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Budgeting for Fiscal Space

by
Allen Schick*

Fiscal space refers to the financial resources available to a government for policy initiatives through the budget and related decisions. This article reviews the factors that contribute to the shrinkage of fiscal space, considers methods for protecting or enlarging it, and reflects on how budgeting may be recast into a process for explicitly allocating scarce fiscal space.

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Fiscal space refers to the financial resources available to a government for policy initiatives through the budget and related decisions. The term excludes money allocated in the previous budget and continued in the next, but does include funds that become available through reallocation, incremental resources generated by economic growth, borrowed funds in excess of current revenues, and additional revenue from increases in taxes. Although the term was initially devised for low-income countries, it has useful application in developed countries as well. In developing countries, fiscal space is an estimate of the growth-enhancing investment in physical and human capital that a government can finance with borrowed funds without prejudicing the long-run sustainability of its fiscal position. In this context, fiscal space justifies allowing cash-short governments to borrow for productive expenditures that have a strong prospect of being repaid through the additional revenues produced by an expanding economy.

This paper focuses on the concept of fiscal space for OECD member countries. In this setting, fiscal space pertains to the way governments go about allocating resources. As a process, fiscal space may be regarded as being as old as budgeting itself, or as a fundamentally new way of making budget decisions. It may be regarded as an old concept because budget officials in all countries routinely estimate the "room" available for new expenditures or the "gap" between projected revenues and expenditures. Budget officials typically make these estimates early in each cycle and update them during formulation of the budget. In most countries, the process is largely informal; it is not codified by budget rules. Nevertheless, the practice is ubiquitous because it informs political leaders and budget officials of the amounts that may be spent through new decisions. They need this information to review spending bids and policy initiatives, and to set the budget aggregates.

In a formal sense, however, the concept of fiscal space deviates from the aims of past budget reforms. It recognises that budgeting is inherently incremental and that most decisions focus on marginal adjustments in programmes and expenditures. In compiling budgets, governments rarely treat spending on existing and proposed new programmes in the same way, nor do they ordinarily undertake a comprehensive review of expenditures. As Wildavsky argued almost half a century ago, incremental behaviour enables governments to complete budget work in a timely manner by reducing conflict over resources and by reducing the number of decisions that must be made. After decades of unsuccessfully trying to uproot budgeting's incremental tendencies through bold innovations such as programme budgeting and zero-base budgeting, some governments have begun to formally incorporate incremental norms into the construction of the budget. Two of the most popular contemporary innovations – baseline projections and medium-term expenditure frameworks (MTEF) – build incrementalism into the routines of budgeting. Baseline projections use the current level of expenditure as the starting point for compiling the next budget; an MTEF allocates resources to spending units in terms of changes to the baseline. Fiscal space reinforces these incrementalist reforms by focusing budget work on the new resources available for allocation. If budgeting is unavoidably incremental, the

fiscal space argument runs, it makes sense to formally structure the process so that it deals with the resources for which decisions will be made.

The prospect of a more constrained budget environment in the decades ahead also has spurred interest in fiscal space. Governments are not concerned about fiscal space when there are sufficient resources to finance ongoing problems as well as significant policy initiatives. They do pay attention to fiscal space when the budget is tight and when spending priorities are crowded out by insufficient resources. Population ageing in most OECD countries and a concern that economic growth may be less robust than in the past indicate that fiscal space may shrink or possibly vanish in the years ahead. The loss of fiscal space gives rise to the possibility that budgeting will become a decremental process that allocates losses rather than gains. If this were to occur, budgeting will likely become a more contentious process, and politicians will have difficulty financing policy initiatives.

From this perspective, the budget predicament of high-income countries shares some common traits with the situation that confronts low-income countries. Because resources are scarce and demands are elastic, both groups of countries have incentive to structure budget decisions in terms of the space available for allocation. But not all scarcities are alike. There are observable differences between governments that have incremental funds for programme enhancements and those that lack sufficient resources for existing programmes. For developing countries, fiscal space means the capacity to finance productive investment with borrowed money; for affluent countries, space is the increment available to expand programmes.

This paper deals with developed countries. Hence, the concept of fiscal space presented here is inextricably linked to incrementalism in budgeting. Section 1 reviews the factors that contribute to the shrinkage of fiscal space, including pressure on both the revenue and expenditure sides of the budget. Section 2 considers methods for protecting or enlarging fiscal space through adjustments in spending commitments to free up incremental resources and through changes in the way budgets are prepared and expenditures managed. The concluding section reflects on how budgeting may be recast into a process for explicitly allocating scarce fiscal space.

1. The shrinkage of fiscal space

In all highly developed countries, the national government has vastly more money to spend than it had half a century ago. In almost all, however, the government has narrower budget options than it once had. Spending more but having less to spend undermines incremental behavior and underlies the contemporary interest in fiscal space. The volume of space depends on four variables: the extent to which existing programmes claim incremental resources, the propensity of a government to tax, its propensity to borrow, and the performance of the economy. All four factors may now be less favourable than during the post-war spurt in government spending, which is why budget options appear to be more constrained. Each variable is considered in the paragraphs that follow.

1.1. Public expenditures

Contemporary governments have less to spend because public expenditures are sticky – that is, they do not readily respond to changes in political conditions or national priorities. A decision to spend money one year usually is a decision to spend in future years as well, even where there is no legal requirement to do so. When a government launches a

new programme, it also ignites political and bureaucratic pressure to continue or enlarge that programme. Groups form to protect their interests, administrative entities are established and staffed to run the new programme, and the programme's expenditures are incorporated into the "base" when the room for incremental expenditure in future budgets is estimated. Often, the new programmes are protected against price increases, thereby increasing their claim on future resources.

If expenditures were not sticky, budgeting would not be incremental. A government could treat new and old claims alike, and broaden its discretion to the full amount of expenditure. Stickiness has a positive side, for it stabilises government, gives citizens clear expectations of the services that will be available in the future, and diminishes conflict over resources. It would be a mistake, however, to regard expenditures as perfectly sticky. Much of the political craft of budgeting involves adjustments at the margins. These sometimes entail programme terminations, but they more frequently amount to shifts within programmes. These shifts are often below the "radar" of budgeting; they are implemented unilaterally by spending units and are not brought to the attention of central budget makers. This tactic has the advantage of reducing the risk that shifts might lead to a loss of resources.

Expenditures tend to be sticky even for programmes that do not perform well. In fact, a government may consider it necessary to augment resources when results fall short of expectations. For example, governments frequently supplement the budgets of troubled schools, either in response to parental demands or in the hope that the additional funds would enable them to improve. Of course, expenditures for successful programmes are also sticky, as supporters exploit their performance to extract more money from the government.

The problem for contemporary governments is not only that expenditures are sticky but that they are so very large, much larger as a share of GDP in member countries than they were when the OECD was established nearly half a century ago. Table 1 shows that, although countries differ significantly in the relative size of the public sector, all member countries have experienced a progressive increase in government spending. Several powerful trends account for most of this rise. One is the shift in risk from households to the government; related to this is growth of the entitlement state which has transformed more than half of national expenditure in most OECD countries from discretionary budget decisions into spending mandated by permanent law.

In industrial countries, the government has become the holder of risk for society. The government indemnifies workers for loss of jobs, seniors for retirement, patients for illness, and families for various losses of income. In some countries, citizens and enterprises are compensated for losses due to natural or human-made disasters, farmers are protected against the risk that the market price of commodities will fall, depositors against the risk of default by financial institutions, exporters against changes in currency values, and so on. Some important risks still remain in private hands, but in all advanced countries the public budget is exposed to risks taken by the government.

The pooling of risk through government action has certainly contributed to economic and personal well-being, even though it has sometimes opened the door to moral hazard. A bigger problem is that a government rarely has a reliable estimate of the risk it is taking, nor does it provision for downstream costs in the budget. When these come due, sometimes only years later, the government has no choice but to make good on its obligations.

Many of the biggest risks facing contemporary governments are in the form of entitlements, which give the eligible persons a legal right to payment from the government.

Table 1. **Year-to-year percentage change in real GDP**[1]

Annual average, selected periods 1960-2000

	1960-68	1968-73	1973-79	1979-89	1989-2000
Australia	5.0	5.5	2.6	3.4	3.2
Austria	4.2	5.9	3.0	2.1	2.5
Belgium	4.5	5.6	2.4	2.2	2.2
Canada	5.6	5.6	3.9	2.9	2.5
Denmark	4.6	4.0	1.5	1.4	2.2
Finland	3.9	6.7	2.4	3.6	2.0
France	5.4	5.9	2.8	2.4	1.8
Germany	4.2	4.9	2.4	2.0	1.8
Greece	7.3	8.2	3.3	0.8	2.1
Iceland	4.1	7.6	5.3	3.2	2.5
Ireland	4.2	4.8	4.9	3.1	7.4
Italy	5.7	4.6	3.5	2.4	1.6
Japan	10.5	8.8	3.5	3.8	1.8
Luxembourg	3.1	6.5	1.3	4.3	5.6
Netherlands	4.8	5.3	2.6	2.0	3.0
New Zealand	3.1	5.1	0.0	2.0	2.5
Norway	4.4	4.1	4.6	2.7	3.2
Portugal	6.6	7.4	2.9	3.3	2.9
Spain	7.5	6.8	2.3	2.8	2.7
Sweden	4.4	3.7	1.8	2.2	1.7
Switzerland	4.4	4.5	–0.4	2.1	1.1
Turkey	5.8	5.5	4.5	4.0	4.1
United Kingdom	3.1	3.2	1.5	2.4	2.2
United States	4.5	3.3	3.0	3.0	3.1

1. This table only includes countries that were OECD members throughout the periods covered.

Sources: Data for the periods 1960-68 and 1968-73 are drawn from *OECD Historical Statistics 1960-1983*; data for subsequent periods are drawn from *OECD Historical Statistics 1970-2000*. The two data sets are not consistent; hence the data reported here are not strictly comparable across all periods.

Typically, entitlements are open-ended; they establish a formula for payment, but do not limit a government's exposure. A government must make room for them in the budget when the event or condition triggering the entitlement occurs. Governments can enlarge space in the budget for priorities by curtailing entitlements, but doing so may ignite strong protest. Quite often, bold efforts to trim entitlements end up as marginal adjustments that have little or no effect on near-term budgets, but may create space in distant budgets.

The prognosis in almost all developed economies is that demographic trends will compel national governments to allocate a rising share of their budgets to entitlements established in previous generations. Not only will these expenditures be sticky, but much of the increment available for allocation will also be sticky. The challenge for future governments will be to "unstick" a sufficient portion of expenditure to maintain budgeting as a genuine allocation process.

1.2. The propensity to tax

When space is insufficient to finance programme ambitions and past commitments, governments are tempted to look at the revenue side of the budget. Obviously, spending could not have grown so much during the past half century if governments had relied only on the increments supplied by economic growth. In fact, all governments of OECD countries raised tax rates and expanded the tax base during that expansionary period. They boosted tax revenues in good times because voters wanted enhanced services, and

they boosted them when fiscal space was inadequate because expenditures were sticky. Table 2 compares government revenue as a share of GDP at various points during the past 40 years. With revenue in the OECD area rising from 28% of GDP in 1960 to 37% in 1990, the data suggest that governments had ample space for budgetary initiatives.

Table 2. **Current receipts of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	25.6	27.7	28.7	31.6	32.2
Austria	35.8	40.3	43.1	46.4	47.6
Belgium	30.1	35.2	43.9	46.6	46.8
Canada	27.8	34.8	36.8	39.3	–
Denmark	30.1	42.5	45.2	52.0	54.3
Finland	30.8	35.0	41.7	44.8	50.7
France	37.2	38.8	40.7	45.5	46.5
Germany	36.1	39.5	44.0	45.1	45.3
Greece	23.6	26.7	29.1	32.8	41.8
Iceland	30.3	33.4	35.9	41.4	36.6
Ireland	27.2	33.9	35.9	41.4	36.6
Italy	29.7	30.6	33.5	36.8	43.9
Japan	20.4	20.9	24.6	30.6	30.5
Luxembourg	34.2	36.3	50.1	–	44.9
Netherlands	36.4	35.8	51.0	55.2	47.8
Norway	36.2	45.4	48.4	50.3	51.4
Portugal	19.5	23.0	27.6	35.0	37.7
Spain	18.6	22.5	25.7	34.0	38.0
Sweden	37.5	47.9	54.4	59.4	57.3
Switzerland	23.6	26.6	32.7	34.1	–
United Kingdom	32.6	38.1	38.9	40.9	37.8
United States	27.0	29.8	29.7	31.0	–

1. This table only includes countries that were OECD members throughout the periods covered. New Zealand and Turkey have been excluded because of lack of data.

Sources: Data for the periods 1960-67 and 1968-73 are drawn from *OECD Historical Statistics 1960-1983*; data for subsequent periods are drawn from *OECD Historical Statistics 1970-2000*. The two data sets are not consistent; hence the data reported here are not strictly comparable across all periods.

Table 2 reveals, however, that the rate of expanding budget space through sizeable tax increases has ended in many OECD countries. In a few, revenues have actually declined as a share of GDP, as governments have purposely reduced their fiscal space in a determined effort to shrink the relative size of the public sector. In most countries, revenues have remained stable for an extended period, suggesting that the government faces political resistance to tax increases as well as pressure to maintain existing programmes. Although it is hard to generalise across the OECD area, because member countries have different tax policies, it is reasonable to conclude that most countries now finance policy initiatives through economic increments and cutbacks or efficiency gains in existing programmes. These actions purchase fiscal space for the budget cycle immediately ahead, but do not significantly alter the long-term imbalance between revenues and expenditures.

Tax policy is never fully at rest. Governments endlessly tinker with rates and rules, sometimes to add or subtract revenue, often to adjust the burden on particular sectors or activities. The extent to which future adjustments affect fiscal space will depend on citizen sentiment and political preferences. In some countries, voters will prefer to hold on to

promised benefits or to expand governmental responsibilities, even when doing so compels higher taxes. In others, future fiscal space will be constricted by strong resistance to any increase in the tax burden. Countries with relatively high levels of taxation may face conflicting pressures. On the one hand, the high tax rates may indicate political support for a large government role; on the other hand, high tax rates may establish a ceiling on the capacity to generate additional revenue. Countries with an elevated dependency ratio due to ageing populations will likely be pressured to boost taxes. They may find it more expedient to spread the cost among consumers and income earners than to impose benefit cuts on those already receiving payments from the government or scheduled to do so in the next ten years or so.

Budgeting is a process of marginal adjustment to enlarge short-term space. On the tax side, there are numerous opportunities, such as raising "sin" taxes and making small adjustments in other revenue sources. Countries with relatively high levels of tax expenditures may consider it expedient to enlarge budget space by curtailing these subsidies. Governments may also ease budget pressures by relying more heavily than in the past on non-tax income such as fees for public services. In the long run, however, the impact of revenue policy on fiscal space will depend on two key variables: the propensity of governments to make big rather than small adjustments in tax burdens, and the performance of the economy. The worst scenario for future budget makers is one in which the economy stagnates and political leaders lack the will to generate additional revenue; the most favourable scenario is the reverse. Though unlikely, it would enable the governments of OECD countries to recreate the golden age of expansion.

1.3. Deficit budgeting

Fiscal space can be enlarged by adding borrowed funds to the resources produced by current revenues. In fact, many OECD countries borrowed heavily during the post-war growth spurt to finance investment as well as current expenditure. Evidently, the surge in revenue did not fully cover burgeoning public expenditures. Governments had a propensity to borrow because of a far-reaching shift in fiscal doctrine from the balanced budget norm to active demand management. As has often been noted, the governments of OECD countries came to regard balancing the economy as more salient than balancing the budget. The accumulation of public debt was considered prudent because governments would repay their obligations out of the dividends of economic growth.

In those halcyon years, fiscal space was rarely a problem, though governments routinely were pressured by steeply rising demands. When the economy was buoyant, a government acquired ample space from the surge of revenue into its coffers. When the economy weakened, the government created space by justifying deficits that would narrow the gap between potential and actual output. Two factors converged in the late 20th century to undermine the case for deficit financing. One was the looming demographic tide that would impose enormous budget costs on future governments; the other was a shift away from flexible fiscal policies to fixed targets that constrain budget deficits. Most of the early targets were political statements that lacked enforcement and were frequently ignored. Nevertheless, the targets were useful political messages; they signaled to spenders that the high-growth era was drawing to a close and that future budgets would be constrained.

Accommodating targets have been replaced in many OECD countries by preset rules, such as the Stability and Growth Pact (SGP) which limits the annual budget deficit and public debt of euro-zone countries to a fixed per cent of GDP and authorises the European Commission to sanction countries that breach the limits. The original SGP was rigid: its

limits allowed no exceptions, regardless of economic circumstances or demands on the budget. Whatever its virtues, rigidity impaired a government's capacity to adopt stimulative budget policies during cyclical weakness in the economy. Moreover, the limits blocked counter-cyclical adjustments through the budget's built-in stabilisers. In 2005, the EC revised the SGP to allow some flexibility when warranted by economic conditions. Arguably, the changes have vitiated the rules but, in this writer's view, the appropriate test of their effectiveness is whether they constrain fiscal outcomes, not whether they absolutely bind politicians. To the extent that they have narrowed the fiscal space available for budget allocation, the rules have had a pronounced impact.

Outside the European Union, countries generally have taken a more flexible path that relies on political accountability rather than imposed limits to strengthen fiscal discipline. This fiscal responsibility approach requires a government to establish multi-year targets for selected aggregates (such as the primary balance or public debt as a share of GDP), to update the targets periodically and explain changes to them, and to report fiscal outcomes. This self-enforcing rule aims to make political leaders accountable for fiscal results, but it does not bar them from running up deficits. In contrast to fixed rules which are most constrictive when the economy is weak, the fiscal responsibility concept constrains the budget when the economy is strong and deficits are receding or have disappeared. When the economy is faltering, a government can fulfil its fiscal responsibilities by explaining why it has eased the constraints. The penalty for fiscal irresponsibility is that voters will turn the government out of office.

Fine-tuning fiscal rules so that they distinguish between different economic conditions is exceedingly difficult. One approach, which was popular during the growth era but subsequently fell into disuse, is to separate out the portion of deficit due to economic weakness while requiring that the budget be structurally balanced. Structural rules were abandoned because they were difficult to enforce and may have contributed to the upward creep in public expenditure, tax burdens and public debt. It appears that there is no perfect time for enforcing fiscal rules. When the economy is robust, a government has plenty of money to distribute via tax cuts and spending increases; when the economy is weak, the government must spend more than it has.

Although they may have limited effectiveness, fiscal rules do shrink budget space. Whether in the form of fixed limits or fiscal responsibility procedures, the rules bespeak a more constrained budget environment, a sense of constraint and a need for government to be more prudent. Inasmuch as the effects of fiscal rules depend on political will, the fact that government leaders are less willing to spend in excess of revenue reduces the space available for allocation. Table 3 confirms this conclusion, for it shows lower net borrowings by OECD countries during the past decade.

1.4. Economic performance

The final element in assessing fiscal space is the performance of the economy. High growth rewards a government with incremental revenues which (due to tax elasticities) generally rise faster than GDP. Of course, the reverse holds when the economy weakens, leaving a government with a shortfall in revenue. Expenditures also fluctuate with shifts in economic conditions, though not to the same extent as revenues. With revenues and expenditures moving in opposite directions, the budget has automatic stabilisers which enlarge fiscal space in good times and shrink it in bad times.

Table 3. **Net lending of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	1.4	1.9	–3.4	–3.3	–2.2
Austria	0.6	0.8	–2.0	–3.2	–3.0
Belgium	–	–	–5.8	–10.7	–4.2
Canada	–0.7	0.9	–2.0	–4.8	–
Denmark	1.5	2.9	0.5	–2.1	–0.6
Finland	2.3	4.1	5.0	3.6	–1.2
France	0.5	0.6	–0.9	–2.3	–3.5
Germany	0.8	0.2	–3.0	–2.1	–2.9
Iceland	2.9	0.9	–8.4	–9.4	–
Ireland	–3.4	–3.6	–9.2	–11.0	–0.5
Italy	–1.8	–4.8	–9.2	–11.0	–6.9
Japan	–	1.0	–3.4	–1.5	–3.5
Luxembourg	2.4	1.7	2.9	–	3.0
Netherlands	–0.7	–0.3	–2.0	–5.1	–2.6
Norway	4.0	4.3	2.5	5.2	3.8
Portugal	–0.2	1.5	–5.3	–5.5	–3.9
Spain	–	0.4	–0.7	–4.4	–4.0
Sweden	3.3	4.4	1.3	–1.6	–2.9
United Kingdom	–1.1	–0.4	–3.9	–2.3	–3.1
United States	–0.5	–0.6	–1.5	–3.4	–

1. This table only includes countries that were OECD members throughout the periods covered. Greece, New Zealand, Switzerland and Turkey have been excluded because of lack of data.

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Budgeting is a temperamental process. When the economy is strong, budget makers tend to allocate resources in the expectation that favourable conditions will continue. The opposite tendency prevails when the economy is weak. To the extent that economic performance has trended downward in recent decades, it has diminished the amount of space that governments have allocated. Table 4 displays economic growth trends for OECD countries; it shows that, while all countries experienced cyclical variations in performance, growth spurts have been weaker than in the past.

In forming expectations about the future, potential performance carries more weight than predictions about how the economy will actually perform. An economy's potential rests on two main variables: the size of the workforce and its productivity. In most OECD countries, future workforce growth will be significantly lower in the decades ahead as their populations age and older workers retire. Most of the gain in output will have to come from rising productivity, which is extremely difficult to predict. It is highly probable that productivity gains will be uneven over an extended period and that GDP growth also will be uneven. Fiscal space will expand and shrink in response to economic developments, and budget policy will adjust to swings in performance. It is not feasible to predict exactly how the economy will perform in the future, but demographic trends will make it difficult for OECD countries to match past results.

Table 4. **Current disbursements of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	20.4	22.1	30.2	33.8	31.7
Austria	29.3	33.4	40.0	46.2	48.1
Belgium	39.1	33.9	46.6	54.9	50.3
Canada	25.8	31.6	36.9	42.6	–
Denmark	25.1	35.0	43.2	54.2	55.6
Finland	24.3	27.5	33.8	39.0	50.9
France	33.0	34.8	38.9	45.8	48.2
Germany	30.2	34.1	42.2	43.8	44.2
Greece	19.7	22.4	28.0	39.2	46.1
Iceland	21.3	24.1	25.6	29.5	–
Ireland	26.7	32.8	40.0	47.4	35.6
Italy	11.1	13.0	38.7	44.3	48.7
Japan	13.7	14.6	21.7	26.3	28.4
Luxembourg	28.7	30.6	41.3	–	38.7
Netherlands	32.3	41.1	49.1	56.3	49.0
Norway	29.0	37.2	42.1	42.8	45.5
Portugal	17.5	19.1	29.1	36.5	39.1
Spain	14.5	19.0	23.6	34.3	38.8
Sweden	29.6	38.5	49.5	59.2	59.0
Switzerland	19.0	22.0	29.2	30.3	–
United Kingdom	30.8	33.4	39.8	42.0	39.6
United States	26.3	29.7	30.7	33.9	–

1. This table only includes countries that were OECD members throughout the periods covered. New Zealand and Turkey have been excluded because of lack of data.

