decisions were made. The political decision is whether to increase expenditures for a high-priority area, for example education, and to reduce expenditures, for example defence programmes. Only the largest and most significant programmes reach this level of political reallocation. The key point is that each ministry has a pre-set limit on how much it can spend.

Once this decision is taken, the Finance Ministry largely withdraws from the details of budgetary allocations for each ministry. The Finance Ministry concerns itself only with the level of aggregate expenditure for each ministry; not the internal allocations. “Each minister is his own Finance Minister”, is the saying in some countries. Each ministry has a total amount and it can freely reallocate that money among its various agencies and programmes. This has several advantages to it. It serves to hamper creeping increases in expenditures as new policies are funded by reallocations from other areas within the ministry. It creates ownership in the respective ministries for the actions that are taken. Decisions are also better informed as spending ministries are in the best position to judge the relative merits of their programmes. The role of the Ministry of Finance is to verify that the offsetting cuts to finance new programmes are real.

This is a remarkably simple budgeting system once it is in place. It does, however, involve considerable time to establish because the entrenched traditions of both spending ministries and Finance Ministries work against it. The Finance Ministry may be very suspicious of the real motives of spending ministries and have a tendency to exert their influence on the detailed allocations within spending ministries. This serves to undermine the basic premise of the system. Spending ministries on the other hand fear that any cuts in programmes they make will be accepted by the Finance Ministry, but not the corresponding reallocations for new initiatives. This leads to spending ministries proposing unrealistic cuts in programmes that they know will not be accepted by Parliament (or the Finance Ministry), and then the whole old-style bargaining starts again. Trust needs to be built between the two and it has varied greatly in different countries whether that is possible and how much time it takes. The end results however clearly indicate that it is well worth the effort.

2.4. *Relaxing central input controls*

Relaxing central input controls is another feature of successful fiscal consolidation strategies in member countries. This is based on the simple premise that the heads of individual agencies are in the best position to choose the most efficient mix of inputs to carry out the agency’s activities. The end-result is that an agency can produce the same services at less cost, or more services at the same cost. This greatly facilitates fiscal consolidation strategies by mitigating their effects on services.

Relaxing central input controls operates at three levels: first, the consolidation of various budget lines into a single appropriation for all operating costs (salaries, travel, supplies, etc.); second, the decentralisation of the personnel management function; third, the decentralisation of other common service provisions, notably accommodations (buildings). The can be seen as the public sector's version of "deregulation".

The consolidation of budget appropriation lines is rather straightforward and simple. It is now common for agencies to receive one single appropriation for all of their operating expenditures. (It should be clear that this does not apply to transfers or capital appropriations, only to operating expenditures.) This single appropriation is, however, not enough to generate managerial flexibility as various central management rules inhibit this flexibility.

It is in the area of human resource management where most of the central management rules exist. The cost of staff is generally the largest component of operating expenditures, and it makes little difference to consolidate budget lines if central rules in this area prevent any flexibility. All countries are increasing flexibility in this area, although to significantly varying degrees. The country that has gone the furthest in this area is Sweden.

Personnel management in Sweden has historically been decentralised with the outstanding exception of collective bargaining arrangements. Directors-general of agencies are, and have been, responsible for the recruitment, grading and dismissal of their staff. There are no restrictions on whom they may hire. There is no "civil service" encompassing the government as a whole. Vacancies are generally advertised in the press with all qualified applicants being treated equally. Staff is not tenured in Sweden. They can typically be dismissed at two- to 12-month notice depending on how long they have been employed by the agency. In fact, there are essentially no differences between the labour legislation governing the public sector and the private sector in Sweden.

In 1994, collective bargaining was totally devolved to the agencies and is now the responsibility of the director-general of each agency. The cost of personnel is now one of the many items of expenditure that directors-general must manage within the limit of their single operating appropriation. There is no longer any automatic adjustment to their budgets to compensate for pay agreements that are concluded. The Ministry of Finance and Parliament no longer have any direct influence on the contents of the collective agreements establishing the salaries and other conditions of employment for government staff. The agreements are negotiated entirely by the agencies.