Sources: Data for the periods 1960-67 and 1968-73 are drawn from *OECD Historical Statistics 1960-1983*; data for subsequent periods are drawn from *OECD Historical Statistics 1970-2000*. The two data sets are not consistent; hence the data reported here are not strictly comparable across all periods.

2. Protecting and enlarging fiscal space

Fiscal space is a variable quantity that is enlarged or decreased by government action. As discussed in the previous section, past expenditure decisions greatly narrowed the options open to future budget allocators. The task facing contemporary budget officials is to expand fiscal space so that expenditures reflect the policies and preferences of the government.

An essential step is to guard against revenue or spending actions which have only modest impact in the year(s) immediately ahead but balloon in future years. When the current budget is tight, politicians may be tempted to structure revenue losses and expenditure increases in ways that claim little space in the current budget but pre-commit future space without regard for downstream demands on the budget. Many costly entitlements have this characteristic, especially when payments are deferred to later years as is often the case in government-financed retirement benefits. Many types of programmes can be designed to shift fiscal impacts beyond the time horizon of the budget process. Future space can be consumed by deferring necessary maintenance on government facilities, launching numerous projects but extending completion over a period of years, awarding public employees small pay increases in the current year and much bigger ones each of the next several years, booking fees for issuing government guarantees as current revenue but ignoring the claims that will arise in case of default, and other bookkeeping tricks.

Even when they do not shift costs to future budgets, politicians act in ways that reduce future space. Whenever an ongoing programme is established, it reduces the room for

manœuvre in future budgets. Several instruments are available for protecting space, ranging from procedures that inform policy makers of downstream consequences to procedures that limit current actions. Baseline projections of the future costs of current policies merely inform budget makers, but when linked to medium-term expenditure frameworks, they limit spending decisions to the amounts that can be accommodated within each year's framework. A variant on this approach is to require that any expenditure increase or revenue loss due to new budget decisions must be offset by spending cuts or revenue increases.

New procedures have been introduced or proposed to protect future space. One is to apply the accrual basis to liabilities that come due beyond the year(s) for which budget decisions are made; another is to account for the estimated present value of future revenue or spending changes as a cost in the current budget. Accruals and present-value estimates can be incorporated into fiscal rules which limit the gap between revenues and expenditures. For example, if a policy change was estimated to add 100 million to the present value of future expenditures, that amount would be expensed in the budget and included in enforcing limits on the deficit. It would be feasible for a government to implement this procedure without shifting the entire budget to the accrual basis. However, enforcing this rule would compel the government to extend its fiscal horizon well beyond the 3-5 years of a medium-term expenditure framework. This issue is taken up in the final section, which discusses changes to the budget process.

2.1. Enlarging fiscal space

Governments that encounter shrinking or inadequate room for policy initiatives have introduced numerous reforms to expand their opportunity for manœuvre. Reforms that have sought to depose incremental norms have always failed, for reasons mentioned earlier in this paper. Accordingly, the adjustments considered here focus on marginal changes in revenue and expenditure policy that would expand the increments available for allocation.

Assuming that increases in tax rates are off the table, the most appropriate course for a government might be to review and prune tax subsidies that diminish its revenues. This option should be the most attractive for countries which forgo significant amounts of revenue through tax expenditures, but these might well be countries in which beneficiaries of tax subsidies are the most effectively mobilised to protect their interests. Nevertheless, it is worth the effort, not only to generate additional revenue, but also to curtail distortions in economic activity caused by undue provision of tax expenditures. In the trade-off between more tax breaks or higher tax breaks, national governments with insufficient budget space would do better by curbing subsidies than by raising already-high rates in order to finance burgeoning expenditure commitments.

On the expenditure side, the most obvious option for enlarging space – reallocation from less to more effective programmes – usually is exceedingly difficult. Every national government has experienced occasional bouts of reallocation: terminating or curtailing major programmes and shifting the funds to other issues. But these bouts are episodic, provoked by fiscal crisis or by major changes in political sentiment and leadership. These reflections are not formally built into the routines of budgeting but are driven by the opportunities of the moment. Quite frequently, however, proposed reallocations fail because they provoke opposition from multiple sources: programme beneficiaries threatened with loss of services, agencies which do not want to surrender coveted activities, politicians discomfited by the prospect of angering voters, public employee unions determined to protect jobs. Explicit reallocation is difficult, even when it is based on evaluative findings and other evidence.

Budgeting is incremental because major reallocations are rare. At the margins, however, there are frequent shifts of resources as new opportunities emerge and old ones recede. These shifts generally are not explicit – they do not overtly pit programmes against one another in a competition for scarce funds. Nor do these shifts take money away from spending units. Instead, they are implicit, and savings are retained by the affected agency. Sometimes these adjustments are made unilaterally by the agency and not even brought to the attention of the central budget office; at other times, the adjustments are agreed in formal budget negotiations. They may be initiated by the spending agency under conditions that significantly lower the risk of losing resources. One objective of the medium-term expenditure framework is to encourage ongoing reallocation and to broaden its scope. But this aim has often been thwarted by faulty implementation of MTEFs.

Four reallocation tactics warrant brief mention. One is to increase budgeted levels by less than the expected rate of inflation. In this situation, programmes and agencies get nominal allocations at the previous year's level or a bit higher, but not enough to compensate for price changes. Recourse to this ploy has been impeded in recent decades by indexation of various programmes and by adjustment of baseline projections for estimated price changes. This issue shall be further discussed in the concluding section below.

Second, marginal reallocations can be financed by reducing agency operating budgets by an amount equal to expected or average gains in productivity or efficiency. These adjustments, which typically range between 1-2% of operating expenditure, are subtracted from either the agency's base budget or from baseline projections. Programme expenditure and transfer payments are exempt from these enforced cuts. Although the amounts saved are small and often are below actual efficiency gains, they stir considerable resentment and can be difficult for small agencies which have little flexibility in managing their budgets.

Third, some governments have experimented with "sunset" rules which automatically terminate programmes or subject them to review according to a fixed schedule, such as every five or ten years. The idea is to require an explicit decision by the government to continue each programme. In practice, sunset provisions have modest impact on minor programmes which have little visibility or political support, but rarely affect the fortunes of large programmes.

Finally, governments can resort to across-the-board cuts to open space for new budget allocations. Singapore, which imposes a 5% cut, puts the savings in a common pool which is allocated through annual budget decisions. This form of cutback is used from time to time by budget officials to close a projected gap between revenues and expenditures. The new version is deployed to make money available for allocation. Consequently, agencies can win back some of the enforced savings by bidding for additional resources.

2.2. Shifting risks and costs

The space created by the various ploys discussed here reinforces incremental tendencies. The ploys do not significantly alter the government's fiscal position. Far-reaching efforts under way in some countries would create budget space by shifting either risk or expenditures from the public treasury to private hands. It was noted earlier that the modern state has become the holder of significant risks for society. Recently, there have been some efforts to reverse this trend through a variety of approaches that offload risk. The most prominent initiative involves retirement benefits which increase in cost as the number of pensioners rises. Traditional defined-benefit plans place the full risk on the government: it must pay promised benefits regardless of the financial condition of its

social insurance funds or the longevity of eligible recipients. By converting all or a portion of payments to defined-contribution schemes, governments shift a sizeable fraction of the risk to recipients. Some governments have gone further and introduced private retirement accounts, usually with a guaranteed minimum payout. A few have adopted a scheme devised by Sweden which adjusts payments at retirement for changes in life expectancy. These types of risk-shifting moves are likely to accelerate in the decades ahead as governments are burdened by the costs of supporting an ageing population.

The best way to avoid risk is to be cautious in taking it on. Because a risk taken one year usually comes due in later years, it can be regarded as costless. It would be prudent for governments to wall off decisions on whether to accept risk from an assessment of potential exposure. Ideally, the assessment should be carried out by an independent office or a central agency, not by the entity tendering guarantees or other risks. Governments can induce a more cautious posture by provisioning for risks in advance or by sharing risks with other parties. A rarely tried mechanism would be for a government to purchase reinsurance when it takes actions that expose it to potential losses. It also can purchase insurance for destabilising events, such as natural disasters which burden national budgets by depressing GDP and public revenues and by compelling the government to pay for reconstruction, even when it does not have a legal obligation. But such insurance may be viewed as a bad deal by politicians because the premiums eat into current budget space.

Governments can shift costs by privatising activities or by financing them privately. Public-private partnerships (PPPs), typically for major construction projects, have become a popular arrangement for shifting upfront construction costs or operating expenses to private entities. In exchange for hiving off these costs, governments may guarantee operating performance. For a road construction project, a government may guarantee a minimum volume of traffic or toll revenue, with the government compensating private investors for shortfalls. In this arrangement, the government reduces near-term expenditure but adds medium- to long-term risk. If PPPs are not diligently crafted with prudent assessment of risks and carefully drafted contracts, a government may gain budget space but undermine the control of future budgets.

Some governments have gone beyond PPPs to sell existing assets and book the income as current revenue. This tactic is open to governments that operate on a cash basis; they can disregard the unpleasant facts that the income is non-recurring and that the increase in budget space is ephemeral. A government determined to invent space by liquefying assets can create novel financing instruments, such as securitising future streams of revenue. This imprudent tactic, which has the same effect as pre-spending future budget space, is never appropriate, even when the government is short of revenue to maintain existing services.

Two different conclusions can be drawn from the foregoing discussion. If the objective is to produce increments for budget allocation, a government has an array of marginal adjustments that give it more fiscal space. If, however, the aim is to transform budget choices, few OECD countries have the political resources to vastly expand fiscal space through fundamental changes in revenue or spending policy. As demographic pressures intensify, more governments may feel compelled to question established revenue and spending policy.

3. Adjusting budget processes

The conduct of budgeting affects the space available for allocation. This concluding section considers how the process might be adjusted to protect and enlarge space. Key

adjustments pertain to the role of the budget office, the time frame of budgeting, the construction of baseline estimates, and incentives for marginal reallocations.

The primary role of the central budget office should be as guardian and allocator of fiscal space. Performing these tasks requires that it have the macroeconomic and programme analytic skills to estimate available space and the impact of proposed or adopted policy changes. The budget office would manage the baseline, extend its data and decisions to future years, provide incentive for spending units to propose and implement policy changes, inject evaluative and performance evidence into budget work, and seek opportunities to expand the space available for allocation. Budgeting, in short, would be the key process for identifying, deciding and financing policy innovation. To be positioned for these tasks, the central budget office would have to abandon some traditional responsibilities, especially the close monitoring and control of expenditures. If it does not offload control functions, the budget office will lack the time, skills, disposition and credibility to manage policy change.

Many central budget offices in OECD countries have already transitioned from control to costing and reviewing policy initiatives. For some, the changeover has been difficult because they no longer are certain of how they fit into the overall financial management framework of government. Modern budget offices realise that it is not viable to intervene in the details of expenditure, but are unsure of which tasks they should perform and which should be devolved to spending agencies. For example, they may be ambivalent about whether programme evaluation and performance measurement – two useful inputs into the policy process – should be led centrally or by line agencies. They may also be anxious about the leverage which is surrendered when they let go of the instruments of control. Having surrendered some powers but not having yet consolidated new ones, the budget office may be a weak counterpart to spending units which have superior access to information and closer ties to sectoral interests.

To facilitate the transition from traditional responsibilities to new roles and relationships, it would be useful for the central budget office to regard fiscal space as its space – that is, as the portion of the budget on which it focuses. From this vantage point, the budget office has an obvious incentive to expand the space by encouraging trade-offs, expanding available increments, setting aside money in bidding funds or other pools, and taking other steps discussed in the previous section. It also has incentive to protect future space by assuring that trade-offs and savings are accurately costed. This assignment can be a challenging one because spenders have incentive to overstate expenditure reductions and underestimate increases when they propose reallocations. To deter these machinations, the budget office must have relevant data and analyses that enable it to review and correct agency misestimates. Even more important, it must have political support at the top of government to confront agencies. When budget trade-offs are collegially decided by cabinet, the budget office may be overwhelmed by log-rolling ministers for whom spending initiatives have higher priority than protecting future fiscal space.

The budget office's role in protecting fiscal space also is undermined when governments make *ad hoc* spending decisions throughout the year. Nowadays, politicians make *de facto* budget decisions when they meet at international forums, interact with interest groups, respond to a crisis or media attacks, and (in some countries) just about every time cabinet meets. In this writer's observation, *ad hoc* budgeting has become much more prevalent than a generation ago, probably due to heightened mobilisation of political interests, greater pressure on governments to deal with unfolding events, stronger transnational

networks, and more openness and transparency in budgeting and other government activities. In a few countries, year-round budgeting has been energised by abundant surpluses which are whittled down by *ad hoc* spending decisions. In some countries, more spending decisions are taken during the period between budgets than during budget season. In several countries, sectoral ministers have "sold" the prime minister costly programme initiatives immediately before the scheduled cabinet meeting, and the proposals were approved without much discussion and without being vetted through the budget process. Whatever the rationale, this practice puts fiscal space at risk by significantly weakening the capacity of the budget office to assess future spending impacts.

3.1. Baseline estimates

To allocate fiscal space, the budget office needs two essential types of information: the volume of available space for the next year or longer; and the extent to which that space would be claimed by proposed or adopted changes in revenue and spending policies. Medium-term (or longer) projections of current policy have become standard budget practice in many countries, particularly those that have introduced MTEF-type arrangements. In contrast to traditional "base" estimates which use the previous year's spending level as the starting point for budget work, baseline projections adjust the base for estimated future changes in prices, workload, and other economic or programme conditions.

In baseline budgeting, fiscal space is the difference between projected revenue and expenditure, plus or minus targeted surpluses or deficits. Policy changes are the estimated changes to these projections due to revenue or spending initiatives of the government. For example, suppose that a government estimates that baseline surpluses will be 100 million next year. It then legislates changes in revenue laws that are estimated to reduce the projected surplus to 80 million. In this case, the policy change consumes 20 million of the available space. Re-estimates due to changes in economic conditions or other technical considerations (such as updated estimates of the number of persons receiving payments under existing law) generally are excluded from the computation of policy changes.

It is important to note that national governments differ significantly in how they construct baseline projections and estimate policy changes. Some governments incorporate estimated price changes in the baseline; others do not. Some include only permanent or structural changes in measuring the impact of policy changes on fiscal space; others include all adjustments. The rules for projecting the baseline have a significant impact on both the volume of space and the estimates of policy change, as shown by the hypothetical comparison in Table 5.

Table 5. **Comparison of baseline projections**

	Baseline revenue	Current expenditure	Estimated price changes	Projected space
Country A	120	100	10	10
Country B	120	100	No adjustment	20

In this illustration, the country that does not incorporate estimated price changes in the baseline has twice as much fiscal space to allocate than the country which includes price changes. In making budget allocations, country B can opt to compensate spending agencies for expected price changes or it can allocate the money for other purposes. Suppose the government decides to spend 105, which would compensate agencies for half of the

projected price increase in this hypothetical case. Country A's decision would be measured as an expenditure cut; country B's decision would be measured as an expenditure increase. Even though the actual expenditure would be identical for both countries, political perceptions would differ greatly. Because of this, country B would likely have far greater difficulty protecting and allocating fiscal space than country A.

There are powerful arguments for and against building estimated price changes into the baseline but, regardless of one's point of view, it should be recognised that baselines are not neutral instruments. How they are prepared directly affects the perceived volume of budget space.

Constructing the baseline and measuring the policy changes are two critical roles of the modern budget office. That office establishes rules for the baseline, updates the projections periodically to incorporate new economic and technical estimates, and measures the budget impact of proposed or approved changes in revenue and expenditure policies. Estimating policy changes is exceedingly difficult for revenue legislation and mandatory entitlements because budget experts must consider how taxpayers and programme beneficiaries will respond to the changes. To make matters even more critical, estimated impacts matter when budget allocations are made, not the actual impacts which only become known after the budget has been decided. In baseline budgeting, erroneous estimates are more relevant in allocating space than what actually ensues in the future.

Because of this, the budget office faces conflicting pressures. From a professional point of view, it must base estimates on specific programme knowledge, an understanding of possible behavioural responses, interactions among programmes and between the policy changes and projected economic conditions, and other variables. From a political perspective, the budget office may feel pressured to produce accommodating estimates that enable policy initiatives to proceed. Ideally, the budget office would deal with these pressures and with the inherent difficulty of projecting an uncertain future by producing a range of estimates. In practice, however, the process of allocating budget space demands that a government have point estimates of the impact of policy changes on revenues and expenditures. Although these estimates are often wrong, sometimes by large amounts, they are the stuff out of which innovative governments allocate budget space.

3.2. Time frames

It makes little sense to allocate fiscal space solely in the context of a single fiscal year. Doing so would give politicians and other claimants the opportunity to veil the true impact of revenue and spending decisions by manipulating the timing of policy changes. In one-year-at-a-time budgeting, programme expansions or revenue reductions scheduled to take effect in a subsequent year would have zero impact on fiscal space. When a government looks only one year ahead, it almost certainly will take actions that deprive it of adequate space in future budgets.

There is yet another reason for extending the time frame: fiscal space tends to be relatively narrow in the year immediately ahead and to widen in subsequent years as the economy grows and revenues become more plentiful. Therefore, a government has greater room for manœuvre when it considers a stream of years rather than only one. When the reverse occurs and the space narrows (or disappears) in future years, the government has a powerful signal that current policies need to be re-examined.

Governments would not be able to expand their fiscal horizon if they lack contemporary budget tools such as baseline projections, socioeconomic models, policy analyses and trend data. The central budget office uses these tools to measure and allocate fiscal space, but other participants in the process use them as well. In contrast to traditional "number crunching" in which the budget office had a monopoly or comparative advantage, it has no special claim of expertise in policy analysis. Anyone with a model or data can estimate the impact of policy changes on future budgets. But although anyone can contribute data and analysis to the policy debate, at the end of the day there can only be one authoritative measure of fiscal impacts, and it is usually the one from the budget office or another central organ.

In advanced countries, budgeting for fiscal space is proceeding along two time frames: the medium term, typically for the next 3-5 years; and the long run, stretching 30 years into the future. The medium term is used for allocation, the long term for analysis of fiscal sustainability. The period of 3-5 years for allocative decisions through an MTEF or similar arrangement recognises the shortness of political terms and the variability of economic conditions. Although it may be desirable to have a longer frame, it may be imprudent to give politicians a platform for pre-spending space too far into the future.

Long-term projections are not used for allocation; rather they analyse whether existing policies are sustainable and equitable across generations. Sustainability focuses on whether extending the revenue and expenditure regime into the distant future will create negative space – that is, a shortfall in resources that would either compel far-reaching policy changes or risk insolvency. Equity focuses on whether future generations will be disadvantaged, compared to the current generation, by a loss in benefits or a rise in tax burdens. It would be desirable to feed long-term projections into ongoing budget work, though one may question whether the budget office should have the main responsibility. Governments that budget exclusively on the cash basis may deem it appropriate to assign long-term work to specialised staff who assess the fiscal position in terms of liabilities rather than disbursements.

3.3. Medium-term expenditure frameworks

The MTEF is at once among the most popular contemporary innovations and among the most misapplied. In blueprint, it is a splendid process for allocating space through policy changes that are costed and decided in compiling the budget. In practice, it often is separated from budgeting and is used to campaign for future spending increases.

The MTEF has two basic features that are relevant to budgeting for fiscal space. First, it has a preset constraint on total spending and (typically) on sectoral or ministerial spending as well. To set the constraint, it is first necessary to estimate the space that will be available for allocation during the next medium-term cycle. Once this space is determined, the constraint is the portion of space that the government intends to allocate. Second, each ministry or sector submits bids for resources consistent with the sub-constraint allocated to it. Any savings proposed by the ministry or sector free up an equivalent amount of resources for allocation. Acting on behalf of the government and, in some countries, with its concurrence, the finance ministry sets the constraint and reviews spending bids to assess whether they are accurately costed and consistent with government policy.

The MTEF accommodates a variety of scenarios with respect to budget space. The standard arrangement may be labeled "positive" space in that the aggregate constraint and sub-constraints have room for expenditure increases. On the other hand, a government

may allocate "negative" space, which would be the volume of savings that would have to be achieved in rolling the MTEF forward. When a ministry is allocated positive space, it may enlarge the resources available for policy initiatives by proposing reductions to existing programmes. These arrangements would not be feasible without baseline estimates and central capacity to estimate the budget impacts of savings and initiatives over the medium term. Moreover, the constraints and sub-constraints must be firm; except for compelling reasons, they should not be modified during preparation of the MTEF. Ideally, proposed reallocation should be based on performance indicators, programme evaluations or other evidence of effectiveness.

It is not hard to understand why the MTEF has been a popular innovation. It extends the time frame of budgeting, declutters the process of less significant detail, focuses on the allocation of fiscal and policy changes, and gives spenders some incentive to propose reallocations. More often than not, however, the MTEF is misapplied, with the unintended result that it may put fiscal space at risk. The major deficiency in implementing an MTEF is that it is treated as a separate activity, not as the core process of budgeting. In some countries, the MTEF has its own staff, a separate database, and distinct procedures for compiling out-year estimates. When a government pretends to have two processes for allocation, only one of them totally matters and it almost always is the annual budget process, not the MTEF.

An improperly implemented MTEF can jeopardise future fiscal space. To understand why, it is necessary to note that an MTEF entails spending decisions for each of the next 3-5 years. These decisions are reflected in the aggregate and sectoral constraints discussed earlier. Each year, when a new budget cycle is launched, the MTEF is rolled forward and the decisions made the previous year are incorporated into new baseline estimates. The previous decisions become constraints on how much can be spent in the years covered by a new MTEF. Revisions to these constraints are budgeted as adjustments to the baseline. A government has the option to keep to the baseline or to authorise policy changes that add to or subtract from expenditure. When the MTEF is separated from the budget, the constraints tend to be soft and, rather than being viewed as ceilings on future spending, they are regarded as floors that enable spending units to campaign for higher allocations in the future. Rather than being an instrument that protects fiscal space, the MTEF is transformed into a process that puts space at risk. The only way to avoid this fact is to have hard constraints that are built into the budget and are not regarded as separate projections.

In a medium-term expenditure framework, the central budget office becomes guardian of the country's fiscal space and manager of the policy change process. This is a more political role than the customary one of reviewing estimates. It sometimes places the budget office on a collision course with political leaders and other central actors. If it cannot perform this role effectively, the government may end up budgeting for fiscal space that it does not have.

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Budgeting for Entitlements

by
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An entitlement is a provision of law that establishes a legal right to public funds. In most OECD countries, entitlements were the principal growth area of public expenditure from the mid 1950s to the mid 1980s. This article discusses budgeting for entitlements under two rather different conditions: the expansion of this category of expenditure during the quarter century after World War II, and cutback and "status quo" budgeting during the decade since the first oil shock.

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During the past three decades, there has been a progressive enlargement in the relative size of the public sector in most OECD countries, as well as significant changes in the composition of public expenditure. Public expenditure averaged 28.5% of GDP in the 1955-57 period, 34.5% in the 1967-69 years, and 41.4% in 1974-76 (OECD, 1978, Table 2; these are unweighted averages). This enlargement has persisted in recent years, though the rate of growth has been slower and more erratic (OECD, 1982, Table 4-A-C). According to a 1982 OECD study for Working Party No. 1 of the Economic Policy Committee, "except for Australia, Austria, Luxembourg and Iceland, the most buoyant source of public sector growth during the reporting period as a whole [1960-80] has been the increase in transfer payments. [...] Transfer payments are now roughly equal to public consumption expenditure in an increasing number of OECD countries" (OECD, 1982, p. 6). Data from a number of countries illustrate the growing importance of these payments. In Denmark, income maintenance expenditures climbed from 7.5% of GDP in 1954 to 19.7% in 1978. They rose in France from 11.2% to 17.9%; in Germany from 11.5% to 18.2%; in Japan from 2.9% to 7.3%; in the Netherlands from 6.4% to 19.4%; in the United Kingdom from 6.4% to 11.7%; and in the United States from 4.1% to 9.8% (OECD, 1982, Table 4-A-C).

These trends, the causes of which have occasioned much study and controversy, have been accompanied by a substantial increase in the share of public expenditure accounted for by entitlement programmes. The bulk of transfer and income maintenance expenditure is for pensions, unemployment and disability compensation, and other entitlement schemes. In most OECD countries, entitlements have been the principal growth area of public expenditure in recent years.

This paper discusses budgeting for entitlements under two rather different conditions: the expansion of this category of expenditure during the quarter century after World War II; and cutback and "status quo" budgeting during the decade since the first oil shock. Before discussing these conditions and the factors accounting for them, the paper provides an overview and definition of the entitlement problem.

1. The definition and budgetary status of entitlements

Despite their importance, there is no standard definition of entitlements nor, therefore, reliable means of measuring the fraction of the budget accounted for by them. Nevertheless, the budgetary characteristics of entitlements are sufficiently distinguishable from other forms of public expenditure to warrant separate analysis. Budgeting for entitlements is not the same as budgeting for the purchase of goods and services or for other discretionary expenditures. The differences between entitlements and more traditional expenditures account for the basic problem of expenditure management that besets most OECD countries. The methods of budgetary decision and management developed for traditional expenditures might require adjustment when applied to entitlement programmes.

An entitlement is a provision of law that establishes a legal right to public funds. The right might be accorded to an individual, to a household, or to any other designated beneficiary. The law usually sets forth eligibility requirements and either a schedule of payments or a formula by which the payments are computed. The law usually does not specify (or limit) the total expenditure for the entitlement; the total is simply the sum of individual payments.

Social security, unemployment compensation, family allowances and disability payments are entitlements because they accord particular classes of the population rights to money from the public treasury. The right to a social security benefit, for example, is based on age and (in many countries) prior earnings, and the money value of that right is determined according to law. The government (or the social security fund) is obligated to pay the amount to which recipients are entitled whether or not sufficient funds have been set aside for this purpose in the budget. In many countries, a permanent appropriation finances social security and various other entitlement programmes. But even when the entitlement is financed by annual appropriations, the government must provide the benefits mandated by law.

The concept of entitlements can be explicated by contrasting them to other types of expenditure. Programmes which are not entitlements entail either discretionary expenditures or mandatory expenditures. The former are easily distinguishable from entitlements because expenditures are incurred only if they are authorised by appropriations. There is no substantive law requiring the government to spend the funds and no right of recipients to payments from the treasury. If no appropriation is forthcoming, no expenditure is made. Discretionary expenditures are common in the purchase of goods and services. However, in instances where suppliers have a legal right to sell their goods to the government and the government is obligated to purchase those goods at a price determined according to law, then an entitlement would exist. Thus, agricultural programmes which require the government to acquire surplus crops at a price set by law would be entitlements. But when the government spends an appropriation to purchase agricultural products to feed persons in its care, the expenditure probably would not be an entitlement.

The second category consists of mandatory expenditures which are not entitlements. In these cases, the requirement to incur the expenditure arises out of a contractual obligation entered into by the government. Thus, the obligation to pay interest on its debt stems from a contract between the government and bondholders; a government's obligation to pay for goods and services derives from a contractual commitment to suppliers. Without these contracts, no payments would ensue. But the obligation to pay for entitlements derives from law, not from contract. Indeed, many entitlements are unilateral commitments by the government which do not require any reciprocal commitment by beneficiaries.

The distinction between entitlements and other expenditures is not so clear-cut as to rule out all ambiguity. Some programmes may have characteristics similar to entitlements but still permit a measure of discretion in determining expenditure. In the United States, for example, the food stamps programme entitles low-income persons to cash assistance for the purchase of food. Because the law establishing the programme limits the total cost and makes expenditures conditional on annual appropriations, some budget experts do not regard food stamps as an entitlement. Yet Congress always appropriates sufficient funds to pay for all required benefits and raises the limitation on total cost whenever necessary to ensure that all benefits are fully paid. For this reason, some experts classify food stamps as an entitlement.

Ambiguity about the status of some programmes does not impair the analytic usefulness of the entitlement concept. Most expenditures can be clearly classified as entitlements or non-entitlements. The marginal cases make it difficult to tally the full cost of entitlements or their share of national budgets. But to examine how the practice of budgeting has been affected by the growth of entitlements, one need not possess an authoritative listing of these expenditures.

The critical distinction between entitlements and non-entitlements is that expenditures for the former are determined by law and for the latter by budgets and appropriations. When entitlement legislation is being formulated, its future cost can only be estimated; once the legislation has been enacted into law, the government must (unless it changes the law) bear whatever cost is required by the entitlement. In these circumstances, the budget process is more a means of accounting for past decisions than of making new ones. Moreover, the budget may not be the process by which year-to-year changes in entitlement expendures are determined. These changes are more likely to result from changes in the number of eligible beneficiaries and from inflation than from discretionary budget actions. As a consequence, budgetary control of the "increment" – the portion of expenditure over which the budget organisation historically had greatest influence – has been weakened. In extreme cases, where indexation is widespread and entitlements are highly sensitive to economic performance, expenditure growth is on "automatic pilot" and the procedures of budgeting have little sway over the trend in expenditure.

In some countries, entitlement expenditures are classified as "uncontrollable". This label should be interpreted to mean that the level of expenditure is not determined by a budget decision alone. That is to say, if the budget and appropriations do not provide sufficient funds, the government still is obligated to make the payments prescribed by law. But entitlements are controllable through changes in law; in this sense, the "uncontrollable" label can be misleading.

The fact that entitlements now constitute a much larger share of public expenditure than they did 10-30 years ago has important implications for budgeting. For one thing, unless it changes the law, the government must incur the expenditure, regardless of the condition of the economy or of other claims on the budget. Moreover, as noted above, year-to-year increases in expenditure are likely to be decided independently of the budget process. In fact, variations between budgeted and actual expenditures are likely to be greater and less predictable for entitlements than for other programmes.

Entitlement issues tend to draw wider participation both within and outside government than do conventional budget decisions relating to consumption expenditures. Conventional budgeting has been described as "government talking to itself", as ministries communicate their spending wants to the budget organisation. Taking decisions for entitlements is likely to be a more open process, for the affected beneficiaries have a direct stake in the outcome and strong incentives to make their interests known to public officials. Furthermore, the distributive effects of entitlements are more visible than are those of consumption spending.

This "politicisation" of budgeting poses few difficulties when the economy is growing and resources are available to finance increased entitlements. But when the economy is weak and cutbacks are sought, the budget process may have difficulty coping with political conflict over entitlements.

2. The establishment and growth of entitlements

No single factor accounts for the prominence now accorded entitlements in public expenditure. Budget officials attribute the growth in entitlements to economic conditions, political pressures, demographic changes and other factors. In sorting out these factors, it would be useful to distinguish between the establishment of entitlements (including changes in law expanding eligibility or benefits) and the growth that occurs after the entitlement has been enacted into law.

2.1. The establishment phase

In most OECD countries, the great upsurge in entitlement legislation occurred during the sustained period of economic growth in the decades after World War II. There is widespread agreement that the two conditions were closely related. Economic betterment provided the means of financing entitlement programmes, as well as expectations that the state would shelter its citizens from the fluctuations of the business cycle. Protracted growth legitimised the role of democratic regimes in economic stabilisation and management, and entitlements provided built-in stabilisers against cyclical downturns. Because the post-war growth occurred while memory of the Great Depression and its harsh effects was still strong, it stimulated demands for "safety nets" to assist less fortunate citizens. Widespread affluence (and the expectation of sustained improvement in the standard of living) generated political acceptance of income redistribution schemes, for it now was possible to improve the welfare of low-income persons without lowering the economic quality of life for the more fortunate sectors of society. Governments did not so much redistribute income as distribute the rewards of economic growth. They gave some of the benefits of growth to the elderly, the unemployed, the disabled and others who were cut off from it, but the living standards of workers and businessmen continued to improve.

Economic growth relaxed budgetary constraints on programme expansion and desensitised governments to the costs of their new obligations. Often, entitlements were inaugurated or expanded with little solid data on their future costs and without subjecting them to rigorous budgetary review. Insensitivity to the cost of new entitlements was partly a function of the manner in which these programmes were developed. Entitlement schemes were frequently devised by special task forces or commissions which operated outside the regular budget process and whose proposals garnered a great deal of attention and support before the ministry of finance was called upon to review them. The legislation formulated in response to these political expectations addressed the needs and rights of the persons who were to receive the entitlements. Unlike appropriations, money usually was not mentioned at all. Attention thus was deflected from costs to needs, and there was a parallel shift in the effective locus of decision making from the budget organisation to other centres of political power. It was difficult in these circumstances for budget officials to make their case in terms of costs. As a result, budgetary power gravitated to those who could point to the public good that would be accomplished by aiding the aged, the poor and the unemployed, and away from those who worried about whether the government could afford the obligations it was assuming so willingly.

Inattention to future costs was encouraged by a number of factors. First, the expectation of sustained growth bred confidence that an expanding economy would be able to pay for expanding benefits. Second, some major entitlements, particularly social security, had self-financed funds which accumulated surpluses to pay for future benefits.

These surpluses encouraged the notion that, despite demographic trends, the funds would be able to pay for the obligations which they were accruing. Third, during periods of economic weakness, the prevailing view was that spending on entitlements would spur recovery and lead to still greater improvements in living standards.

The spread of entitlements was fueled by peer pressures among the industrialised democracies. While the pattern and level of benefits varied from country to country, most were swept along by the rising expectations about their role in providing for the elderly, assisting the poor and protecting workers against recessions. A senior budget official of one less economically advanced European country suggested that its membership in the EC impelled it to upgrade the entitlements accorded citizens.

If economic growth was the wellspring of the entitlement state, then one should find entitlements to be less extensive in OECD countries that had low growth rates in the post-war era. There is reason to believe this to be the case in some southern European countries. But some of these countries have undergone rapid democratisation in recent years, opening them to intense pressures for enhanced living standards. One response has been to entitle citizens to various benefits. The Spanish government, for instance, recently enacted legislation entitling veterans of the Civil War (and certain of their relatives) to pensions, a programme which has turned out to be more costly than expected. This is due to the difficulty, common to many such benefit programmes, of establishing reliable estimates as to the number of persons who will claim and qualify for benefits.

Once started, entitlement programmes tend to be expanded. Programmes targeted for particular beneficiaries are broadened to cover additional groups. In the United States, for example, a programme designed to aid coal miners disabled by black lung disease was expanded by legislation to cover virtually all miners. In Sweden and other countries, programmes aimed at impoverished regions were expanded to other areas which did not meet the original eligibility requirements. These examples suggest that even if eligibility is narrowly defined, political forces may be set into motion to expand the entitlement beyond its intended scope. In this way, targeted programmes are incrementally transformed into universal ones, and entitlements which entail modest costs at the outset grow into costly undertakings.

Because the process of expansion is incremental, it is easy to lose sight of the entitlement's original purpose and of its future cost. Each proposed enlargement is considered in isolation, without examining why the programme was cast as an entitlement. At the point of expansion, the issue is often framed in terms of equity: why should one group be denied benefits which are already provided to another similar group? The affinities between those receiving and those denied the entitlement are accented, while the differences are downplayed.

OECD studies show that the expansion of entitlements entails both the extension of coverage and the improvement of real benefits (OECD, 1983a). Between 1960 and 1980, the percentage of the civilian labour force covered by unemployment insurance programmes increased in five major OECD countries and declined in only one. Coverage expanded from 63.6% to 89.6% in Canada; from 38.2% to 58.8% in France; from 38.2% to 47.7% in Italy; from 33.5% to 50.4% in Japan; and from 66.5% to 89.5% in the United States. There was a decline in the United Kingdom. During the same period, real benefits paid to unemployed workers increased in all of these countries (OECD, 1983b, Tables 16 and 17).

During the growth era, there were frequent adjustments in nominal payments to protect recipients against an erosion in their benefits due to inflation. Inasmuch as

economic growth was robust, there often was widespread support for these adjustments, but public officials also were pressured to increase real benefits as well. Typically, therefore, inflation adjustments opened the door to other improvements in entitlements and, as a result, many OECD countries experienced a "benefits creep" with entitlements claiming a progressively larger share of state budgets and national income. In response, some countries turned to indexation as a means of dampening pressure for improvements in benefits. With payments automatcially linked to the inflation rate, there no longer would be need for periodic discretionary legislation. Beneficiaries could no longer use the occasion of inflation adjustments to obtain real improvements. Indexation protected politicians against programmatic pressures that they might not have been able to resist.

In addition to serving as a control mechanism, indexation was welcomed as a means of ensuring that the redistributive features of entitlements were maintained. In a few countries, benefits were linked to wages, thereby ensuring that recipients would partake of the expected economic growth.

2.2. Growth without legislation

The initiation and expansion of entitlement programmes through new legislation slackened after the first oil shock, as most OECD countries attempted to adjust to adverse economic conditions. But the cost of existing entitlements continued to rise because of factors over which governments had little or no control. Demographic trends, in particular the rising portion of the population eligible for pensions, contributed significantly to increased expenditures. The changing age composition of the population meant that even if real benefits and eligibility standards were frozen, entitlements would consume increasing shares of public budgets.

Indexation – which (as noted above) was introduced to strengthen budget control – had the opposite effect during the stagflation that persisted from the mid 1970s until the early 1980s. The confluence of high inflation and high unemployment had a devastating effect on budgetary balance in countries where indexed entitlements were widespread. High inflation automatically raised public spending on these programmes; high unemployment diminished the resources available to pay for them. Because the price level was the most commonly used index, beneficiaries of entitlements often were able to maintain their standard of living at the same time that the real income of workers declined.

Not only did low economic growth and high unemployment erode the revenue base of OECD countries, they also added to entitlement spending. Governments were obligated to provide the unemployment benefits they enacted during the growth years. But now that stagnation took hold, they found themselves locked into much higher expenditures than they had expected. One reason was that unemployment was much higher than in previous post-war recessions, compelling industrialised countries to spend much more than in the past to meet their commitments. Moreover, unemployment did not recede to the pre-recession level during recovery. Much of the unemployment was structural (due to the loss of jobs in declining industries and the incapacity of the economy to absorb large numbers of new entrants into the workforce) rather than cyclical. Structural unemployment burdened contemporary governments with high expenses with little prospect of relief from economic improvement.

If any of the three factors (demographic trends, indexation or unemployment) had occurred alone, the effets on government budgets might have been modest. But all three

occurred in tandem during the past decade, greatly overloading the budgets of OECD countries and impelling them to seek means of moderating the rise in entitlement expenditures. The statutory basis of entitlements means, however, that governments cannot limit spending simply by budgeting and appropriating lower amounts for them. To cut back on entitlements, they must make substantive changes in law.

3. Curtailing the growth in entitlements

Economic malaise and dire forecasts of protracted budget crisis have virtually halted the establishment of entitlements. But OECD countries have not reduced actual spending; rather, they have sought to curtail the growth in entitlements. Entitlements are likely to remain prominent components of government budgets for many years, and the major income support programmes are likely to retain their basic features. Benefits might not be as high as they would be without cutbacks, and coverage might be narrower, but fears that governments will abandon their role in stabilising incomes have no basis in fact. Yet fear of abandonment is very real, and it has inhibited some governments from coming to grips with the entitlement problem. When small cuts in existing programmes spawn protests that the government is retreating from long-established commitments, the better part of political discretion may be to do nothing.

The conclusion that entitlements are here to stay (though not necessarily as prominent as they became during the growth era) is based on more than political considerations. Over the years, dependence on income supports has spread to most sectors of the population. Entitlements are costly because they are broadly available. Indeed, it is the middle class that garners the lion's share of the benefits in most industrialised democracies. It would be unthinkable to cast those who have become dependent on regular paycheques from government entirely onto their own means. There would be enormous economic dislocation, and the possibility of collapse could not be ruled out.

Thus far, the governments of OECD countries have sought marginal cutbacks in the growth rates of entitlements. While more far-reaching retrenchments might be attempted in the future (especially if economic crisis persists), marginal adjustments are likely to be the near-term objective of most budget and finance organisations. The reason is that these organisations are not motivated by long-term efforts to redefine the scope of government, but by an immediate need to redress the imbalance between resources and expenditures. Small cutbacks can produce visible and significant savings in the current and forthcoming budgets and can narrow the gap between revenues and expenditures. These small adjustments might not appear to aggregate to significant redirections in government policy. Transfer payments might still be the largest (and fastest-growing) component of public expenditure. But from the standpoint of budget officials, the marginal savings will be sufficiently large to make the effort worthwhile.

The marginal character of these cutbacks has generated a great deal of political confusion and budgetary opportunity. In many cases, a reduction in entitlements is accompanied by an increase in expenditure for the programme. This anomaly is due to the fact that the reduction often is calculated not in terms of past expenditure (the way reductions are normally computed in budgeting for consumption expenditures) but in terms of what the expenditure level would be without the cutback. Thus, if spending for an entitlement were above the previous year's level, a change in the programme could still be regarded as a cut. This situation can breed confusion and controversy over the size of the

cutback, but it also enables politicians to take credit for both programme reductions and increases. They may thereby respond more easily to the conflicting pressures confronting government: to cut spending and to increase programmes.

3.1. The tactics of cutback

It is relatively easy to mobilise opposition to cutbacks. Because entitlements provide cash (or equivalents), cutbacks are more directly felt than when services are curtailed. Reductions in transfer payments have the same financial impact on beneficiaries as reductions in pay have on workers. In both cases, there is a visible loss in disposable income. Accordingly, governments have found it necessary to implement cutbacks with great care and sensitivity to the potential responses of beneficiaries. In this environment, tactical aspects of budgeting – such as how the cutbacks are presented to the public and the position of the budget organisation *vis-à-vis* spending ministries – have become quite important. The tactics vary from one budget season or political situation to another, their commen element being an opportunistic assessment of what is more appropriate for the objectives of the moment. In one year, the government might act without advance warning in the hope that the shock treatment will overwhelm opposition before it can be effectively organised. In another year, the government might try to build political support for its moves by consulting with affected groups or by openly discussing the problems that compel it to make cutbacks.

The tactics are likely to reflect each country's political culture. In Japan, where consensual budgeting is the norm, efforts have been made to gain support by spreading the burdens of cutback among the affected strata. In Denmark, where coalition governments have fragile majorities in parliament, there is extensive intra-party negotiation within government but, once decided upon, the cutbacks are implemented "by storm". In the United States, Congress has an extraordinary degree of independence, and the president has felt it necessary to appeal for public support through the mass media.

Because of the shifting and opportunistic character of these tactics, governments have made few structural innovations in budgeting to deal with the entitlement problem. Canada's far-reaching Policy and Expenditure Management System (PEMS) is principally designed to deal with discretionary resource allocations, not with expenditure mandated by "statutory authority" (a category comprised mostly of entitlements), though the new system can affect the latter. Yet there have been two significant patterns in budget practice that might harbinger future structural changes. One is the tendency noted by Daniel Tarschys to rely on "packages" rather than on standard budget submissions to propose and implement important changes in expenditure policy. The other is to restore to budget organisations and finance ministries some of the power yielded to programme innovators during the growth era.

Packaging has a number of advantages for those who seek curtailment of entitlements. One is that it enables the government to group together a number of cutbacks and to thereby demonstrate that the burden of restraint is widely (and fairly) distributed. Another advantage is that packaging enables the government to insist that all the cutbacks be acted on as a unit, thereby weakening opposition to individual reductions and making it easier for politicians to support the whole package. In coalition governments, formulation of the package has become the focal point of negotiations among political parties and the test of the government's strength and durability. In the

United States, a packaging technique known as "reconciliation" has been effectively used to enact huge reductions in entitlements and other programmes.

Packaging has been used in the Netherlands and the United States to make multi-year reductions in entitlement programmes. Unlike the regular budget process which is geared to annual decisions, a package can schedule cutbacks to take place over a number of years. The ability to phase in reductions can make them more acceptable to affected parties while ameliorating the disruptions which might occur if all were implemented at once. However, multi-year packages tend to "age" as the government continues in office and opposition has time to mount an effective campaign. The initial perceptions or conditions which gave rise to the multi-year reductions may change or be proven incorrect, making it necessary to revise the package. Thus, one-year-at-a-time cuts imposed by blitzkrieg are likely to have a higher success rate than multi-year cutbacks implemented over several years. The Danish government obtained 90% of the cutbacks it proposed; the Netherland and the United States had lower rates of implementation.