The experience with this new framework is predominantly positive. The agencies have welcomed their increased responsibility for wage formation, and employer policies in general. The pay agreements that have been reached have been within the cash limits of agency appropriations. This is attributed primarily to the "immense" peer pressure that directors-general exert on each other for responsible settlements. There are, however, significant variations between agencies and it is estimated that over 90% of government employees in Sweden now receive individualised salaries, *i.e.* based on their personal performance. Public sector unions have been constructive partners in this area.

Accommodations (buildings) are another area where common service provisions are being relaxed or abolished. In New Zealand, for example, agencies now have the freedom to choose their accommodation. They can simply give notice and get their accommodations supplied by the private sector. The freedom to choose accommodations, however, cannot be enjoyed equally by all agencies. Some agencies occupy very special accommodations, prisons and museums being outstanding examples. This can also create a conflict of interest between the agencies viewed in isolation (as they move to private sector accommodations) and the government as a whole (which may be left with surplus accommodations). This is especially the case when there is a downturn in the private sector property market. These problems should, however, not be overestimated and are in any case temporary transition costs on the way to a more efficient system in the long-term.

Relaxing central input controls have as the goal to empower directors-general to operate their agencies in the most efficient manner possible. No longer can they claim that their poor performance is due to the fact that a budget, which was too detailed, or a set of central management rules, which were overly prescriptive, impeded them in the running of their agencies. Now, they have the power and they must deliver. The experience overwhelmingly shows that they have done so; agencies have become more efficient thus making fiscal consolidation efforts "less painful" from the point of view of customers of government services.

It is worth noting that detailed budgets and central management rules originally came into place to prevent corruption in government. The countries that have gone the furthest in reducing them are the smaller member countries where this is less of a potential problem than perhaps in other member countries. In other words, this reform may not work in all environments.

2.5. *An increased focus on results*

An increased focus on results is a direct *quid pro quo* for relaxing input controls as described above. Accountability in the public sector has traditionally been based on compliance with rules and procedures. It didn't matter what you did as long as you observed the rules. Now, when the public sector is deregulated, a new results-based system is needed to hold managers accountable. This is a fundamental change: holding managers accountable for *what* they do, not *how* they do it. Effectively implementing this is, however, very difficult in practice. The difficulties can be divided into several groups of issues.

At the most basic level, some government activities simply lend themselves to results measurement much more readily than others. For example, an agency that produces a single or a few homogenous products or services can be rather easily measured. An agency that issues passports is a good example. On the other hand, agencies that produce heterogeneous and individualised services can be very difficult to measure. The majority of government services fall into the latter category. Various social services are the outstanding example.

We are also faced with the choice of defining results either in terms of outputs or outcomes. Outputs are the goods and services that government agencies produce. Outcomes are the impact on, or the consequences for, the community of the outputs that are produced. An example highlights this. A government may wish to reduce the number of fatalities on highways caused by drunk drivers. This would be the outcome. In order to achieve this, it may launch a series of advertisements in the media highlighting the dangers of drunk driving. It's easy to measure the output, *i.e.* that the prescribed number of advertisements were in fact shown in the media. Let's, however, assume that at the same time the number of fatalities went up, not down. The link between the advertisements and this outcome is very unclear, since many other factors than the advertisements would impact on the outcome. But what lessons do we draw from this. Do we abandon the advertisement campaign? Do we expand it? Do we try other outputs? Do we wait to see if this is a one-off or a sustained trend?

From an accountability point of view, the question arises whether you hold managers responsible for outputs or outcomes. Outputs are easier to work with in this context; but outcomes are what matters in the final analysis. Do we want an accountability regime based on outputs even though the outputs may not be contributing to the desired outcome? Or do we have an accountability regime based on outcomes, even though a number of factors outside the control of the director-general of the agency may contribute to it?

Of course, a combination of the two is the optimum choice, but experience in member countries shows that one will always dominate.

It is a well-known phenomenon in management that "what gets measured, gets managed". As noted above, some activities lend themselves to measurement more readily than others. This also applies within agencies in that certain activities are more easily measured than others. If the agency's measurement system is biased in favour of those activities that are more easily measured, there's every likelihood that management will focus its attention disproportionately on those activities since their accountability is based on that. This may lead to all sorts of unforeseen and undesired consequences. This creates a huge onus on those designing the agency's measurement system to ensure that it captures all aspects of their activities.