Whatever its advantages, packaging can be disruptive of budgetary routines. The budget cycle can become irregular when big, controversial packages have to be negotiated, adjusted and implemented. It can become difficult to maintain the timetable for the various actions to be taken in the course of a year. But this problem, which has afflicted a number of countries, may be due more to political instability, fiscal stress and tactical considerations than to the packaging technique itself.

The determination of governments to curtail the growth in expenditure has led to potentially important shifts in the balance of ministerial power. Just as the impulse to expand programmes once enhanced the influence of spending ministries at the expense of the budget organisation, retrenchment has recently induced governments to rely more heavily on the recommendations of finance officers. Both the pro-spending shift during the growth era and recent curtailments were accomplished largely through informal changes in budgetary practice, such as in the access of ministers to the head of government or in the influence exercised by various ministers in the cabinet. But there have been some formal changes such as legislation requiring all ministerial spending proposals to be reviewed by the ministry of finance before submission to parliament. In fact, sensitising government officials, politicians and other interested parties to the prospective cost of entitlements has been one of the tactics used by budget organisations to bolster their own position and to constrain spending demands.

Expectations about the future course of spending are an important element in the contest between budget and spending ministries. If it is taken for granted that spending will continue to rise or that higher expenditure is legitimate and sustainable, then budget officials will be in a weak position to resist the demand emanating from spending ministries and from interest groups. A key task of a budget organisation bent on curtailing expenditure growth is to alter expectations about the future. One means of doing this is to disseminate "bad case" scenarios of the budgetary imbalance that the government will face unless it cuts back the automatic growth in entitlements. Multi-year projections have led to multi-year retrenchments in some countries and have been formidable inhibitors of expansion in others. In virtually all OECD countries, expectations of future growth are significantly less buoyant and less legitimate than a decade ago.

If fiscal stress and expectations of future shrinkage become entrenched, modifications in budgetary practice may become more structural and systemic than has been the case

thus far. Rather than relying on tactical and behavioural features of budgeting to constrain expenditures, governments might seek more wide-ranging adaptations. The fact that this has not happened thus far might be due to: *i)* uncertainty about the future course of budgeting; *ii)* the persistence of growth expectations despite recent cutbacks; or *iii)* attention to short-term tactical problems. In any case, no consensus seems to be emerging on the types of structural change that might be appropriate.

3.2. Types of cutbacks

Mention has been made that the cutbacks implemented thus far have tended to be marginal and that their aim has been to curb the rate of growth, not to reduce actual spending levels. Although they may be marginal relative to the total volume of expenditure, these cutbacks can incite a great deal of political strife. Hence, budget officials have sought cutbacks which can save money without generating intense conflict. They often have curtailed expenditures in ways that do not cut programmes directly. That is to say, although financial cuts have programme implications, they can hide programme effects.

Examples of these types of cutbacks can be drawn from various countries. Denmark froze benefit levels for two years and did not adjust them for inflation. Finland engineered delays to postpone expenditure; the United States did likewise by delaying inflation adjustments for three to six months. It also saved an estimated USD 3 billion over a five-year period by rounding benefits down to the next lower dollar. Ireland established a waiting period for eligibility and reduced real benefits in some entitlements from 45% to 25% of employment pay. These financial modifications saved money without making structural changes in the affected programmes.

Financing modifications can be a form of across-the-board reduction in which all beneficiaries suffer some loss regardless of their particular circumstances. Like across-the-board cuts, they veil the effects on programme levels and convey a sense that the burden is being fairly borne by all affected parties. But like across-the-board cuts, they might actually be very unequal in their effects.

Marginal changes have been made in eligibility requirements to curtail expenditure growth. The duration of eligibility can be shortened (or limited), standards for determining eligibility can be narrowed, some groups can be excluded altogether, or a waiting period can be established before recipients become eligible for benefits. The Netherlands excluded some young people from unemployment benefits; the United States purged the disability lists of persons judged capable of working. From the perspective of government, these marginal changes are attractive because they save money without impairing the eligibility of most beneficiaries. As with the financing changes described above, the savings are realised but the basic structure of the programme remains intact.

Governments have sought to curtail expenditure growth through marginal adjustments in entitlement formulas. One such adjustment is to change the index – for example, from wages to prices, or to the lower of the two. Another is to shift from full to partial adjustment for inflation. Yet another is to lag the adjustment behind increases in inflation. However, little progress has been made toward complete de-indexation, perhaps because the propriety of compensating dependent groups for inflation is now widely accepted.

Marginal cutbacks produce marginal savings. It has already been noted that these might suffice for narrowing the revenue-expenditure gap to a politically acceptable range. Some observers believe that more drastic measures which would alter basic contractual

and statutory commitments might be necessary in the future. This expectation has more to do with demographic trends (especially the ageing of the population) than with economic conditions. The argument is that, despite current trends toward economic recovery, the ratio of dependent to productive population will increase to such an extent as to make continuation of the entitlement state in its present scale untenable. If this outlook proves to be accurate, OECD countries will be tasked with much more difficult political and budgetary challenges than they have heretofore faced.

Afterword

In assessing the huge costs of entitlements, it is appropriate to step back from the particulars of the budget process and to focus instead on the social purposes served by these expenditures. After all, budget control is not the only value that governments must consider in designing public policy, nor is it always the more important. Governments purposely weaken the budget's capacity to determine expenditures because tight control clashes with other salient objectives. Most governments of OECD countries have weakened annual budget control by giving workers assurance about their financial wellbeing when they retire. The governments have established payment programmes to assist workers who lose their jobs, health care programmes to provide medical services or financial support to persons afflicted with illness, income support programmes for dependent people, and numerous other transfer programmes.

The values that underlie public entitlements are widely shared by citizens in all OECD countries. Of course, there is political controversy about payment levels and eligibility requirements, but these are marginal issues that affect the amounts spent, not the legitimacy of entitlements established in permanent legislation. Citizens may not favour every entitlement programme, but the bigger the programmes are, the more support they garner in public opinion polls.

If governments had perfect budget control, each year's budget would be unencumbered by past entitlement decisions; no legal commitments would carry over from one year to the next. Governments would annually decide how much to spend on pensions, low-income support, medical care, unemployment compensation and other forms of assistance. The budget would be restored as the means of allocating public money.

However, a world of perfect budget control would not be a perfect world. Social insecurity would be widespread. Workers and households would face an uncertain financial future. Pensioners would have to wait for each year's cycle of budget decisions to find out what their disposable income would be. A strong case can be made that society is better off because of the entitlement regime in place. These pre-decided payments cushion households against the cyclical shocks of recession and the secular shocks of old age and disability. They ease anxieties about inflation, unemployment, illness, and the affordability of health care. Entitlements should be seen as the pooling of financial risk in the largest pool that a country can construct on its own – the whole of society.

Yet, arguing that entitlements do much social good does not mean that all such spending is equally worthwhile, or that all features of these spending programmes are worth the cost. Governments can restore some budget control by periodically subjecting entitlements to scrutiny and by adjusting benefits. In fact, some national governments with the most sustainable fiscal positions have made significant changes in benefit schemes to reduce their long-term exposure.

In principle, entitlements are not compatible with budget control; in practice, the two must be reconciled. The first step in harmonising the need for budgetary discipline and the social need for financial security is for governments to be cautious in undertaking new entitlements. This is especially critical for the newly emergent economies that do not yet have full Western-style entitlement regimes. The second step is to make marginal adjustments that enlarge the increments available for allocation through annual budget decisions. It must be recognised, however, that even marginal changes can stir up political opposition. The third task is for governments to undertake an assessment of which risks can be transferred to private hands through various risk-sharing mechanisms. If governments fail to take these steps, they may be compelled by demographic pressures to move even more boldly in the future to curtail entitlements.

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The Challenge of Decremental Budgeting

by
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At the start of the decremental decade of the 1980s, governments encountered many difficulties in making ends meet. This article discusses some of the problems of post-expansive stagnation and the merits of certain techniques such as indexing, global norms, decentralising hard choices and the well-balanced package.

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Introduction

In June 2009, the OECD Working Party of Senior Budget Officials (SBO) celebrated its 30th anniversary. In a context of financial crisis, the SBO recalled its origins and some of the pressing topics of that time: off-budget and tax expenditures, budgeting for entitlements, and the agonies (challenge) of decremental budgeting, to name a few. Discussion papers were written on each of those topics, and the first two were later published in the *OECD Journal on Budgeting*. The SBO decided in June 2009 to continue its policy of disseminating its work, and decided to publish this additional discussion paper from its second meeting in 1981. Some of the techniques described here have been revisited over the years, as the SBO continues to explore and develop ways to improve the budget process.

The agonies of decremental budgeting

Is it merely an illusion that government budgeting is becoming ever more difficult? Old hands in the business like to remind us of fiscal years in the past that were just as bad as the one we are now beating our brains about. Yet as we enter the "decremental decade" of the 1980s, there are at least some reasons to maintain that the problem of making ends meet in public finance has indeed become more intractable than it used to be.

First of all, there is the general downturn of the world economy and the tendentially rising rates of inflation. Virtually all OECD countries have come to feel the pangs of post-expansive stagnation. While the recurring oil shocks are often advanced as the most important triggers of the deceleration of growth and acceleration of inflation, the causal pattern behind these developments is of course much more complex. At any event, the result has been the simultaneous weakening of revenue bases and exacerbation of demands on public resources.

Second, there is the unusually strong thrust of established programmes and transfers. No earlier recession has ever hit governments with so wide a spectrum of activities and responsibilities. The introduction of planning and the proliferation of entitlements and public services in recent decades have given the evolution of the modern state a particular momentum. The ratio of government expenditures to gross national product (GNP) has continued to increase throughout the western world, and in many countries it has attained levels that were previously considered as inconceivable and self-destructive. The predictions of strategic ceilings for public spending – Leroy-Beaulieu's 12-13% of GNP, Clark's 25% of GNP, and Friedman's 60% of GNP – have all been surpassed.

Third, there is the remarkable immobility of highly mobilised societies. Modern industrial states exhibit many signs of institutional arteriosclerosis. With a vast number of interests organised, articulate, and well-entrenched, the established social structure has become more impervious to change, and efforts to set new priorities meet with stubborn resistance. Increased rationality at the top collides with increased rationality in all other parts of the system. Whether "overloaded" or not, modern governments find it increasingly hard to cope

with the huge empires nominally under their control. And this becomes particularly evident under economic austerity when turfs are defended with great skill and vigour.

While there is always room for the argument that tough choices are the heart and soul of the budgetary process under any circumstances and that difficult decisions must be made whether the economy is flourishing or collapsing, these features intertwined with each other do add new dimensions to the conventional problematique of public resource allocation. Today's budgeteer carries a burden which at least in some respects seems heavier and unwieldier than that of his/her predecessors. How is it handled? As we look across borders, there appear to be many common traits in the current budgetary strategies of different governments. The diffusion of new ideas is relatively rapid, but it could probably be even more rapid and even more efficient than it is. And such diffusion is particularly important in an area where the life expectancy of new inventions is rather short. In budgeting, many new techniques work well for a while until spending departments learn how to cope with them; then they may still work, but not so well. To retain their lead, budget officers have a lot to gain from the creative imitation of their colleagues. The purpose of this paper is to introduce some problems that might fruitfully be discussed by senior budget officials.

1. Indexing

Under inflation, successive adjustments must be made to wage and price increases. Yet by what mechanism, by what standard, and how often? This has emerged as a major problem in contemporary policy making, and in the present squeeze the finance ministries of many countries appear to spot interesting potentials for economies in a more careful and sophisticated design of such adjustment procedures.

The pros and cons of indexing are well known. Spending ministries, transfer recipients, and other beneficiaries of government outlays all press for long-term commitments in real terms. Indexing promotes stability and security in policy programmes and facilitates multi-year planning. But on the other hand, it also ties the hands and feet of future decision makers. With a very large proportion of the public outlays subject to automatic adjustment, the remaining scope for discretionary decision making will shrink considerably and may disappear entirely with a weak development on the revenue side. Indexing of expenditures may also be hazardous for price stability; if cost increases are fully compensated for, there is little to hold back demands for higher prices and wages in the public labour market and in the provision of goods for the public sector.

In view of these drawbacks, there seem to be many second thoughts about indexation at present. A number of governments are involved in attempts to tinker with the established systems. In Italy, proposals to change the construction of the *scala mobile* have been highly controversial. A famous but unsuccessful attempt was made a few years ago by the West German government to adapt the adjustment of old-age pensions. In Denmark, the government has introduced the concept of the "social wage" which eliminates some elements of personal income from the base used for computation of certain social benefits. In Sweden, energy prices and indirect taxes have been deleted from the index base employed to adjust the value of social benefits and the central government income tax. The government has also declared its intention of reviewing the whole bulk of government expenditures with a view of scrapping indexed adjustment mechanisms wherever that appears to be feasible.

Some key considerations at present in the field of adjustment to inflation seem to be the following:

- To what extent should commitments be made in real terms and mechanisms for automatic adjustment thus be built into policy programmes? Is it possible to scrap such mechanisms entirely in some areas and return to discretionary annual adjustments? Or is it preferable to opt for semi-automatic arrangements such as adjustment by specific institutions (boards or arbitrators, bipartite or tripartite commissions, legislatures, etc.)?
- Can further gains be made by centralising the adjustment procedure and/or homogenising the methods employed in it? An alternative strategy is to differentiate between policy sectors or budget items, constructing various computation techniques for different kinds of outlay.
- What is the proper basis for indexation? In most countries, the systems are tied to either wages or prices. During the 1970s, however, there appears to have been a trend towards more composite bases. Many countries now index by a mixture of prices and wages, while others have tried to eliminate particular ingredients from their baskets (indirect taxes, energy, etc.).
- How often should adjustments be made? Under trigger-operated systems, the key variable is the magnitude of the thresholds. Otherwise, the adjustment costs will depend mainly on the length of the predetermined intervals. The construction of automatic adjustment mechanisms is a promising field for new technical inventions.
- Should the compensation be full or partial? While spenders or recipients always press for stable commitments, ministries of finance tend to prefer systems where allowance is made for assumed productivity gains or where there are other incentives for spenders to resist inflationary pressures.

2. Global norms

The Keynesian revolution, whatever its merits, must be blamed for one significant lacuna in contemporary budgeting: the lack of solid standards for the evaluation of deficits. In the 1960s and 1970s, we learned that balancing the economy was more important than balancing the budget. Spending departments were particularly keen to pick up this message. Yet what is to be done when both the economy and the budget are out of balance? Governments in many countries now seem to be groping for some artificial norm to replace the dethroned ideal of equilibrium between revenue and expenditure. The purpose of such a norm is to reinforce budgetary discipline by imposing strong restraints on all actors involved. While the norm performs important functions as a confidence-building signal to the domestic and international environment, its most immediate task is probably to commit the governmental apparatus itself to budgetary stringency.

The global norms now in use relate either to total spending or to the government deficit. In some cases, the targets are internal to the government budget in the sense that they define a ceiling for debt financing of public outlays without any reference to the economy at large. Thus, the recommendation made by the Japanese Fiscal System Council in 1967 prescribed that the rate of reliance on government bond issues should be reduced to less than 5%. In 1979, the figure was set at 10%. A more frequent solution, however, is to link either deficit or expenditure to the GNP. In the Swedish case, the recovery plan presented by the government in the 1980 supplementary budget announced that the budget deficit ought to be reduced by 1% of GNP in each of the next few years. The United Kingdom has set goals

for its balance in terms of money supply and the public sector borrowing requirement (PSBR), and the Dutch have declared that a deficit exceeding 4-5% of the net national product is inconsistent with a satisfactory external balance and a reasonable share of the capital market for the private sector. The norm of the Canadian government sets a limit for the annual increase of public spending. In the Canadian White Paper of 14 October 1976, *Attack on Inflation*, it was declared that the trend of total spending by all governments should not rise more quickly than the trend of the gross national product.

The new norms have been successful in some ways but less successful in others. The general impression seems to be that the norms have indeed contributed to budgetary discipline. Budget officers have found them invaluable in their continuing dialogue with the spending departments. Yet it is also irrefutable that far more targets have been set than met. There may be a strong case for enunciating norms even if they turn out to be unrealistic, but if they are hardly ever attained their symbolic power is likely to wane after a few years. The value of implausible targets must be assessed both from a political and an administrative viewpoint. For the government, the question is whether the short-run benefits of declared firm intentions outweigh the risk of being ridiculed by the opposition for not having achieved one's objectives. And for the budget officers, there is always a question of preserving authority and credibility in relation to the spending departments.

There is a strong need for comparative cross-national evaluations of the use and effects of global norms. Such studies could shed light on, *inter alia*, the following three problems:

- What degree of scientific legitimation could be offered for global budgetary norms? Some governments have preferred to present their targets as a volitional commitment to a certain social development, without any sophisticated scholarly underpinnings. Others wrap up their objectives in popular versions of current economic theories: monetarism, public choice, the concept of crowding out, the Laffer curve, etc.
- Exactly what should be related to what? A main reason why so many governments have failed to reach their targets has been their inclusion of uncontrollables into the objectives or quotas. A recent trend is therefore to refine the concept of public outlays so as to delete items that may ruin the whole enterprise or that seem irrelevant to the established targets. There may also be other motives for distinguishing between different types of expenditure. In Japan, for example, there are statutory rules against debt financing of expenditures other than those for public works, investments, and loans. This is known as the principle of construction bonds. While the government has been unable to observe this principle in the 1970s and has had to resort to special deficit financing bills, there is now a goal to restrain public bond issues within the amount permitted by the principle of construction bonds by the fiscal year of 1984.
- An unresolved problem is the reconciliation of global norms with the requisites of stabilisation policy. The beauty of global norms lies in their stark simplicity; they are easy to propagate and to apply. Yet by the same token they may be too rigid from the viewpoint of conjunctural policy needs. A possible solution is to formulate norms in terms of multi-year goals allowing for some fluctuations along the road, but this may also lead to a weakening of the useful restraints on the spending departments.

3. Hard choices decentralised: frames, envelopes, caps, ceilings, limits, lids, and cheese slices

The success of ministries of finance depends to a great extent on their ability to spread the treasury spirit in wider circles. The enormous amount of budgetary problems engendered by the modern government apparatus and modern society cannot all be solved at the top. Ideally, all administratively financed organisations should be imbued with the same thrift, imagination, flexibility and courage to terminate obsolete activities and commitments. In the real world, these virtues are not quite as diffused as would be desirable, and certain educational instruments are therefore employed to enhance them. Many of these are physical restrictions aimed at decentralising hard choices.

The **frame** is a finite sum of money appropriated for a particular sector or set of programmes, often defined as a multi-year commitment. Sweden's defence expenditures are locked into a frame determined for a span of five years, and all emerging needs in this sector must be met by making reductions inside the frame. This has strengthened pressures for rationalisation and promoted the useful competitive dialogue between critical semi-experts (navy *versus* army, etc.) which is so often lacking in fields where the aspirations of one profession are not as dependent on restraint as in another. But efforts to apply the frame method to other budgetary sectors have not been successful as yet. A main obstacle appears to be the lack of natural boundaries for the lumping together of different programmes.

The **envelope** system recently introduced in Canada implies the setting of government-wide expenditure targets for nine policy sectors. Major budgetary decisions within these sectors are delegated to the Cabinet Committee on Priorities and Planning and to policy committees on social development, economic development, foreign policy and defence, and government operations. A similar system is under consideration in New Zealand.

Experiments with **caps**, **ceilings**, and **limits** of various kinds are under way in many countries. The United Kingdom has taken a lead in the use of cash limits. Staff ceilings are widely used. A tougher version is the global or selective restriction of new recruitment. Under the Finnish system used a few years ago, vacant positions were left unfilled until the matter had been considered by the ministries. In New Zealand, departments are directed to shed 1.5% of their staff annually by attrition or transfer. The disestablished positions are then available for reallocation to high priority areas. The mechanism is known as the **sinking lid**. In still other countries, selective limits are imposed on the resource use of different agencies or sectors. Multi-year staff reduction plans are common in phasing-out situations.

A universal technique in austerity budgeting is the across-the-board cut fixed at a certain percentage of the previous year's outlays. In Swedish budgetary jargon, this instrument is known as the **cheese slicer**. Across-the-board cuts sometimes take the form of undercompensation for inflation or the deduction of assumed productivity gains. The widespread popularity of the method is probably connected with the minimum of information requirements and conflict costs involved in its application. When there is little unity or courage in political and administrative leadership, the cheese slicer is frequently the easy way out of a financial squeeze. While it fails to discriminate between high and low priority areas and areas with different potentials for savings, it has at least the appearance of being fair. Its chief merits lie in its simplicity and comparative acceptability. In contrast to selectively profiled approaches, the use of the cheese slicer entails no stigmatisation of particular programmes or agencies. But its negative sides also deserve close attention. Cutting the cat's tail inch by inch is not always easier than performing one single operation; after some years, small annual

cutbacks tend to undermine both employee morale and operational efficiency. Another hazard is that repeated cheese-slicer cuts may contribute to a gradual deterioriation of the resource mix, since various untied expenditures vital for the sound operation of the programme or agency will often be the first to be sacrificed. A third problem is that the cheese slicer will often be handed down to the bottom of the organisational hierarchy. The across-the-board cut is ideally a method of delegating authority to organisational levels that have a better overview and understanding of priorities and potentials for savings, but the recipients may often be tempted to pass the buck even further.

A more general problem inherent in most of these techniques is their endemic bias for preserving established programmes. When confronted with a demand to cut back expenditures by, say, 3%, few political or administrative leaders will have the energy to save 5% in order to make room for new policies. Yet if modern governments are to be saved from stagnation in the present economic situation, such redeployment manœuvres are very much called for. In the further development of physical restrictions, it would probably be useful to give more consideration to the needs for mobility, flexibility, and innovation. The "tit for tat" idea practised in many countries – meaning that an administrative unit may use the money it manages to save for other purposes – appears to be one promising road towards this goal.

Physical restrictions also entail great circumvention risks. If there is a ceiling for the use of one "currency" – such as manpower or government funds – spending departments and agencies often find other ways of achieving their ends. Consultants could be hired instead of new regular staff, regulation may be used as an alternative to the purchase of services, and new slack may be created by reducing the quantity or quality of the agency's output. Well-known to the students of the "success indicators" problem in socialist economies, these distortions deserve close attention in the design of budgetary steering mechanisms.

4. The well-balanced package

Budgets in themselves are decision packages. In promoting the principles of the unity and the comprehensiveness of the budget, administrative reformers of the past have tried to escape from the financial laxity that so often follows from disjointed decision making in economic affairs. While spenders generally prefer to have their projects considered separately and *ad hoc*, budgeteers have a predilection for lumping things together and weighing one demand against all others at one time. This creates a natural tension in government offices, as budget ministries want to defer to the annual budget exercise questions that spending ministries insist must be settled by next Tuesday.

With the high pace and pressure of modern government, however, the ideal of annual decisions on everything is becoming ever more unattainable. Urgent matters arise that cannot be held back. "Fire brigade" operations are often requested, and the not-so-fine tuning of the economy that is prompted by the need to handle excessive demands in the labour market will frequently necessitate large-scale interventions at irregular intervals. Thus, most industrial societies are now growing used to the miniaturised version of the budget known as the government's "new economic package", the "mini-budget", the "emergency brake", the "cutback plan", the "September arrangement", the "November agreement", or the "December settlement". The noble art of packaging is becoming an important branch of budgetary wisdom.

Why are proposals so frequently thrown together into a bundle and presented at the same time? There seem to be several motives. One is the aim of critical mass: if the government is out to show its muscle, the sheer number of measures may help make the desired impact. Another and frequently more important motive is the need for political balance. Most packages emerge from deals between the government and other political and/or economic forces. By connecting a number of disparate proposals, the negative effects of some measures to certain concerned groups will be neutralised by other policy changes in a more favourable direction. In the well-balanced package, there is good news and bad news for everyone, and even if the bad news dominates, the ambiguity of the package helps mollify resistance.

Many empirical as well as normative questions about packages have as yet no answers. What are the typical techniques of composition? How are packages best presented? To what extent can future gains expected to result from proposed sacrifices in the short run be appreciated and visualised? Cross-country comparisons of policy packages and appraisals of their political and economic impact might be of great value for future efforts in this area.

5. Conclusion

In an expanding economy, the finance ministry can normally sit back and wait for others to report cost increases and to propose policy changes. Its own job will be to look into the dark corners of these reports and proposals, ask pertinent questions, and practise sound discrimination. Yet this less active role will not suffice in a society where the general growth rate has dwindled while the growth rate of public expenditures, through all built-in expansive mechanisms, remains unperturbed. With decremental budgeting on the agenda, budgeteers may have to assume a more active role in the process of policy development. When it comes to economies, cutbacks and rationalisation, spending agencies are not as eager to bombard headquarters with fresh suggestions. Institutional and procedural innovations as well as new methods of policy design and accountability will probably be needed to uphold some measure of control over public expenditure.

The national contributions to the 1980 and 1981 OECD meetings of senior budget officials reflect the widespread concern about weaknesses in current procedures and the universal search for new approaches. While the grand panaceas of the 1960s and 1970s – planning programming budgeting systems (PPBS), zero-based budgeting (ZBB), *rationalisation des choix budgétaires* (RCB), etc. – are slowly fading away and the reformist mood is now tilted towards piecemeal engineering and muddling through, the philosophy behind the magic acronyms is not dead. If used sparingly and with great discrimination, the tools of programme budgeting can still be of great relevance in the present economic predicament.

Yet their impact is much dependent on the extent to which some of the classical principles of budgeting will survive. The idea of the unity and comprehensiveness of the budget is now under a triple threat. First, there is the tendency towards an increasing number of *ad hoc* decisions and packages, noted in this paper. Second, there seems to be a general loss of central control, as a growing number of appropriations are entrusted to autonomous and semi-autonomous bodies such as state governments, municipalities, corporations, quangos (quasi-autonomous non-governmental organisations), and the

like. Simultaneously with the rapid expansion of public expenditures, the state appears to be withering away through the proliferation of independent units. And third, there is the great variety of "currencies" that governments now use in their transactions with society, as described in Allen Schick's paper* on off-budget expenditure. What budget officers can keep track of through traditional bookkeeping may be a diminishing part of real government spending.

* The paper by Allen Schick ("Off-Budget Expenditure: An Economic and Political Framework") was originally presented at the same meeting of the OECD Senior Budget Officials (2-3 June 1981). Professor Schick's paper was later published in the *OECD Journal on Budgeting* (2007), Vol. 7, No. 3, pp. 7-38.

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Budgeting in Indonesia

by
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This article discusses Indonesia's economic and fiscal performance following the 1997/98 financial crisis and the transition to democracy, as well as the budget formulation process and the role of Parliament. Aspects of budget implementation are discussed throughout the article.

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Preface

In an exchange of letters between the Indonesian Ministry of Finance and the OECD in the summer of 2008, it was agreed that the OECD would prepare a profile of Indonesia's budgeting process. The profile would offer a general overview of Indonesia's system of budgeting. The profile concentrates on the national government only.

The profile is divided into three sections. The introduction discusses Indonesia's economic and fiscal performance following the 1997/98 financial crisis and the transition to democracy. The second section focuses on the budget formulation process. The third discusses the role of Parliament. Aspects of budget implementation are discussed throughout the profile.

An OECD mission visited Jakarta in October 2008 to prepare this profile. During its visit, the mission met with senior officials from the various parts of the Ministry of Finance, the National Development Planning Agency (BAPPENAS) and the Ministry of State Apparatus, as well as from several spending ministries and agencies. The mission also met with senior representatives of the Indonesian Parliament and the Supreme Audit Institution of the Republic of Indonesia (BPK).

The mission would like to express its gratitude and appreciation to Mr. Mulia Nasution, the Secretary-General of the Indonesian Ministry of Finance, for his support and the generous time he and his senior colleagues shared with the mission during its stay in Jakarta. The warm and cordial reception by the Indonesian authorities is gratefully acknowledged.

Finally, the mission would like to extend its gratitude to the World Bank for its support in organising the mission and for its invaluable assistance during the mission's stay in Jakarta and throughout the preparation of this profile.

The views expressed in this profile are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisation or individual consulted for this profile.

1. Introduction

Indonesia has historically maintained a responsible and conservative fiscal policy, focused on sustaining aggregate fiscal discipline. In the years prior to the Asian financial crisis, the budget had a moderate surplus (1-3% of GDP) and public debt was relatively low (25% of GDP). The country enjoyed a high rate of economic growth – and thus expanding public resources – and development policies were at the forefront.

The Asian financial crisis affected Indonesia's economy profoundly. The economy shrank by over 13% of GDP in 1998. Government debt rose dramatically in 1997 and 1998 and reached almost 100% of GDP in 1999, reflecting the cost of providing liquidity and eventually the take-over of the banking system.

The financial crisis triggered political upheaval in Indonesia, with the resignation of the long-serving president. The country experienced a series of successive governments as

Box 1. **Indonesia: A short description**

Indonesia is the world's largest archipelago-state, consisting of some 17 000 islands – all straddling the equator. These include five major islands: Sumatra, Java, Kalimantan (Indonesian Borneo), Sulawesi, and the Indonesian part of New Guinea, known as Papua or Irian Jaya. The distance from west Indonesia to east Indonesia is 5 150 kilometers, slightly less than the distance between Paris and New York. The capital of Indonesia, Jakarta, is located on the island of Java.

Indonesia's population of 235 million people makes it the fourth most populous country in the world, following China, India and the United States. Indonesia's population is overwhelmingly Muslim (85%), making it the world's largest Islamic country. Other religions include Christianity (11%) and Hinduism, Buddhism and Confucianism (4%). Indonesia is a secular state. Its national motto, "Unity in Diversity", reflects the many ethnic and cultural backgrounds of its population.

Garuda is Indonesia's official symbol. This mythological bird has 17 feathers on each wing, 8 on the tail and 45 on the neck. These numbers stand for the date Indonesia proclaimed its independence from the Netherlands: 17 August 1945.

Bahasa Indonesia is the national language. It is similar to Malay and written in Roman script based on European orthography.

Indonesia is endowed with vast natural resources, including oil and natural gas, coal, tin, copper, nickel ore, bauxite, copper, coal, silver, and gold as well as timber.

Indonesia was the hardest-hit Asian country during the 1997/98 Asian financial crisis which resulted in political and social disorder. The long-serving president resigned and Indonesia embarked on its transition to democracy. Today, Indonesia is a thriving democracy.

Indonesia has suffered many shocks since its transition to democracy, including repeated natural disasters. The heaviest losses were sustained in the December 2004 *tsunami* which claimed over 200 000 lives and displaced over 300 000 people.

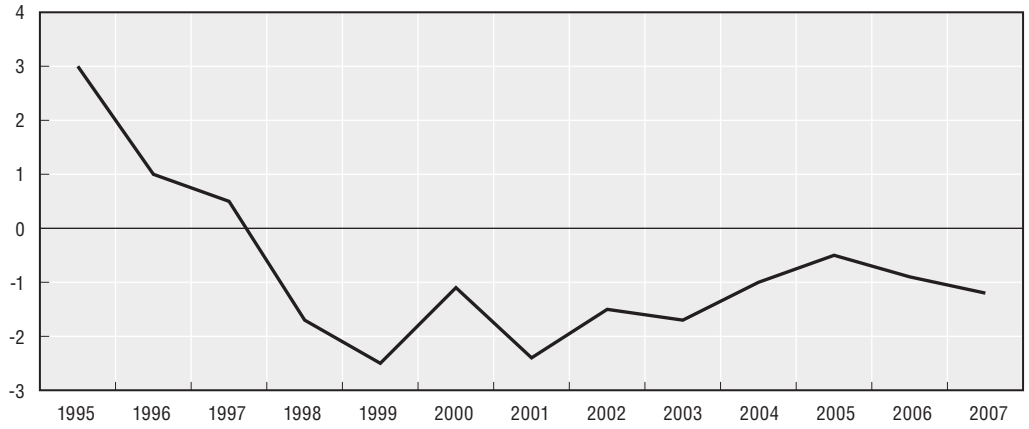
new democratic constitutional arrangements were being finalised. Today, the Parliament is freely elected and has assumed great powers, not least in the area of budgeting. The President, who was previously appointed by Parliament, became directly elected. Great power was also devolved from the centre to regional governments with the "big bang" decentralisation programme.

However, fiscal policy continued on a responsible and conservative track and acted as an anchor for the whole economy. In fact, prudent budget policy is generally seen as having been instrumental in the economic recovery. Even during the height of the fiscal crisis, deficits were modest (reaching a high of 2.5% of GDP). This situation was the result of major expenditure cuts – largely in public investment and other development expenditures – to offset lower levels of revenue and rising interest expenditures to finance the growing level of debt.

In recent years, the government's deficit has ranged between 0.5% and 1.2% of GDP. Debt levels have come down substantially, reaching 35% of GDP in 2008. This situation reflects the steadily improving economic performance as well as the proceeds from the sale of assets taken over during the crisis.

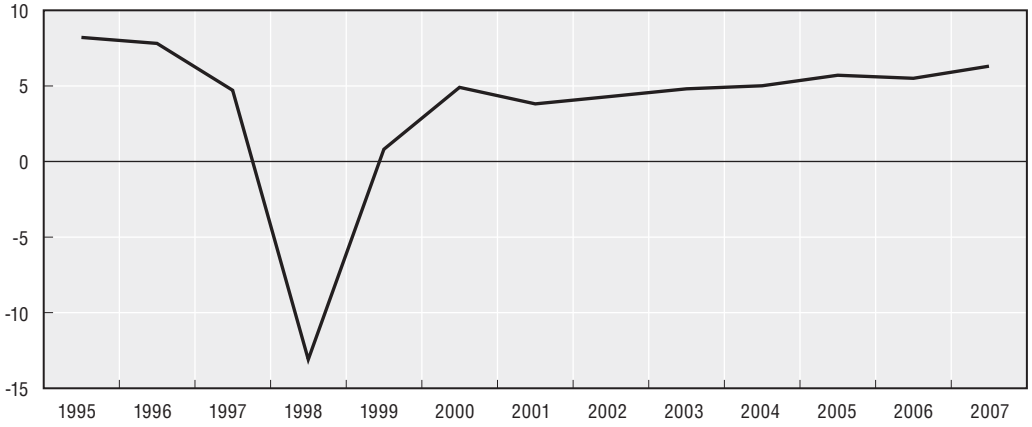
Several significant changes have occurred to the composition of expenditures over time. First, and as noted above, public investment and other development expenditures were cut significantly immediately following the crisis to fund sharply higher interest

Figure 1. **Fiscal balance (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Figure 2. **Real GDP**

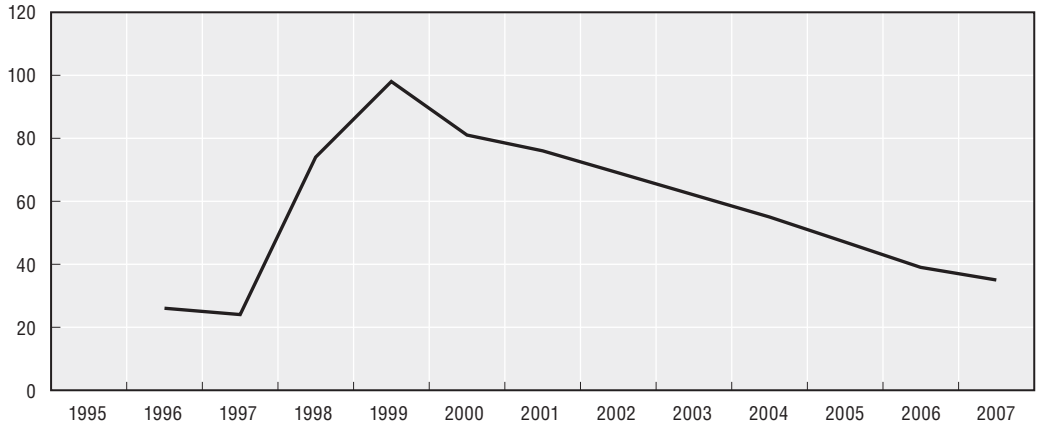


Source: Data provided by the Indonesian authorities.

expenditure. This situation has now been reversed, with lower interest expenditure giving room for increased public investment and other development expenditures as well as increased spending on education and health. Second, a significant amount of operating expenditure (salaries and other running costs) was transformed into transfer payments to regional governments, as they assumed many government services through the decentralisation programme. Third, fuel and electricity subsidies weighed heavily on the budget. Despite significant cuts in the subsidies, fuel subsidies accounted for almost 20% of spending in 2008, up from about 13% in 2007, owing to high international oil prices. Fuel subsidies are discussed further in Sub-section 2.2.4.

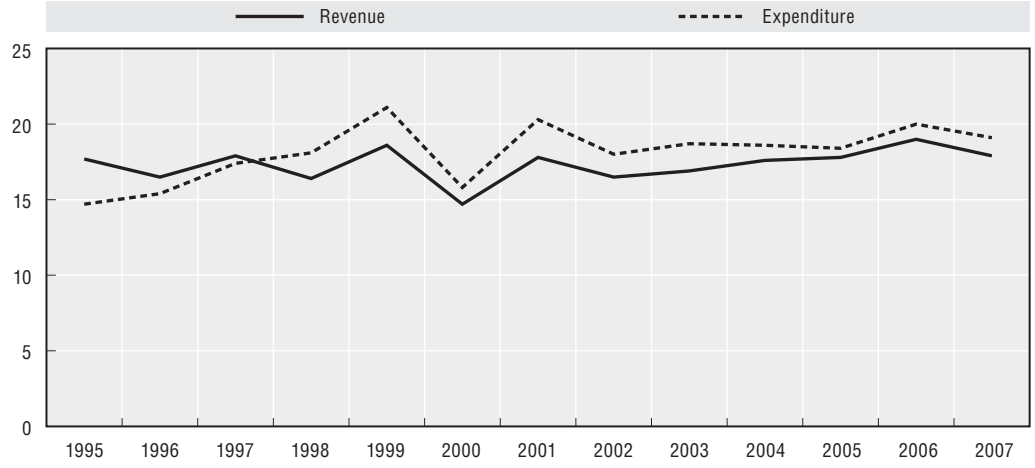
The government has also placed emphasis on strengthening the revenue side of the budget by increasing the share of non-oil and gas receipts. This serves not only to increase revenue, but also to lessen dependence on volatile oil and gas receipts. Improved tax administration has been key in this regard, especially in the field of personal income tax which is heavily dependent on a small number of taxpayers. For example, in 2007, nearly 60% of personal income tax revenues came from only 1% of taxpayers.

Figure 3. **Debt (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Figure 4. **Revenues and expenditures (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Box 2. **Indonesia's response to the current financial crisis**

In late January 2009, Indonesia announced a stimulus package worth 1.5% of GDP in increased expenditure. The money will be earmarked for infrastructure and other projects in order to generate employment. This package will see the government's projected budget deficit go from 1% of GDP to 2.5%. These measures were announced following the enactment of the 2009 budget, and the government will seek Parliament's agreement in a supplementary budget later in the year.

2. Budget formulation

This section outlines the budget formulation process in Indonesia. It is divided into four sub-sections. The first outlines the fundamental changes implemented following the 1997/98 economic and political crisis. The second sub-section describes distinctive

characteristics of the Indonesian budget process. The third highlights each step in the annual budget formulation process. The fourth sub-section concludes.

2.1. "Reinventing budgeting" following the 1997/98 economic and political crisis

The Indonesian budgeting system was transformed following the 1997/98 economic and political crisis. This transformation involved:

- a new legal framework for budgeting;
- a unified and more comprehensive budget;
- massive fiscal decentralisation and the empowerment of local governments.

A fourth point – the transformation of the role of Parliament in the budget process – is outlined in Section 3 below.

2.1.1. New legal framework for budgeting

Prior to the crisis, there was no effective legal framework for budgeting in Indonesia. In fact, the process was essentially a continuation of the Dutch colonial budgeting system where the preparation of the budget was conducted internally by the Governor-General. The process was characterised by a lack of transparency and accountability. After independence, this executive-driven legal framework was embraced by Indonesia's very strong presidents.

Following the crisis and the transition to democracy, a strong emphasis was placed on reforming the legal framework for budgeting. A series of successive laws were adopted in the early 2000s following extensive consultations involving a multitude of stakeholders. The major laws are:

- The State Finances Law 17/2003.
- The State Treasury Law 1/2004.
- The State Planning Law 25/2004.
- The Regional Governance Law 32/2004 (which replaced an earlier law from 1999).
- The Fiscal Balance Law 33/2004 (which replaced an earlier law from 1999).
- The State Audit Law 15/2004.

The State Finances Law 17/2003 details the constitutional provisions for the budget process, mandates specific milestones and dates for the preparation and adoption of the budget, specifies general principles and authorities for the management and accountability of state finances, and establishes the financial relationship between the central government and other institutions.

The State Treasury Law 1/2004 outlines the responsibilities of the Treasury and articulates the creation of treasurers in government ministries and agencies, together with general principles on the management and accountability of public funds.

The State Planning Law 25/2004 outlines the national development planning process, the preparation and approval of plans, and the role of the National Development Planning Agency (BAPPENAS).

The Regional Governance Law 32/2004 outlines the responsibility of regional governments for a range of public services, including education, health, public infrastructure, agriculture, industry and trade, investment, the environment, land, labour, and transport. It replaced an earlier law from 1999.

The Fiscal Balance Law 33/2004 outlines the responsibility of regional governments for managing their own public finances, their revenue-raising authority and the system of transfers from the national government. It replaced an earlier law from 1999.

The State Audit Law 15/2004 outlines the operational framework of the Supreme Audit Institution of the Republic of Indonesia (BPK), and mandates it as a professional and independent institution required to submit its reports to Parliament.

Several comments can be made about these laws. First, all of the laws were enacted unanimously by the Indonesian Parliament. This is part of the Indonesian tradition of seeking consensus. It is a major achievement for such critical pieces of legislation to be passed in the immediate post-crisis environment. However, it is also a reflection of the fact that, in certain areas, the laws are open to interpretation and their exact meaning has not been fully established. For example, the State Treasury Law mandated the future use of accruals, but whether this was meant to apply only to the financial statements or also to the budget was not clear. Neither was it clear whether it applied to certain transactions only, such as agency-specific or consolidated whole-of-government accounts.

Second, the laws are very specific and detailed in other areas. This relates principally to the requirements for detailed input controls in the laws and to various "fences" – including fiscal rules – designed to promote fiscal responsibility and the prudent use of public money. This detail was largely a function of two factors. The trauma associated with the financial crisis led to the creation of the various "fences". Indonesia's endemic problems with corruption were also behind the emphasis on detailed input controls. The controls were viewed as forming the basis for greater accountability for the use of funds.

Third, the separate budgeting and planning laws were largely enacted in isolation from each other. In fact, the explanatory notes to the State Finances Law 17/2003 were quite dismissive of the national planning function. One year later, the new State Planning Law 25/2004 strongly endorsed the national planning function. Indonesian officials emphasise, however, that through co-ordinated implementation regulations, the respective laws work well together. As is discussed later, the budgeting and planning functions do in fact appear to interact with each other well and avoid duplication of functions.

2.1.2. A unified and more comprehensive budget

The second major transformation was to have a unified and more comprehensive budget. Previously, there were separate routine (operating) and development (capital) budgets and significant off-budget activity. Efforts in this area took several different forms.

The first step was to merge the separate routine and development budgets as of 2005. This division was originally intended to emphasise the significance of development. It was the focus of development assistance to Indonesia and it reflected the division of responsibility between the Ministry of Finance (routine) and BAPPENAS (development). The newly unified budget formed the basis for the enhanced interaction of the planning and budgeting functions. It served to avoid duplication and to make the assessment of the different policy option trade-offs more efficient, as is discussed later in this section.

The more difficult step was to bring various activities that were previously off budget onto the budget – *i.e.* to make the budget more comprehensive. Such off-budget activity can be divided into two groups.

The first group consists of government activity whose classification had to be changed to include it in the budget. The outstanding examples here were various revolving funds and funds financed by specific earmarked taxes. Great progress has been made in this area, and these funds are now mostly incorporated into the budget and the government's financial statements.

The second group of off-budget activity consists of various commercial and other activities which individual government ministries and agencies had set up over time to supplement their official budget allocations. The outstanding example is the military which previously used to be self-financed through such activities to a very large extent. Significant progress has been made in this area although it is very difficult to quantify. The best indicator may be that the growth in on-budget military expenditure has been about 100% in real terms since 2001. This figure is said to reflect, for the most part, on-budget expenditure replacing off-budget expenditure. However, the process of conversion will be long and gradual. It should also be emphasised that this is not just a technical exercise but also reflects a historic change in the balance of power between the civilian government and the military.

Finally, previous governments had granted various special concessions and land development privileges to friends of the government. These concessions and privileges were often associated with corruption and misuse of government funds. The government has recently started recovering such assets and incorporating them into the budget.

2.1.3. Massive fiscal decentralisation and regional government autonomy

The third major transformation was Indonesia's "big bang" decentralisation programme which began in 2001 and which involved unprecedented political autonomy for the regions as well as the transfer of significant functions from the central government. The programme was very much designed to further the democratic reform agenda by bringing government closer to the people, instead of being concentrated in Jakarta. Regional governments were directly elected rather than being appointed by the national government.