Somewhat contradictory to the above point is the problem of information overload. Agencies produce so much information that it's very difficult for outsiders to judge which are the more important pieces of information. The lesson here is for agencies to differentiate between the measurements they do for internal purposes and those they perform for external purposes. A weighed index of various internal measures may be the optimum solution for an external audience.

The reliability and consistency of the performance information is also of primary importance. In some member countries, the performance information is audited together with the financial information by the Supreme Audit Institution. Time series of performance measurements are often the most revealing pieces of information. It is therefore important to maintain consistency over time, or to re-state prior information if a change in the objects of measurement are deemed necessary. Such changes should however be few and far between. It is increasingly recognised as a *prima facie* evidence of there being something wrong with the operations of an agency if such changes are frequently made.

Building on the last point is the issue of whether explicit targets should be set at the beginning of the year, or whether the evolution of time-series data should be used to judge the performance of an agency. There are two schools of thought on this subject. The first says that any target will either be set so low that it's guaranteed to be fulfilled or so high that it can never be attained. The second school believes that target setting is a very important tool to ensure that agencies focus on those aspects of their operations that are deemed high priority from a political point of view. The jury is still out on this.

Notwithstanding these challenges, an increased focus on results is a most definite trend in all member countries. Reducing input controls plays a key role in increasing the efficiency of the public sector, and replacing them with an increased focus on results is the new and necessary basis of accountability. Robust results information is often of great value in improving results allocation as well.

Finally, there are many sceptics concerning this development, as a focus on results is not a new attempt for governments. This has been attempted since at least the 1950s with very mixed results. What gives more hope to it being successful this time is that it is a requisite for eliminating input controls, it replaces them rather than being a new layer of controls as was the case with previous attempts.

2.6. Budget transparency

Increased transparency in budgeting made significant advances in the late 1980s and early 1990s. This was a period associated with unfavourable budget conditions in most member countries: high annual deficits and increasing levels of outstanding debt. Governments needed to institute large fiscal consolidation programmes. These were often painful and getting the public's understanding of the problems was necessary. The most effective manner for achieving that was simply to throw open the books and say to the public: "Look, things are really as bad as we told you, we're not hiding anything." This may sound a bit sinister at first, but in actuality it is government at its best: being honest with citizens, explaining the problem to them in order for an understanding to emerge as to the best course of action to take.

This time period also coincided with increased attention being paid to good governance in general. The budget is the principal policy document of government, where the government's policy objectives are reconciled and implemented in concrete terms. Budget transparency – openness about policy intentions, formulation and implementation – is therefore at the core of a good governance agenda.

If we take a look at fiscal transparency in concrete terms, we can say that it has three essential elements:

- The first is the release of budget data. The systematic and timely release of all relevant fiscal information is what we typically associate with budget transparency. It is an absolute pre-requisite, but it is not enough.
- The second element is an effective role for the legislature. It must be able to scrutinise the budget reports and independently review them. It must be able to debate and influence budget policy and be in a position to effectively hold the government to account. This is both in terms of the constitutional role of the legislature and the level of resources that the legislature has at its disposal.
- The third element is an effective role for civil society, through the media and non-governmental organisations. Citizens, directly or through these

vehicles, must be in a position to influence budget policy and must be in a position to hold the government to account. In many ways, it is a similar role to that of the legislature albeit only indirectly.

These three elements work together. The scrutiny of fiscal information by the legislature and by civil society can only take place if the information is released in the first place. Similarly, released budget information is only of value if it is effectively scrutinised by the legislature and by civil society. The legislature and civil society have a very similar function, one is responsible for shaping budget policy and for holding government directly to account while the other performs this role indirectly.

Although conventional wisdom is that a strong role for Parliament equates an undermining of fiscal discipline, the experience in member countries simply does not show that to be the case. The OECD strongly believes that an effective role for the legislature is a key ingredient in establishing and maintaining fiscal discipline. It provides the necessary link with civil society and fosters accountability by the Executive.