The decentralisation programme was also meant to stem the rising resentment of outer provinces that wanted self-determination, most notably the resource-rich provinces. It was for this reason that the decentralisation programme was focused on devolving power to the 400+ regions rather than the 32 provinces. There was more danger of separatism at the provincial level than at the regional level.

The programme involved massive and rapid changes, perhaps best symbolised by the transfer of 2.5 million civil servants – including in education, health care, and infrastructure development – with just one year of preparation. There were relatively few service interruptions and the regional governments performed their functions well. This is no small achievement given the circumstances and the short lead time. The share of total expenditure accounted for by regional governments rose significantly, from less than 10% to one-third of total government expenditure in a very short period of time.

The decentralisation programme was greatly facilitated by Indonesia's previous system of deconcentration. Deconcentration was the practice whereby national government ministries and agencies organised themselves on a regional level. Decentralisation meant that those regional offices no longer reported to the respective ministries and agencies, but to the newly elected regional governments themselves.

Regional governments, however, have very limited own fiscal resources. They depend overwhelmingly (90%) on transfers from the national government. The taxing power remains very much centrally based today.

The fiscal transfer arrangements are composed of three key elements:

- revenue sharing;
- general allocation grants;
- specific allocation grants.

Revenue sharing involves the national government sharing property tax, personal income tax and natural resources revenue (oil, gas, forestry and mining) with the regions. The rates of revenue sharing for natural resources vary, with the producing regions receiving a disproportionately higher rate of revenue sharing. Revenue sharing accounts for over one-fourth of all transfers from the national government.

The general allocation grants require the transfer of 26% of all central government revenue (after revenue sharing). There are two components.[1] First, grants are distributed on a derivative basis to cover the wages of officials previously employed in deconcentrated units and now transferred to the regions. This distribution guarantees their salaries and greatly facilitates decentralisation. Second, the grant includes an amount based on a formula that takes into account the difference between a region's fiscal needs (which depends on indicators such as population, human development index, and land area) and its fiscal capacity (defined as the sum of own revenues and shared revenues). In practice, the grant is overwhelmingly focused on covering salary costs, with only a minor component dedicated to equalisation. General allocation grants amount to two-thirds of all transfers from the national government.

Specific allocation grants are used for special needs of individual regions – including funding for natural disasters and other emergencies – and for financing central priorities at the regional level. Regions apply to the central government for the grant and must provide 10% matching funds from their own resources. Such grants account for less than one-tenth of all transfers from the national government.

Fiscal discipline was maintained during this transition period and continues to be maintained. In fact, regional governments have been unable to spend significant sums of money due to capacity constraints. The energy-rich regions have benefitted greatly from the rise in commodity prices and have amassed significant reserves.

Regional governments must submit their budgets and have them approved by the national government. There are also significant constraints on local government borrowing, including the need for pre-approval from the national government and a complete ban on foreign borrowing.

The decentralisation programme has not been free of problems, however, and full implementation will take time. Some functions are yet to be clearly defined between different levels of governments and, in some instances, ministries continue to exert influence over the activities of the regional governments. There is a need for greater own resources and fiscal equalisation for regional governments, but resources have increased in all cases. There are capacity constraints at lower levels, and further institution building is required. The issue of corruption is especially relevant at the regional level as well.

2.1.4. New role for Parliament

As noted, the fourth major pillar of the post-crisis transformation was the highly assertive role of the new democratic Parliament in the budget process. This role is described in Section 3 below.

2.2. Distinctive characteristics of the Indonesian budget process

This sub-section reviews five distinctive characteristics of the Indonesian budget formulation system:

- a fiscal rule;
- underspending of budget appropriations;
- national planning function;
- special role of fuel in the budget;
- rigidities in the budget.

2.2.1. The fiscal rule[2]

Indonesia has historically maintained a responsible and conservative fiscal policy. In the years prior to the Asian financial crisis, the budget had a moderate surplus (1-3% of GDP), and public debt was relatively low (25% of GDP).

The Asian financial crisis affected Indonesia's economy profoundly. The economy shrank by over 13% of GDP in 1998. Government debt rose dramatically in 1997 and 1998 – reaching almost 100% of GDP in 1999 – reflecting the cost of providing liquidity and eventually the take-over of the banking system.

Fiscal policy, however, continued on a responsible and conservative track and acted as an anchor for the whole economy. Even during the crisis, deficits were modest, reaching a high of 2.5% of GDP. This percentage reflected large expenditure cuts to offset lower levels of revenue and rising interest expenditures to finance the growing level of debt.

In 2003, Indonesia adopted a fiscal rule which caps annual deficits at 3% of GDP and accumulated debt at 60% of GDP. At that time, the government's deficit was 1.7% of GDP and debt was at 57% of GDP, and the economy was well on its path to recovery.

The aim of the fiscal rule – very much inspired by the Maastricht criteria for Economic and Monetary Union in Europe – was to solidify these gains and to promote future fiscal discipline by enacting these fiscal responsibility criteria into law. There was broad political agreement for the fiscal rule, reflecting the general consensus that a stable macroeconomy was an essential framework condition for sustained growth.

It was emphasised that these were maximum levels, and Indonesia's actual fiscal performance has consistently been much better than the criteria of the fiscal rule. The debt levels have continued to decrease, reaching 35% of GDP in 2008. This percentage reflects mainly the proceeds from the sale of the assets taken over during the crisis as well as the steadily improving economic growth. Annual deficits have ranged between 0.5% and 1.2% of GDP since 2003.

A regulation, based on the law, interprets the fiscal rule to apply to both the central government and lower levels of government. (The data in Figures 1-4 above reflect the central government only.) Due to the general fiscal controls exerted on lower levels of government, their inclusion would not materially change the overall deficit and debt figures.

2.2.2. Underspending of budget appropriations

It is most noteworthy that government ministries and agencies typically do not fully use all of their budget allocations. This spending applies principally to capital expenditure and the purchase of goods and services from third party vendors. Spending on such items also tends to be concentrated during the last few months of the fiscal year, suggesting inefficient use of resources as well.

Most recently, only about 88% of such appropriations were spent in total during the year, which is an improvement on earlier years, and about half of all appropriations are disbursed during the last three months of the year. There have in fact been instances where over 50% of such expenditures were disbursed in only the last month of the fiscal year (December).

Several explanations have been put forth for this phenomenon. First, appropriations for such items have increased sharply in recent years. It is common in OECD countries for there to be a noticeable lag between such sharp increases in appropriations and the resulting increases in spending. This lag is generally resolved by the use of carry-forward facilities. While such facilities do exist in Indonesia – including the possibility of multi-year appropriations – experience shows that they are only used to a very limited extent. In reality, projects come to a halt at the end of each budget year and, in some cases, funding for projects has ceased entirely in some years only to continue later.

Second, a cumbersome process is in place for getting all necessary approvals to disburse such funds. Procurement falls within the authority of each government department or agency; there is no centralised procurement agency. Each capital project requires the nomination of individual project managers, treasurers and procurement officers. For projects over EUR 4 000, a special tender committee needs to be constituted to award the contract. The procurement committee is *ad hoc*; its members perform this function in addition to their regular assignments. The selection of the individual officers and members of the tender committee must be based on criteria stated in the procurement regulations. Only when these procurement formalities are fulfilled will a spending warrant be issued. Ministries find it difficult to have the requisite human resources capacity to comply with these procurement regulations, especially in times of sharply increased funding.

Third, the delays appear to reflect caution resulting from the government's anti-corruption efforts. Procurement has been identified as particularly high risk for corruption, and stiff penalties have been instituted for violators. This characteristic has resulted in special vigilance in adhering to the procurement regulations. It has also fostered reluctance among officials to serve in procurement positions. A director of BAPPENAS (the National Development Planning Agency) said that underspending occurs because officials were afraid that actions taken in good faith might contravene the new rules in some way: "If they do nothing, they will not face any risk of prosecution, so it's better not to make any decisions."[3]

This problem may well be a temporary transition issue as people become more and more familiar with the necessary rules, including those pertaining to anti-corruption. There is, however, also a capacity issue with the need for increased training of staff to make procurement decisions. This issue is already being addressed. There may also be a case for establishing a central procurement agency, where individual ministries and agencies could (voluntarily) go in order to carry out their procurement needs. The current

National Public Procurement Office only focuses on setting procurement policy and on training and certification of procurement staff.

2.2.3. National planning function

Indonesia has a strong central planning function which is undertaken by BAPPENAS, the National Development Planning Agency. In relation to the budget process, the roles of the plan and BAPPENAS can be seen in several lights.

First, there is a long history of development planning in Indonesia, and it is viewed in a very positive light. Indonesia's very impressive growth since independence is seen to a great degree as a function of successful development planning. The plan is comprehensive as it takes account of multiple public policy instruments in addition to budgeting to achieve the goals of the plan, *i.e.* regulatory measures. The plan is also more future-oriented with a longer time horizon than the budget.

Second, the plan has been the major organising vehicle for development assistance from donors to Indonesia. In that sense, the plan can be seen in effect as a marketing device for attracting foreign assistance and also for highlighting opportunities for private sector investment in various capital projects (public-private partnerships).

Third, the five-year plan parallels the five-year term of office of the President. As such, it functions to explicitly highlight the political priorities of the government and is in essence the policy agenda for the President's term of office.

It is important to note that the five-year plan is not a rolling plan, but a fixed one issued at the beginning of a President's term of office. It is broad in scope and is operationalised each year through annual work plans, which are very much linked to the budget process.

Fourth, the plan reflects the division of responsibility between BAPPENAS and the Ministry of Finance. In contrast to the Ministry of Finance where most staff have a finance and accounting background, the staff of BAPPENAS have substantive expertise in the various sectors, such as economic development, infrastructure, social development, health care, and education. BAPPENAS maintains close substantive relationships with the various sectoral ministries. For example, BAPPENAS has separate directors paralleling each and every government ministry and agency. By contrast, the Directorate-General for the Budget in the Ministry of Finance has three directors that together parallel the rest of the government. The current very close co-operation between the Ministry of Finance and BAPPENAS is imperative, as the latter is best placed today to advise on sectoral and ministerial priorities.

The Indonesian planning system is therefore different from a typical central planning model. It cannot be characterised as having parallel planning and budgeting structures that duplicate each other in isolation from each other. They do complement each other at present. It can more accurately be said that a core planning function of the typical budget office is located outside the budget office in Indonesia, namely in BAPPENAS. In OECD countries, this planning function would be integrated in a single budget office, rather than separately as is the case in Indonesia. There are further inefficiencies in Indonesia, as the plan and the budget have separate structures – although this separation is being addressed as part of the performance budgeting reforms.

Box 3. **Reorganisation of the Ministry of Finance**

The Ministry of Finance has evolved greatly in recent years. First, some functions of the Directorate-General for the Budget were moved in 2003 to newly established directorates-general: treasury operations and budget implementation functions were moved to the new Directorate-General for the Treasury and fiscal relations with lower levels of government were moved to the new Directorate-General for Fiscal Balance. Second, the role of the Directorate-General for the Budget is in transition. It is most involved in costing budget proposals and is best placed to manage the new medium-term expenditure framework being developed. Third, a new Fiscal Policy Office was created in 2006. This office is focused on macroeconomics, long-term fiscal sustainability and fiscal risks, discussed in Sub-section 2.3.1.

2.2.4. Special role of fuel in the budget

Fuel plays a special role in the Indonesian budget, both on the revenue side and the expenditure side. Indonesia is an oil-producing country. However, oil production volume has steadily declined over the past ten years – by 40% in total – and, last year, Indonesia symbolically withdrew from the Organisation of Petroleum Exporting Countries (OPEC). Indonesia generally exports crude oil products and imports refined oil products.

Oil revenues account for a very substantial share of total revenue. In 2008, nearly over 15% of total revenue came from oil and other energy sources. Much of this revenue is shared with regional governments, especially the producing regions.

On the expenditure side, fuel subsidies accounted for almost 20% of total spending in 2008. Fuel subsidies correspond to the transfers from the central government to the state-owned oil company (PERTAMINA) to cover the losses the company incurs when the domestic price of fuel is kept below international prices.

The volatility of oil prices plays havoc with the Indonesian budget. At some (lower) international prices, the government's revenue exceeds its expenditure on subsidies. At other (higher) international prices, the expenditure on subsidies exceeds the revenue from fuel. The government has made significant reductions in the level of the subsidies in 2001/02, 2005 and 2008. Until most recently, these reductions were more than offset by rising international fuel prices, and the total expenditure on fuel subsidies increased significantly over this period.

The authorities have reiterated on several occasions their intention to eliminate these subsidies, as they benefit the well-off more than vulnerable individuals (who consume less) and because the subsidies crowd out higher quality expenditure on infrastructure investment, human capital accumulation and social protection programmes. This proposal has however faced strong political opposition, especially as oil prices have been rising.

Finally, there are some dysfunctional incentives for the government to underestimate oil revenue in the budget.

2.2.5. Rigidities in the budget

All budgets are rigid in one sense, and changes occur only at the margins ("incremental budgeting"). Indonesia, however, has some unique rigidities – at several levels – which limit annual flexibility.

First, the revenue-sharing arrangements impose rigidities. Much of the natural resources revenue and 26% of all government revenue (net of revenue sharing) must be transferred to regional governments in the form of general allocation grants.

Second, there are constitutional provisions that mandate the level of allocations to certain sectors. For example, the Constitution mandates that 20% of total revenue must be allocated to education. There is disagreement as to what should be considered "education" for these purposes, and there have been numerous court cases to resolve the issue.

Third, there are numerous other examples of tax revenue being earmarked for certain functions. The largest example is forestry fees that are dedicated to reforestation and related activities. Other and numerous examples are often small in amount but do accumulate.

The effect of earmarking varies greatly according to how specific it is. Earmarking in bulk to large sectors such as education – which is generally and objectively considered to need additional resources – is the equivalent of setting expenditure ceilings, or rather "floors", for those sectors. Budgeting then consists of allocating that aggregate amount among the various programmes within the sector. Earmarking for very specific purposes imposes rigidities of a different order. This type of earmarking undermines effective budgeting, and measures should be taken to avoid such specific earmarking.

Civil servants are also generally tenured for life once appointed. This protection has the effect of largely insulating them from fiscal adjustments and from critical scrutiny during the budget formulation process.

More generally, the traditional split of budgeting into development and routine budgets left the latter largely on "auto pilot" and not subject to critical scrutiny. This problem is now being addressed, but room for manoeuvre is limited, not least because of civil service protections.

2.3. Annual budget formulation cycle

The annual budget formulation cycle can be divided into five stages:

- establishing the level of resources available for the next budget;
- establishing priorities for new programmes;
- pre-budget discussions with the Parliament;
- finalisation of the budget proposal;
- preparing detailed budget implementation guidance.

2.3.1. Establishing the level of resources available for the next budget

The first step in the annual budget formulation process is establishing the level of financial resources available. This activity typically starts in February to guide the budget formulation process, but is continually refined until the budget proposal is finalised. This activity is the responsibility of the Ministry of Finance, namely the Fiscal Policy Office and the Directorate-General for the Budget.

The Fiscal Policy Office prepares the economic assumptions and revenue forecasts for the budget, thus establishing the maximum level of expenditures under the government's deficit target.

The Fiscal Policy Office relies on a committee of technical experts to prepare the economic assumptions and revenue forecasts. Its members represent the Ministry of Finance,

BAPPENAS (the National Development Planning Agency), the National Statistical Agency, the Central Bank, the Ministry of Energy and Mineral Resources, and the co-ordinating Ministry for Economy, Finance and Industry. This committee is chaired by the Ministry of Finance which has final responsibility for the economic assumptions and revenue forecasts.

This committee will meet on numerous occasions. Several of the participating bodies have an independent forecasting capacity and will come to the meetings with their internal results. These results will be discussed, and new information from bodies with specialised insights – *e.g.* the Ministry of Energy and Mineral Resources – will be incorporated and deliberated.

Interestingly, this committee proposes a range – albeit a narrow one – rather than fixed points for each variable: economic growth, foreign exchange, interest, inflation, oil price and crude oil production. Fixing the exact variables within the range is subject to negotiations between the government and Parliament.

The budget documentation makes explicit the key economic assumptions and provides sensitivity analysis for some of them – *i.e.* the effects of different oil prices. However, there is no independent scrutiny of the assumptions nor formal comparison with private sector assumptions or other forecasts. The underlying macroeconomic models are not made publicly available.

It should be noted that projecting oil prices and oil production has been especially difficult in recent times. Indonesia is generally viewed as having forecasted these variables very conservatively in the past. There may also be dysfunctional incentives to do so. Under Indonesia's revenue-sharing arrangements with regional governments, the amount is based on the assumed oil prices contained in the budget. If the actual revenue is higher, there is no need to share the additional revenue. If the actual revenue is lower, the government cannot get any money back from the regional governments. In some years, the oil price was underestimated by over 100%. More recently, the oil prices were more realistic but still underestimated by just over 10%.

At the same time, the Fiscal Policy Office has been incorporating larger prudency reserves as a risk management strategy for the accuracy of the economic assumptions. These reserves total about EUR 1.5 billion. The emergence of these reserves several years ago aimed to increase the transparency of the contingency reserves, as they had previously been incorporated implicitly in the excessively conservation economic assumptions. The Fiscal Policy Office also prepares an annual fiscal risk statement which accompanies the budget. It identifies, assesses and quantifies the level of fiscal risks – including in the state-owned enterprises sector – in terms of contingent liabilities and other risks.

Once the macroeconomic framework has been established, the Directorate-General for the Budget divides the resulting available resources into those that are required for funding ongoing activities ("non-discretionary") and those that are available for new programmes ("discretionary"). These two categories largely mirror the previous dual budgeting system of "routine" expenditures and "development" expenditures, respectively.

For the first category, the Directorate-General for the Budget will take the current year's budget and apply set norms and indexes to arrive at a figure for the next year's budget. For example, salaries would rise by a certain percentage. This process also highlights the rigid nature of the budget: once an amount is in the (routine) budget, the system generally assumes that it will stay there in perpetuity. The Directorate-General for the Budget will

Box 4. **Economic assumptions**

Economic assumptions are the government's principal fiscal risk. In OECD experience, nothing derails the government's annual budget more than the use of inaccurate economic assumptions. The greatest risk is for the assumptions to be "too optimistic", thus making it seem that more resources are available than is really the case. In OECD countries, the focus is to ensure the independence of those responsible for the calculations, to insulate them from political pressure.

In some countries, the political tradition grants independence to the economics departments within finance ministries – for example, in the Nordic countries. In other countries, separate and independent government bodies exist to calculate the economic assumptions – for example, in the Netherlands with the Central Planning Bureau. In other countries, expert panels are drawn from the relevant institutions that are responsible for the economic assumptions – for example, in Australia. In the United States, the independent, non-partisan Congressional Budget Office plays a leading role in ensuring the accuracy of the economic assumptions. In other countries, non-government organisations play a leading role in calculating the economic assumptions. Canada, for example, bases its assumptions on an average of leading private sector forecasts. Chile uses an independent non-governmental panel of experts to determine the economic assumptions. All these arrangements ensure safeguards against the use of unrealistic, or "optimistic", economic assumptions.

The Indonesian practice of politically negotiating the economic assumptions – albeit within calculated ranges – between the government and Parliament is not applied in OECD countries.

Box 5. **Medium-term expenditure frameworks (MTEF)**

Indonesia is in the process of adopting a medium-term expenditure framework. Such a framework will greatly assist the Directorate-General for the Budget in carrying out its functions in this area. The MTEF extends the time frame of budgeting and offers baseline projections on the future costs of existing programmes. Importantly, it will also show the full multi-year costs of new programmes, including the future operating expenditure associated with capital projects.

Most OECD countries use an MTEF, but a much smaller number do so successfully. Based on OECD experience, three key dangers with an MTEF must be highlighted:

- First, ensure that the MTEF follows the same format and detail as the budget. This parallel structure will make their linkage natural and will foster the use of the MTEF. There are major implications for Indonesia where the current very detailed budget documentation may need to be simplified significantly in order to successfully implement an MTEF.
- Second, ensure that the MTEF is always up to date. Some OECD countries update the MTEF every week, following cabinet meetings. Any decision made at the cabinet meeting that has a fiscal impact would immediately be incorporated in the MTEF. Otherwise, the risk is that the MTEF becomes obsolete, and there would in effect be a need for a new MTEF each year rather than having an updated rolling one in place.
- Third, locate the responsibility for the MTEF within the same unit that deals with the regular budgeting responsibilities. That unit will have the most ready access to the information and the incentive to keep it up to date because it will see value for itself in doing so. Having a special MTEF unit separate from the budget office almost guarantees the failure of an MTEF.

also adjust certain amounts on an exceptional basis. The most frequent adjustment would be to accommodate an activity that was not operational for the full year in the current budget, *i.e.* a new office opened in the middle of the year would be adjusted exceptionally to take account of operating costs for the full year during the following fiscal year.

It should be noted that the Fiscal Policy Office itself also estimates the amounts of oil subsidies, of transfers to regional governments, and of interest payments. Those amounts are already deducted from the level of available resources which are "handed over" to the Directorate-General for the Budget.

2.3.2. Establishing priorities for new programmes

Once the Ministry of Finance has established the ceiling for resources available for new, "discretionary" programmes, BAPPENAS takes the lead responsibility, in co-operation with the Ministry of Finance, for allocating those funds.

The first point of reference is the five-year plan whose preparation will have been co-ordinated by BAPPENAS at the beginning of the President's five-year term of office. This is a comprehensive, fixed plan which elaborates the President's priorities.

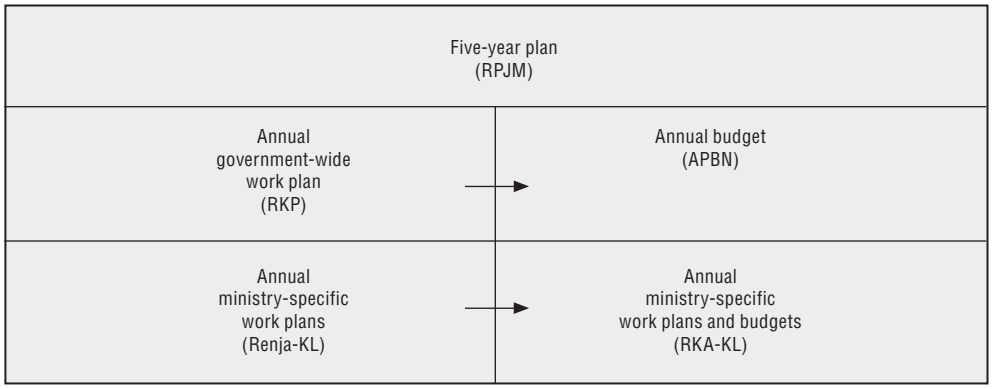
An annual government-wide work plan (RKP) elaborates on the national priorities specified in the five-year plan (RPJM). The annual government-wide work plan provides the general framework for the preparation of ministry-specific work plans (Renja-KL) and ministry-specific work plans and budgets (RKA-KL). A schema is shown in Figure 5.

BAPPENAS will have started the year with a series of internal workshops identifying the specific priorities for the following year and their funding needs. Once BAPPENAS receives the expenditure ceiling from the Ministry of Finance in early March, it will fine-tune its draft government-wide work plan and new programme initiatives.

The President and Vice-President are actively involved in this stage. They will meet several times with the minister for BAPPENAS, the finance minister and the three co-ordinating ministers (see Box 6). In certain cases, individual ministers will attend the meetings as well. These meetings generally take place in an informal "retreat" setting.

The exercise is essentially top-down, although spending ministries do of course give input through preliminary contact with BAPPENAS and through the co-ordinating ministers. This process culminates in a March cabinet meeting to discuss the draft annual government-wide work plan and to approve its broad outlines.

Figure 5. **Hierarchy of planning and budgeting in Indonesia**



Box 6. **"Spending ministries" and "co-ordinating ministries"**

The term "spending ministries" refers to the 73 organisations in the Indonesian government. These organisations include the 36 ministries with a cabinet post and 37 non-departmental government institutions.

Due to the large number of organisations, Indonesia operates a system of three "co-ordinating ministries": for Economy, Finance and Industry; for People's Welfare; and for Political, Legal and Security Affairs, respectively. Each of the 73 organisations is associated with one of the three co-ordinating ministries.

The co-ordinating ministries were especially powerful during the pre-democracy period when their role was primarily to communicate to ministers the decisions made by the President. The process has become much more open now. Most recently, the post of the co-ordinating Minister for Economic Affairs was given to the Minister of Finance who performs both duties concurrently.

Following the March meeting, BAPPENAS and the Ministry of Finance issue a joint budget circular to spending ministries. The circular provides guidelines on the preparation of ministry-specific work plans and includes indicative budget ceilings for each ministry, broken down by programmes and expenditure types.

Each spending ministry must then finalise its ministry-specific work plan on the basis of the indicative budget ceilings and submit it to BAPPENAS and the Ministry of Finance. During April, meetings are held between each spending ministry and BAPPENAS and the Ministry of Finance. These discussions take place at the level of senior officials. BAPPENAS focuses on the substantive aspects of the ministry-specific work plan. The Ministry of Finance's key role is to ensure robust costing of new initiatives. It is exceptional if changes are made to the aggregate budget ceilings, but changes within them can be made.

BAPPENAS also conducts a series of national forums (*Musrenbang*) with regional governments, deconcentrated units of government ministries and various civil society organisations before finalising the government-wide work plan. These forums typically take place in late April or early May. The *Musrenbang* are principally an occasion for BAPPENAS to outline the draft government-wide work plan and to solicit any changes at the margins. The *Musrenbang* are also an important input to the regional governments' budget formulation processes.

The final government-wide work plan is issued by the President following a cabinet meeting in May. By law, it must be issued no later than mid-May. The President will then meet with ministers and heads of agencies to emphasise the importance of carrying out the government-wide work plan.

The government-wide work plan is based on the structure of the government five-year plan. It contains 160 programmes, varying substantially in scope and size. Programmes are not aligned to organisational structures, and about 30 of them cut across ministry boundaries. These programmes are in turn divided into about 1 300 activities, but this differs from the programme structure of the budget. The performance budgeting reforms aim to unify this structure – a unification that is profoundly important for simplifying the relationship between the plan and the budget and for creating a unified chart of accounts for planning, budget formulation and budget implementation.

Box 7. **Performance budgeting**

Indonesia is committed to the introduction of performance budgeting and is already taking important steps towards that goal. Its experience with the plan provides an important foundation for the introduction of performance budgeting.

OECD countries have reported a number of benefits from using performance information, not least the fact that it generates a sharper focus on results within government. The process also provides more and better understanding of government goals and priorities and on how different programmes contribute to them.

Performance budgeting is a simple concept that is applied in great variety across OECD countries. Some countries focus on the presentational value of performing budgeting – *i.e.* to improve the transparency of the budget by providing information on results. At the other extreme, some countries use performance budgeting to directly link appropriations to results in certain sectors. Most commonly, countries employ performance budgeting to inform budget allocations.

Implementing performance budgeting can be done in a top-down or bottom-up fashion; it can be introduced incrementally or as a "big bang" undertaking; it can focus on outputs or outcomes, or both; it can be used comprehensively throughout the budget, or only partially in certain sectors; and it can employ targets, or not. It is fair to say that no two countries have implemented performance budgeting in exactly the same manner. Nonetheless there are emerging lessons from OECD countries.

First, the structure of performance information should follow the organisational structure, as accountability will always be on an organisational basis – *i.e.* programmes should not cut across ministries and agencies. In some cases, an organisation will have just one programme associated with it, although having 3-5 programmes is more common. Again, the multiple programmes would generally mirror the organisation's internal structure. The experience with attempts to present performance and results information independently of the organisational structure is extremely disappointing. If there is good reason for two organisations to share the same performance and results information, then there is probably good reason to consider merging those organisations.

Second, it is fundamental to link outputs with their full costs. For example, not allocating staff costs to the different outputs undermines the whole performance budgeting exercise. Furthermore, full costs include not only the direct costs of the service, but also costs shared with other programmes (joint costs). Determining full costs can be complex, especially when joint costs must be allocated. The effort made in costing should be commensurate with the scale of the programmes. In some cases, it may be appropriate to use reasonable estimates for allocating joint costs rather than elaborate cost accounting systems.

Third, concerns persist about information quality and information overload. Frequent changes to the measurement basis for performance information tend to erode confidence in its quality. In some countries, the national audit office has a role in ensuring the integrity of performance information. Performance information should also be commensurate with the needs of the user. Very detailed performance information in most cases should be used only for in-agency management purposes. External reporting to Parliament and the public should be more high level. In Sweden, parliamentary committees, ministries and agencies engage in dialogue on what is the appropriate level of performance information to be reported externally.

Box 7. **Performance budgeting** *(cont.)*

Fourth, the introduction of performance budgeting is often linked to broader efforts to improve expenditure control as well as public sector efficiency and performance. Thus, performance budgeting is generally combined with increased flexibility for managers in return for stronger accountability for the results, so as to enable them to decide how to best deliver public services. If not linked to broader reforms, there is a risk that managers will view performance budgeting as simply another layer of central control and will resist it. Provisions for sanctions – including dismissal of staff – in the case of non-performance need to be in place. Robust systems of accountability and control, including internal and external audit, are required before granting increased flexibility.

Finally, the most difficult issue with implementing performance budgeting in OECD countries is to persuade politicians – Ministers and Members of Parliament – to use it in decision making. They overwhelmingly continue to focus on inputs and ignore performance and results information.

In the case of Indonesia, the very detailed budget documentation and parliamentary deliberations pose a fundamental obstacle for the successful introduction of performance budgeting.

2.3.3. Pre-budget discussions with Parliament

Immediately following the issue of the government-wide work plan, the government submits a "fiscal policy and budget priorities" document to Parliament. This document is essentially a pre-budget report that includes a description of the macroeconomic framework, fiscal policies and priorities, deficit target, revenue projections and proposed expenditure ceilings for the upcoming budget year. The government also submits the government-wide work plan and ministry-specific work plans for information. The discussions take place in two parallel venues.

First, the Ministry of Finance and BAPPENAS have discussions with the Budget Committee and with Commission XI. The Budget Committee is a "committee of committees" that is composed of selected members of the 11 sectoral commissions. Commission XI is a sectoral commission dealing with economic and financial affairs. Commissions are described in greater detail in Section 3 on the role of Parliament.

These first discussions focus on the broad macroeconomic and fiscal policy objectives, including energy subsidies and transfers to regional governments. Specifically, the Ministry of Finance and Parliament will arrive at fixed points within the proposed ranges for the key economic assumptions and revenue forecasts. Working groups consisting of representative of the government and Parliament are generally formed for the detailed discussions of the economic assumptions and revenue forecasts.

Second, individual spending ministries will have discussions with their respective sectoral commissions on their ministry-specific work plans and proposed expenditures. These discussions generally focus on small and detailed items of expenditures rather than a general overview. However, the relationship between ministries and their respective commission varies greatly. The aggregate ceilings for ministries would generally not change but their composition could.

These parliamentary pre-budget discussions take approximately one month to conclude. This phase is an important one in the budget process, as the macroeconomic framework for the upcoming budget is agreed at this time.

2.3.4. Finalisation of the budget proposal

After agreement with Parliament on budget policies and priorities in mid-June, the Ministry of Finance issues a revised budget circular including a preliminary budget ceiling for ministries' programmes. Again, the overall budget ceiling rarely changes but its composition does.

Ministries and agencies revise and finalise their ministry-specific work plans in line with the preliminary ceiling issued by the Ministry of Finance. It is noteworthy that spending ministries will often have informal contact with their respective parliamentary commissions during this phase.

Ministries and agencies then prepare their ministry-specific work plans and budgets (RKA-KL), which have a different structure and format than the ministry-specific work plans (Renja-KL). Efforts are being made to harmonise the two as part of Indonesia's performance budgeting reforms. Ministries must submit the RKA-KL and the Renja-KL by 15 July. BAPPENAS reviews them to ensure conformity with the government-wide work plan, and the Directorate-General for the Budget reviews them for compliance with the preliminary budget ceilings, unit costs and classification. Currently, performance information is not systematically integrated into the ministry-specific work plans and budgets.

The Ministry of Finance finalises the budget documentation and prepares the budget proposal and the accompanying financial notes. The budget contains the estimated revenue, estimated expenditure, appropriations, and general provisions applicable to the appropriations. The financial notes contain details on expenditure allocations by economic, functional, organisational (ministry/agency) and programme classification; they also contain information on macroeconomic assumptions, debt management, the "fiscal risk statement" and other supplementary information. The annual government-wide work plan is submitted as an appendix to the budget.

The President delivers a budget speech to Parliament on 16 August, when the budget documentation is presented to Parliament as well. Indonesia's Independence Day is 17 August and, by tradition, the budget is delivered the day before this national holiday.

2.3.5. Preparing detailed budget implementation guidance

It is rather unusual to cite guidance as the last step in the budget formulation process, but Indonesia is unique in this respect. The budget is approved by Parliament a full two months prior to the fiscal year in order to prepare the detailed budget implementation guidance which can in fact be viewed as the last stage of the budget formulation process.[4]

The budget that is approved by 31 October is at a very detailed level. The problem is that Parliament's review sometimes goes beyond this date even if the budget has been formally approved. It should be emphasised that Parliament's review is not a formal part of the budget process. Individual sectoral commissions can place "holds" on disbursements from the approved budget until their concerns have been addressed. These "holds" are generally at a very detailed level. The concerns are addressed in discussions (negotiations) between each ministry and its respective sectoral commission in Parliament. The result has sometimes been that – even with the two-month period to finalise the details – budget

Box 8. **Budget documentation**

Budget documentation should follow three basic principles: comprehensiveness (*i.e.* include information on all relevant activity), transparency (*i.e.* fully disclose all relevant information) and simplicity (*i.e.* promote understanding by users of the budget documentation). There can be tension between the last two principles, transparency *versus* simplicity.

There has been a trend in OECD countries to simplify the budget documentation presented to Parliament, to allow Members of Parliament and the public a greater overview of the government's activities, focusing more on performance and results and less on very detailed input information. Such information continues to be available but in other types of documents. Detailed input information is typically available *ex post* in the financial reports of individual ministries and agencies and in the consolidated government financial statements. This simplification of budget documentation generally occurs alongside the introduction of other reforms such as medium-term expenditure frameworks and performance budgeting.

It would appear especially appealing for Indonesia to reconsider its budget documentation, which is very detailed and cumbersome, as it embarks on the introduction of other reforms. This would in turn serve to reorient the basis for parliamentary deliberations of the budget.

disbursement has not been authorised until several months into the next fiscal year. In 2007, for example, about 45% of total expenditures were delayed.

Following the final approval of Parliament's sectoral commissions, the Directorate-General for the Budget prepares disbursement warrants that are issued at the level of "budget users" (*Satker*). There are over 20 000 such budget users. Each warrant is very detailed, providing breakdowns by organisation, function, sub-function, activities, and two levels of economic classification of expenditure. Each breakdown must be respected, and reallocations (virements) are very difficult, even within *Satkers*. The use of carry-overs is possible for certain transactions, but in practice is not used to any significant extent. Spending ministries then prepare budget implementation guidance (DIPAs) for each of their budget users.

2.4. Conclusion

The economic and political crisis of 1997/98 triggered truly transformative changes to budgeting in Indonesia. Changes included creating a modern legal framework for budgeting, unifying the budget and making it more comprehensive by trimming off-budget activity, and rapidly introducing a massive decentralisation programme. While some aspects of these reforms are not complete, the scale of this undertaking cannot be overestimated. Fiscal discipline was maintained throughout this period, and it should also be noted that Indonesia experienced major shocks at that time – including the catastrophic *tsunami* – which makes the achievements all the more noteworthy.

Compared to practices in OECD countries, the biggest distinction in Indonesia is the existence of a national planning function alongside budgeting and the corresponding institutional arrangement, with the Ministry of Finance and BAPPENAS both playing a key role. They do, however, appear to work well together and the division of roles appears to be clear. The reform to unify the structure of the plan and the budget will further harmonise the two and remove inefficiencies.

Box 9. **Regional treasury offices**

Indonesia operates a system of regional treasury offices throughout the country, some 172 in total. All budget receipts and outlays pass through one of these offices except for ongoing payments such as salaries which are handled centrally. The regional treasury offices are part of the Directorate-General for the Treasury in the Ministry of Finance.

An ongoing process of streamlining the operations of the regional treasury offices is in place. Payments to vendors are processed in one working day from receipt of the payment order from the *Satkers*. This timing is most impressive given the prevalence of paper documents rather than online transmission of data in this process. A large-scale computerisation project is currently under way.

At the beginning of each year, *Satkers* register their DIPAs with their respective regional treasury office. The documentation presented with the DIPA includes the annual ministry-specific work plan and budget and the projected monthly cash flows.

Regional treasury offices receive the payment order in paper form which is checked for completeness of documentation. It is then verified against the DIPA and for consistency with underlying documents. The payment order is then confirmed by the head of the regional Treasury Office. After ensuring the availability of funds in the bank account of the regional Treasury Office, all certified payment orders are sent at the end of the day by messenger to the bank for overnight payment.

Although *Satkers* do provide their projected monthly cash flows to their regional Treasury Offices, they are in fact entitled to spend up to their total annual budget allocations at any time. There is no monthly apportionment of the annual budget. Good cash management practices are thus impaired, as regional Treasury Offices maintain buffer balances and the government is limited in its ability to invest (seasonal) surplus balances.

Indonesia operates a fiscal rule based on maximum deficits and debt, similar to the Maastricht criteria for Economic and Monetary Union in Europe. The rule has not been tested, as Indonesia's fiscal performance has been significantly better than the limits contained in the fiscal rule. Consideration could be given to introducing a more operational expenditure-based fiscal rule.

Underspending and the concentration of spending in the last months of the fiscal year constitute a significant problem in budget implementation. This situation relates principally to capital expenditure and the purchase of goods and services from third party vendors. Further capacity building in procurement is essential to implement the budget as enacted and to ensure higher quality expenditures.

The experiences of OECD countries with economic assumptions (Box 4), medium-term expenditure frameworks (Box 5), performance budgeting (Box 7) and budget documentation (Box 8) could serve as useful inputs for Indonesia as it embarks on reforms in these areas. A particular challenge is Indonesia's emphasis on a great level of detail on an input basis in its official budget documentation, which in turn forms the basis for Parliament's deliberations at the same level of details and inputs. This amount of detail will hamper some of the reform initiatives under consideration in Indonesia.

The State Treasury Law 1/2004 mandates the future use of accruals, although it is unclear whether this was meant to apply only to the financial statements or to the budget as well. Neither is it clear whether it applies to certain transactions only, to agency-specific

financial statements or to consolidated whole-of-government financial statements. The emerging consensus in OECD countries is to apply accruals only to the government's financial statements and to continue to budget on a cash basis, or to apply accruals only to specific transactions in the budget such as civil service pension programmes. It does not appear that the introduction of accruals should be a priority for Indonesia.

3. The role of Parliament

Following the transition to democracy in 1998, the Indonesian Parliament acquired a strong role in the budget process. Prior to that, power was overwhelmingly concentrated in the government, and its budget proposal was never questioned nor amended by Parliament.

Today, Parliament is deeply involved in every stage of the budget process, from the earliest budget formulation stages to budget implementation. Parliament has unlimited powers to amend the budget proposal submitted by the government. Indeed, Parliament does amend the budget, sometimes significantly. Parliament's scrutiny tends to focus more on detailed line items than overall budget policy and strategic priorities. Parliament is hampered by its lack of capacity in this area, reflecting its history of non-involvement in the budget process.

This section outlines the parliamentary budget process. It is divided into four sub-sections. The first describes the Indonesian Parliament as an institution. The second examines the parliamentary budget process for approving the government's budget proposal. The third reviews the resources available to Parliament to assist in its budget approval role and draws on the experiences of other countries. The fourth sub-section concludes.

3.1. The Indonesian Parliament

The Indonesian Parliament is a bicameral institution consisting of the House of Representatives and the Regional Representatives Council, the upper chamber. The Regional Representatives Council has a very limited set of tasks and is principally an advisory body. It has no role in the budget process where the House has sole responsibility.

The House of Representatives consists of 550 members elected for five-year terms. A proportional representation electoral system is in use, with multi-member constituencies (between 3 seats and 12 seats each) as established by the independent Election Commission. The elections are based on party lists – *i.e.* citizens vote for one party rather than individuals in their constituencies.

The Regional Representatives Council consists of 128 members – namely, four representatives from each of Indonesia's 32 provinces – elected for five-year terms. In contrast to the House of Representatives, the Constitution provides that these elections should be based on individuals, not parties, although many members do in fact have strong party affiliations. With an average of 30 candidates contesting the four seats in each province in the last election, many candidates were elected with less than 10% of the vote.

Previously, 38 members of the armed forces and the police were appointed *ex officio* to seats in Parliament. As part of the democratic reforms, those appointed seats were abolished.

There are currently 16 political parties in the House of Representatives. The two largest parties have roughly 20% of the seats each. Another five parties have about 10% of the seats each. The final 10% of seats is split among nine small parties, some of which have only one elected Member of Parliament.

As a result of this fragmentation, political parties are grouped into factions. There are currently ten such factions. The larger parties individually form a faction whereas the smaller parties have to join one of the larger parties' factions or the smaller parties have to unite to form a faction themselves. Every Member of Parliament must be a member of a faction. The faction is the principal organising vehicle in Parliament whereby the activities of Members of Parliament are co-ordinated in order to increase the effectiveness and efficiency of the House of Representatives. Indonesia is known for strong party (faction) discipline and the powerful role of party (faction) leaders.

Box 10. **The President of Indonesia**

The President of Indonesia was previously appointed by Parliament. From 2004, the President has been directly elected by the people for a term of five years. This was a profound reform, with the President now accountable directly to the people rather than to Parliament.

A two-round majority run-off electoral system is used in order to ensure that the President has strong backing across the country. For a candidate to be elected, he/she must not only poll an absolute majority of votes cast but also meet a distribution requirement of 20% of the vote in at least half of the provinces.

It is interesting that, in appointing ministers, the President generally consults with the leaders of the various parties (factions) in Parliament and appoints ministers based on their recommendations. In that sense, Indonesia has elements of both a presidential and parliamentary system of government. The ministers are, however, directly responsible to the President and not to Parliament. When ministers appear before Parliament, they do so as representatives of the President.

3.2. Parliamentary budget approval process

As was discussed above, Parliament interacts extensively with the government throughout the budget process:

- approving overall fiscal policy orientation and preliminary budget ceilings;
- holding informal discussions between ministries and agencies and their respective sectoral commissions on contents of budget proposals;
- approving the government's formal budget proposal;
- approving detailed budget implementation guidance.

This sub-section will focus on the third element, as the others were discussed earlier.

The government's budget proposal is submitted on 16 August each year, one day prior to Indonesia's Independence Day which is a national holiday. This date also represents the start of Parliament's annual session. On this day, the President delivers a budget speech to a joint session of the Indonesian Parliament. This very high-profile event is the outstanding event on Parliament's annual calendar. Parliament is adjourned following the speech.

When Parliament reconvenes, it holds two plenary sessions dedicated to a general exchange of views on the government's budget proposal. The Minister of Finance (and other ministers, as appropriate) responds on behalf of the President. However, this exchange is more ceremonial than substantive in content.

Table 1. **Parliamentary budget approval timetable**

Mid-May	The government submits the pre-budget report.
Mid-May to mid-June	Discussions are held by the Ministry of Finance with the Budget Committee on fiscal policy and overall ceilings. Discussions are held by spending ministries and agencies with their respective sectoral commissions on detailed allocations.
16 August	The government submits the budget proposal. The President delivers the budget speech.
16 August to late October	The Budget Committee and sectoral commissions review the budget proposal.
By 31 October	The House of Representatives approves the annual budget.
November-December[1]	Finalisation of detailed budget implementation guidance ("informal" process).
1 January	Start of fiscal year.

1. Finalisation of detailed budget implementation guidance may extend into the new fiscal year.

The budget is then referred to the Budget Committee where Parliament's scrutiny of the budget takes place. The deliberations in the Budget Committee constitute the first reading of the budget proposal. The Budget Committee is considered the most powerful committee in Parliament. It consists of 83 members representing the 11 sectoral commissions in Parliament; it is therefore a "committee of committees". The representatives from sectoral Commission XI play an especially active role in the Budget Committee. Commission XI is the counterpart to the Ministry of Finance and BAPPENAS.

The Budget Committee meets frequently over the next two months as it conducts the scrutiny. The finance minister will appear before the committee at the start of its deliberations, and may be accompanied by the minister for BAPPENAS, the Central Bank governor, and other spending ministers. During this stage, each party (faction) will state its views on the budget in more detail and the government will respond. Senior officials from the Ministry of Finance will have extensive discussions with the Budget Committee throughout its scrutiny period.

The Budget Committee focuses on reviewing the macroeconomic assumptions and revenue forecasts on which the budget is based, government expenditure priorities for different sectors, and the financing of the budget deficit.