The OECD has recently elaborated a set of *Best Practices for Budget Transparency*.[*] They are in three parts. Part 1 lists the principal budget reports that governments should produce and their general content. Part 2 describes specific disclosure to be contained in the reports. This includes both financial and non-financial performance information. Part 3 highlights practices for ensuring the quality, integrity and usefulness of the reports. The following box lists the major headings of the *Best Practices*.

A final example of the advancement of budget transparency – and its concomitant helpfulness in maintaining fiscal responsibility – comes from Finland. In Finland it was recently ruled that the country's Freedom of Information Act mandated that the original funding requests from spending ministries to the Ministry of Finance be published at the same time as the government's budget proposal is presented to Parliament. This had the impact that original funding requests from ministries became more reasonable. The reason was simple. As their more extreme requests would be rejected in any case, spending ministers did not want them published since this would reveal them to be either fiscally irresponsible or politically impotent in following through on their initial requests. As a result, the original requests became more reasonable.

* "Best Practices for Budget Transparency", *OECD Journal on Budgeting* (2002), Vol. 1, No. 3.

The OECD Best Practices for Budget Transparency

1. **Budget Reports**
   - 1.1. The Budget
   - 1.2. Pre-budget Report
   - 1.3. Monthly Report
   - 1.4. Mid-year Report
   - 1.5. Year-end Report
   - 1.6. Pre-election Report
   - 1.7. Long-term Report
2. **Specific Disclosures**
   - 2.1. Economic Assumptions
   - 2.2. Tax Expenditures
   - 2.3. Financial Liabilities and Financial Assets
   - 2.4. Non-financial Assets
   - 2.5. Employee Pension Obligations
   - 2.6. Contingent Liabilities
3. **Integrity**
   - 3.1. Accounting Policies
   - 3.2. Systems and Responsibility
   - 3.3. Audit
   - 3.4. Public and Parliamentary Scrutiny

2.7. Modern financial management practices

The modernisation of financial management within governments made great advances during the past 10 years. The sheer scale of government means that such improvements had a material effect on fiscal outcomes. These include the introduction of accruals, capital charges, carry-overs of unused appropriations, and interest-bearing accounts. Each of these is discussed below.

2.7.1. Accruals

Cash and accruals represent two end points on a spectrum of possible accounting and budgeting bases. The cash end of the spectrum has traditionally been applied by member countries for their public sector activities. In recent years there has been a major trend towards accruals end of the spectrum in member countries. About half of member countries have now adopted accruals to one degree or another. This is a very rapid migration; it was only in the early 1990s that the world's first accrual based financial statements and budget were produced by a government (New Zealand).

The objective of moving to accruals is to make the true cost of government more transparent. For example, accruals attributes the pension costs of government employees to the time period when they are employed and accumulating their pension rights rather than having this as an unrelated (and uncontrollable) expenditure once they have retired. Instead of spikes in expenditures when individual capital projects are undertaken, accruals incorporates them into the annual operating expenditures through an allowance for depreciation. Treating loans and guarantee programmes on an accrual basis fosters more attention to the risks of default by those who have been granted them, especially if there is a requirement for such default risks to be pre-funded. In a cash system, outstanding government debts can be designed in such a way that all interest expenditure is paid in a lump sum at the end of the loan rather than being spread through the years when the loan was outstanding as would be the case under accruals. All of these examples show how a focus on cash only can distort the true cost of government.

A further objective for adopting accruals is to improve decision-making in government by using this enhanced information. This needs to be seen in a wider context. The countries that have adopted accruals have generally been at the forefront of public management reforms in general. These reforms have been highlighted in this paper. A key aim is to hold managers responsible for outcomes and/or outputs while reducing controls on inputs. In this context, it is expected that managers should be responsible for all costs associated with the outcomes and/or outputs produced, not just the immediate cash outlays. Only accruals allows for the capture of these full costs, thereby supporting effective and efficient decision-making by managers. In short, when managers are given flexibility to manage their own resources (inputs), they need to have the necessary information to do this. The adoption of accruals is therefore an inherent part of these wider reforms.

There are a number of issues with accruals which are beyond the scope of this paper. This includes to what extent to adopt accruals (for financial reporting only, or for budgeting as well; or for certain categories of transactions only); how to treat certain types of asset and liabilities that simply do not exist in the private sector (heritage assets, military assets, infrastructure assets and the treatment of social insurance programmes); what valuation methods should be used (historical cost or current cost); who should be responsible for setting accounting standards as a great number of judgements and assumptions need to be made in accrual environment.

It should, however, be noted that a significant number of countries have very serious reservations about the use of accruals. These concerns are on a number of levels. First, the introduction of accruals could undermine fiscal discipline. For example, governments could decide on expensive capital projects whose cost would appear in the budget over a number of years (as depreciation), rather than appearing fully at the same time as the political decision to go ahead with the project was made. Second, accruals depends on complicated technical assumptions that can be easily manipulated. Cash can be manipulated, but only in terms of timing at the margins. Third, accruals is poorly understood by politicians. From a democratic point of view, if politicians do not understand the numbers in the budget, which is the government's premier policy document, then accruals simply should not be in place.

2.7.2. Capital charges

Capital has tended to be viewed as a free good in the public sector. Once an asset was in place, there was no mechanism to track and charge for the cost of capital tied up in the asset. A number of member countries have been making headway in this regard.

Capital charging regimes generally operate as follows. The government decides to levy a charge on the cost of capital tied up in all assets in an agency. For example, if an agency has $10 million in assets, the government will levy a charge (often equivalent to the long-term government bond rate) of 10%. This means that the agency will have to pay the Finance Ministry $1 million annually. When the system is first introduced, the appropriations to all agencies will be increased by the amount of their capital charge, so there's no net impact on agencies or for the government as a whole. However, agencies will in future be allowed to dispose of the assets and thus relieving themselves of the capital charge while retaining the original appropriation to cover it (or part thereof). This creates the incentive. Thus, they could decide to sell excess assets or move from high-priced areas to lower priced areas and use the amount of the capital charge they save for other purposes. This has had a great impact on asset management in government, a field that was simply neglected previously.

2.7.3. Carry-overs

All countries operate on the principle of an annual budget. Previously, this meant that all appropriations lapsed at the end of the fiscal year thus creating a great and irrational rush to spend money before the end of the fiscal year. Not only because they would otherwise lose the money that year, but also because future years' appropriations would take account of this under spending as well. You were losing what you did not spend in one year, permanently. This has now changed with operating expenditures generally being freely transferable (sometimes up to a certain limit) from one year to the next. Only in cases where an agency continuously, year-on-year, builds up carry-overs does the Ministry of Finance intervene. The advent of medium-term expenditure frameworks also gives a benchmark for agencies to see that their appropriations are in fact being carried-over.

2.7.4. Interest-bearing accounts

Some countries have also introduced interest-bearing accounts for agencies. This means, for example, that the appropriation of an agency is divided into twelfths (representing each month) and deposited into an agency's account (either within the Finance Ministry or with a commercial bank). If an agency spends at less than this rate, they will receive interest on the difference. If they spend at a faster rate, they will pay interest on the difference. The ability of individual agencies to vary their spending patterns, does of course vary significantly but they are now much more aware of cash management practices.

All of these practices – accruals, capital charges, carry-overs of unused appropriations and interest-bearing accounts – serve to improve the information available for agency heads and gives them increased freedom to act on that information. Although a very technical area, the impact on the government's finances is great given the sheer size of government.

3. Conclusion

This paper has highlighted the seven key institutional features of the budget process that the OECD believes are essential for achieving sustained fiscal consolidation:

- medium-term budget frameworks;
- prudent economic assumptions;
- top-down budgeting techniques;
- relaxing central input controls;
- focus on results;
- budget transparency;
- modern financial management practices.

As noted at the outset, economic growth and political commitment play the primary roles, but they are not enough. The institutional framework must be such that it fosters and reinforces fiscal discipline. This is recognised in member countries and all of them are moving in this direction: different countries are starting from different positions and are moving at different speeds – but the direction is clear. The journey will take longer in countries with very entrenched traditions in the public sector. But the benefits are significant as shown by the success currently enjoyed by the early reformers.

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