The Budget Committee is guided by the deficit target agreed with the government during the preceding months (June-August). During its scrutiny, the committee focuses especially on revising the macroeconomic assumptions and revenue forecasts upwards, thus adding resources to fund additional expenditures. The analytical basis for such revisions is not clear, but is likely in response to the government's (past) practice of underestimating revenue, especially oil revenue. Each faction may produce a specific list of issues in this regard. The Budget Committee usually forms several smaller working groups to focus on specific subjects.

Most notably, the meetings of the Budget Committee are not open to the public and no record is made available of its proceedings.

During its scrutiny, the Budget Committee also invites sectoral commissions to submit advisory opinions on budget priorities and financial needs. Any additional resources may go to financing these requests. In general, the Budget Committee accepts all advisory opinions from sectoral commissions, as they would have been agreed informally before being submitted. In this context, it is important to highlight that the sectoral commissions interact only with their respective ministries and agencies. Neither officials from the Ministry of Finance nor BAPPENAS participate in the sectoral meetings.

Box 11. **The sectoral commissions**

There are 11 sectoral commissions which mirror the work of groups of government ministries and agencies. Each ministry and agency "belongs to" one of the sectoral commissions. The sectoral commissions play a key role in the budget process by focusing on the detailed allocations of individual appropriations within their respective sectors. There is a very close relationship between the commissions and their respective ministries and agencies throughout the year. Ministries and agencies exercise great care to satisfy the wishes of their sectoral commissions.

The work of the commissions can be viewed to a large degree as independent of the review by the Budget Committee. This independence is demonstrated by the fact that the Budget Committee will endorse the budget proposal and the House of Representatives will approve it before the sectoral commissions have finished their work. The result is delays in issuing budget implementation guidance, as discussed in Sub-section 2.3.5. However, it should be noted that practices vary greatly between commissions.

There are on average 50 members in each commission. Their members are elected in proportion to each party's (faction's) share of seats in Parliament.

The second – and final – reading of the budget takes place in plenary session by the end of October. The leadership of the Budget Committee will report on its deliberations, the parties (factions) will deliver their final opinion on the budget, and the government (Minister of Finance) will respond. This final reading is largely a formality, as the House in plenary session always endorses the conclusions reached by its commissions.

It is most noteworthy that the budget – as amended by the Budget Committee – is enacted by consensus, rather than by majority voting. This phenomenon is very much in line with the political culture of Indonesia which emphasises continuous deliberations and negotiations among parties (factions) until a satisfactory agreement is reached by all. As part of this emphasis on consensus, the government itself must be in agreement with the final proposal as well.

The approval of the budget two months prior to the start of the fiscal year is meant to give sufficient time to finalise budget implementation guidance and for sub-national governments to finalise their own budgets prior to the start of the fiscal year. Fiscal transfers are the primary revenue source of sub-national governments.

As was noted previously, even though the budget has been enacted, the sectoral commissions may continue their scrutiny and place restrictions on the implementation of the budget (see also Box 11).

3.3. The capacity of Parliament

The capacity of the Indonesian Parliament in its review of the budget proposal is weak. This weakness manifests itself on several levels. First, there is great turnover of Members of Parliament. Second, the overall resources of Parliament have not increased in line with its new responsibilities. Third, there is not a sufficient specialised analytical capacity in Parliament despite recent reorganisations of the functions of the Parliamentary Secretariat-General.

In the latest elections to the House of Representatives, nearly three-fourths (75%) of the elected Members of Parliament were entering Parliament for the first time. This

Box 12. **Mid-year budget revisions**

The Indonesian government must present to Parliament a half-year report on budget implementation for the first six months and the outlook for the whole fiscal year. These reports have on occasion given rise to supplementary budgets, sometimes significantly revising the budget. For example, the underestimated oil and gas revenue in the original budget would become apparent and those new resources would be allocated as part of the mid-year budget revisions – typically for infrastructure and other development projects. With the more accurate oil and gas revenue projections in the most recent budgets, the level of the mid-year budget revisions has decreased significantly.

Indonesia has also experienced significant natural disasters – including the catastrophic *tsunami* and devastating earthquakes – which have given rise to in-year emergency revisions of the budget as well.

situation does in part reflect the transition to democracy, but it also highlights the lack of legislative experience of most Members of Parliament. This lack is especially acute in such complex matters as deliberating the budget where Members of Parliament – especially new ones – can be overwhelmed by the sheer magnitude of the budget documents, their technical detail, and the years of expertise possessed by government budget officials. As a result, Members of Parliament tend to focus on very small details of the budget rather than overall fiscal policy and strategic budget directions. Members of Parliament have also not had the expertise nor the strength in numbers to overhaul some processes and structures in Parliament. The fragmentation of Parliament into multiple small parties exacerbates this problem.

In terms of overall resourcing of Parliament, it is striking that it is largely similar to the previous era when Parliament had no effective role. In fact, Parliament is subordinate to the government when it comes to resourcing. The government must agree to the Parliament's own budget. The staff of Parliament are government employees, hired according to traditional civil service procedures. All organisational changes and staff actions need to be approved by the government. Staff are generally hired in their youth and hired for life. New hires are essentially trained "on the job" rather than bringing in needed specialised knowledge.

In terms of specific analytical capacity, there are 35 experts in the Secretariat-General of the House of Representatives. Their responsibilities are to support Parliament in its entire realm of activities. Among the 35 experts, there are only seven who are solely responsible for providing support in the budgeting area, in spite of recent reorganisations. They appear also to focus on preparing lengthy research studies rather than on timely policy synthesis and analysis for Members of Parliament.

Most recently, commissions have been allowed to hire part-time advisers to assist them. The advisers are not civil servants but individuals with specialised expertise, and are often associated with a specific political party (faction).

In addition, each Member of Parliament is entitled to hire one expert on a contract basis (*i.e.* not civil servants), and each party (faction) can also recruit a limited number of experts according to its proportion of seats in the House of Representatives. These experts are obviously not dedicated exclusively to budgeting issues.

Box 13. **The Swedish parliamentary budget process***

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

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

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

Indonesia has similar organisational features and may wish to consider aspects of the Swedish system to strengthen the institutional framework for parliamentary treatment of the budget.

* For a description of such a system in operation, see Jon R. Blöndal (2001), "Budgeting in Sweden", *OECD Journal on Budgeting*, 1:1.

Regardless of this latest development, the commissions rely on cost calculations submitted by the Ministry of Finance or the respective line ministries when discussing the budgetary impact of various amendments under consideration. Although there appears to be confidence in the cost calculations prepared by the ministries, there have been calls to set up an independent budget office so that Parliament will not be dependent on the government for such matters.

Box 14. **Korea National Assembly Budget Office (NABO)**

As the Korean National Assembly took a more active role in the budget process following the transition to democracy, it established an independent National Assembly Budget Office in 2003 to assist it. The official mission of the NABO is to:

- conduct research and analysis on the budget, settlement of accounts and performance of fiscal operations;
- estimate costs for bills;
- analyse and evaluate national programmes and medium/long-term fiscal requirements; and
- conduct research and analysis on request by committees or members of the National Assembly.

The NABO is organised into three substantive divisions: the Budget Analysis Division, the Economic Analysis Division, and the Programme Evaluation Division. It has over 100 full-time professional staff members. The Chief of the NABO is appointed by the Speaker of the National Assembly and approved by the House Steering Committee. The Chief appoints all NABO staff; for higher-level staff, the Speaker must confirm the appointment based solely on professional competence, not political affiliation. Over 90% of staff members hold advanced degrees in economics, public policy, accounting or related fields.

3.4. Conclusion

Following the transition to democracy in Indonesia, Parliament has taken on its role in the budget process with great zeal. This move is to be commended, as the budget is the single most important policy document of governments and its scrutiny and amendment where necessary by parliaments is imperative for a well-functioning democracy.

Indonesia's Parliament stands out when compared to most OECD member country parliaments on several counts.

First, the Indonesian Parliament is involved in more details and at more occasions throughout the budget process than the parliament of any OECD country. While the pre-budget phase is exemplary, it would be more beneficial if Parliament were to focus on budget policy in more aggregate and strategic terms. The government could assist in this regard by providing appropriate high-level budget documentation at that point rather than the very detailed work plans, for example. As a result, Parliament could focus more on inter-sectoral allocations of funding and thus take on a greater role in setting overall budget policy. Parliament's emphasis on detail also inhibits the successful implementation of medium-term expenditure frameworks and performance budgeting.

Second, the practice of undertaking political negotiations on the economic assumptions and revenue forecasts that underlie the budget is at odds with OECD practice. In OECD countries, the usual procedure is to obtain such assumptions and forecasts on a purely technical and independent basis. The aim is to make them so professional that they are not subject to political debate.

Third, the role of the Budget Committee *versus* the sectoral commissions could be made more explicit. Again, the involvement of the sectoral commissions in the Indonesian budget process is exemplary by OECD standards. If the Budget Committee were to focus more on aggregates and strategic priorities, it could be in a position to issue budget ceilings

to the sectoral commissions. This change could be part of the introduction of a formal multi-step budget approval process in Parliament to foster fiscal discipline. As noted in Box 13 on Sweden, the role of the Budget Committee could evolve into a fiscal "policeman" akin to the role of the Ministry of Finance *versus* spending ministries. The fact that the Indonesian Budget Committee is a "committee of committees" representing the sectoral commissions may complicate this proposed new role.

Fourth, much of the power of the sectoral commissions stems from informal arrangements, such as their frequent contacts with their respective ministries and agencies. For example, the role of the sectoral commissions in the budget implementation guidance is completely informal.

Fifth, the final decisions of Parliament are by consensus achieved through informal negotiations and discussions among the various parties (factions) rather than majority voting. This situation reflects Indonesian political tradition. It does however hamper transparency, as the means of reaching consensus takes place outside of public view.

Finally, the capacity of Parliament is quite limited in exercising its important budget-related functions. Due to the high turnover of Members of Parliament, an emphasis on providing training and analytical support for them is critical. The option of creating an independent, non-partisan, professional parliamentary budget office to provide high quality support is especially attractive.

4. Concluding remarks

The economic and political crisis of 1997/98 triggered truly transformative changes to budgeting in Indonesia. With the creation of a modern legal framework for budgeting, the budget has been unified and made more comprehensive, and a massive decentralisation programme has been launched. It is commendable that fiscal discipline was maintained throughout this period. Indonesia could now consider introducing a more operational expenditure-based fiscal rule. In addition, it would be advisable to avoid the concentration of spending in the last months of the fiscal year. Another particular challenge is Indonesia's emphasis on a great level of detail on an input basis in its official budget documentation, which in turn forms the basis for Parliament's deliberations. This amount of detail will hamper some of the reform initiatives under consideration in Indonesia, although Parliament has taken on its role in the budget process with great zeal, and the existence of a national planning function alongside budgeting augurs well for Indonesia's fiscal health.

Notes

1. In the original 1999 legislation, each region received a lump-sum payment of equal amount regardless of size. This provision was eliminated with the 2004 legislation as it had created incentives for regions to split, thus yielding higher grants.
2. For a discussion of the appropriate design of fiscal rules and the benefits of expenditure-based rather than deficit-based fiscal rules, see Anderson and Minarik (2006).
3. Mr. Bambang Prijambodo, as quoted by Reuters.
4. This early approval is also meant to give regional governments time to finalise their budgets, as they are highly dependent on transfers from the national government.

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Budget Transparency around the World: Results from the 2008 *Open Budget Survey*

by
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The movement for greater fiscal transparency has been gaining momentum in recent years. To contribute to these efforts, the International Budget Partnership (IBP) developed the Open Budget Survey *in 2006. The 2008 Survey finds that the state of budget transparency around the world is deplorable, although a number of countries have improved their performance over the past two years. This article discusses the results of the 2008 Survey and ways of improving budget transparency.*

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1. Introduction

The movement for greater fiscal transparency has been gaining traction in recent years. International financial institutions, credit ratings agencies, regional economic blocs, and civil society organisations (CSOs) have all taken up the cause, strengthening the case for fiscal transparency as a key governance issue and intrinsic public good. United States President Barack Obama recently articulated this commitment to budget transparency in his inaugural address:

> Those of us who manage the public's dollars will be held to account – to spend wisely, reform bad habits, and do our business in the light of day – because only then can we restore the vital trust between a people and their government.

The current global financial crisis has put even more emphasis on the importance of fiscal transparency. Some have posited that a lack of transparency and oversight facilitated the unsustainable expansion of the credit market. At the same time, a global economic contraction makes budget transparency even more pertinent, as countries around the world face lower foreign and domestic investment, aid and tax revenues, making decisions about how to spend public money more contested.

The International Budget Partnership (IBP) was established in 1997 to promote civil society budget engagement in order to make budget systems more transparent, accountable, and responsive to the needs of poor people. Today, the IBP partners and allies are actively engaged in public budget processes in over 100 developing and transitional countries throughout Africa, Asia, Eastern Europe, and Latin America. Civil society organisations in some of these countries have registered notable successes in opening their governments' budgets to public scrutiny and encouraging more responsive and accountable budgeting. However, they have also faced a number of challenges. In particular, one overarching challenge has constrained the ability of groups in many countries to conduct credible and timely budget analysis and advocacy: a lack of access to comprehensive budget information. In light of this situation, the IBP developed the *Open Budget Survey*, the first independent, comparative survey of budget transparency and accountability around the world. The Survey was first conducted in 2006 and most recently updated in 2008.

1.1. Recent research on budget transparency and inclusive budgeting

In 2005, the IBP published the results of a pilot survey on budget transparency, based on research conducted in 36 countries (see Gomez *et al.*, 2005). The study built on prior efforts by the IBP and some of its partner organisations in Africa, Eastern Europe and Latin America to develop methodologies for assessing budget transparency and participation in the budget process. The pilot study looked at countries' performance in three main areas: executive budget documents, monitoring and evaluation reports, and public and legislative involvement in the budget process. Overall, the study found that countries tend to do a better job of meeting international best practice guidelines for the information presented in the executive's budget proposal than they do for providing information on the budget

after it has been enacted, or taking steps to encourage public and legislative involvement in the budget process. Only two countries – Slovenia and South Africa – were found to have strong practices in all of the major areas covered by the questionnaire.

Beyond the previous efforts of the IBP, the *Open Budget Survey* belongs to a limited but growing literature on budget transparency and inclusive budgeting. Existing research results shed some light on two key questions that are fundamental to the IBP work. The first asks whether transparency (and in particular budget transparency) actually affects governance and poverty, and if so, how. The second enquires about the role that civil society has played so far in advocating for increased transparency, and whether such efforts have had any significant impact on transparency and also more broadly on governance and poverty.

1.1.1. The impact of transparency on governance and poverty

The World Bank and the International Monetary Fund (IMF) have generated much of the recent research on cross-country evidence of the impact of transparency. These institutions have supported governance reforms and also have substantive resources for research and access to comparative data and information. In a paper entitled *Do More Transparent Governments Govern Better?*, Islam (2003) sets out to assess whether freedom of information laws and more frequent publication of government economic data are associated with better governance, measured via aggregate governance indicators produced by the World Bank. Indeed, the data show a strong correlation between transparency and the quality of governance in 169 countries. Bellver and Kaufmann (2005) follow a similar path, but attempt to create a better measure of transparency that summarises data from over 20 independent sources (including the first *Open Budget Survey*) for 194 countries. They also find that transparency is associated not only with lower levels of corruption, but also with better socio-economic and human development indicators, and with higher competitiveness. In another attempt at developing a measure of transparency, this time more focused on budget-related matters, Hameed (2005) used data from IMF fiscal reports on the observance of standards and codes (ROSC) for 57 countries to develop an index of fiscal transparency based on information linked to the credibility of budget data, to the quality of medium-term budgeting, to existing reports on budget execution and to possible sources of fiscal risk. His findings show that more transparent countries have better access to international financial markets, better fiscal discipline and less corruption, after controlling for other socio-economic variables. Glennerster and Shin (2008) also provide evidence of the impact of increased fiscal transparency on lowering borrowing costs for countries in sovereign bond markets, which are used as an indicator of the market's perception of the economic conditions in a given country.

The results drawn from macro-level cross-country analyses are encouraging, highlighting the role that transparency might play in promoting sound governance and improved socio-economic outcomes. These results ought to be taken with some caution, however, given that the indicators used in these analyses are quite recent and have not been rigorously tested. Furthermore, registering a correlation between two indices says little about what is causing what. It could be argued that rather than transparency contributing to better governance and economic performance, better transparency is instead a result of positive trends in those two areas.

Some interesting additional evidence comes from a few existing micro-level studies. In a much quoted case study of Uganda, Reinikka and Svensson (2004) showed that

increased transparency in the form of newspaper publication of information on the grants that local governments were meant to receive for basic education dramatically reduced the leakage and corruption in these transfers. In 1995, a public expenditure tracking survey (PETS) showed that schools received only about 20% of the grant they were supposed to receive; by 2001 that percentage had increased dramatically, with 80% of the grant reaching its intended beneficiaries. The authors argue that much of the difference can be attributed to the increased transparency and availability of information to the general public, which facilitated greater community monitoring at local level and, as a consequence, limited the degree of capture by local politicians and bureaucrats. Other researchers have examined budget transparency in the context of participatory budgeting. In a study of multiple countries, Brautigam (2004) finds that greater transparency is a prerequisite for increased citizen participation in the budget process. However, in order to achieve any impact, transparency needs to be coupled with other factors, such as a clear pro-poor agenda by the political party in power, a strong auditor general and an informed media.

Transparency and accountability issues in countries that are heavily dependent on either foreign aid or natural resource revenues deserve specific mention, too. For example, Brautigam and Knack (2004) argue that aid dependence distorts government accountability away from citizens towards donor agencies, often in ways that are neither transparent nor easily monitorable, given that the majority of aid-financed projects and programmes are still kept off budget. Donors have only recently started to recognise this problem (de Renzio, 2006), but are not doing enough to address it adequately. Looking at the vast literature on resource-dependent countries, Ross (2001) argues that dependency on oil revenues, for example, may have antidemocratic effects because it allows governments to be opaque and unaccountable, as they do not rely on direct taxation as their main source of revenues. Using data from the 2006 Open Budget Index (OBI), de Renzio, Gomez and Sheppard (2009) find that, indeed, resource-dependent countries suffer from a "transparency gap", and argue that the existence of an active civil society might be one of the factors explaining how countries can escape from the "resource curse".

1.1.2. The role of civil society in promoting transparency and better governance

Civil society involvement in policy processes, and in budget processes more specifically, is quite a recent phenomenon. As a consequence, existing evidence on whether such involvement has led to improved transparency and governance standards is still quite scarce. Documenting the work carried out by the *Mazdoor Kisan Shakti Sangathan* (MKSS) in the Indian state of Rajasthan, Jenkins and Goetz (1999) highlight how a grassroots organisation managed to tackle widespread corruption in the management of public works programmes and other pro-poor policies such as minimum wage regulations and the distribution of basic goods at subsidised prices at local government level. The MKSS fought to obtain access to official records on the implementation of these programmes and then organised public hearings where such information was checked with local communities, exposing frauds and other forms of corruption. The MKSS work has been widely praised for its focus on transparency as a human rights issue and as a precondition for participatory development and anti-corruption efforts. In fact, the MKSS not only pushed for legislative and regulatory reforms that could provide better access to official documents such as budget information, but also ensured that such information could be used to promote local accountability and to address corruption. The MKSS work contributed to the enactment of

a national freedom of information law in India, as well as the national rural employment guarantee scheme (Ramkumar, 2008).

In its efforts to assess the impact of the activities of civil society groups working on budget monitoring and advocacy, the IBP has recently carried out a series of case studies (see Robinson, 2006 and 2008; and de Renzio and Krafchik, 2006) which provide evidence of how civil society involvement can enhance not only budget transparency, but also the awareness and participation of different groups in the budget process and, in some cases, can have an impact on budget policies and outcomes. Budget groups, the research shows, have played a vital role in expanding, interpreting and disseminating budget information. For instance, in India the work of DISHA, a social movement dedicated to the empowerment of the poorest citizens, is based on obtaining budget documents (which are not publicly available) from opposition politicians and publishing a thorough analysis, including a cross-check on the accuracy of government data, which is then used by the media and by members of the local assemblies. In Mexico, FUNDAR (the Center for Analysis and Research) was able to use right-to-information legislation to uncover major corruption in the use of public funds for HIV/AIDS prevention and treatment. The work of IBASE (the Brazilian Institute of Social and Economic Analyses) in Brazil has focused recently on pushing for increased transparency of the national development bank, which is bigger than the World Bank and whose operations have been shrouded in secrecy. After organising an NGO network to monitor the bank's activities more closely, IBASE recently managed to pressure the bank's management to release information on the largest projects in its investment portfolio.

As this brief literature review shows, some encouraging evidence exists to show that increased transparency is associated with better governance standards and better economic and social outcomes. Furthermore, the literature also demonstrates civil society's capacity to increase transparency and to use it to promote accountability and the effectiveness of pro-poor policies.

1.2. The Open Budget Survey: *Rationale and characteristics*

The *Open Budget Survey* is based on a rigorous questionnaire that reflects generally accepted good practices related to public financial management. Many of the criteria used are similar to those developed by multilateral organisations such as the IMF, the International Organization of Supreme Audit Institutions (INTOSAI), and the OECD. However, the Survey's scope and research process clearly distinguish it from similar initiatives by these organisations. Most of the questions in the Survey focus on the content and timeliness of eight key budget documents that – according to international good practices – all countries should issue. The averages calculated from the responses to these questions form the "Open Budget Index" (OBI), a comparative measure of budget transparency which scores countries on a scale from 0 to 100. The remaining Survey questions assess the strength of key oversight institutions (the legislature and the supreme audit institution or SAI), as well as opportunities for public engagement in the budget process. One limitation of the Survey is that it focuses on central government only and does not examine the availability of information at the sub-national level. The Survey also does not evaluate the quality or credibility of the information provided by governments, although it does examine the comprehensiveness of this information.

Research to inform the Survey was conducted by independent civil society experts (based at academic institutions or civil society organisations) in each of the 85 countries,

rather than by government officials or donor agency staff. Using a detailed set of guidelines, researchers filled in detailed questionnaires, reviewing all available budget documents, testing the extent of public access to these documents, and interviewing relevant government officials.[1] Once the questionnaires were completed, IBP staff and independent peer reviewers in each country checked them for internal consistency and cross-referenced the answers against publicly available data.[2] Two further tests checked the reliability and robustness of the data. First, the results were compared with the results of other indices of governance and transparency. Second, a "unanimity score" was calculated for each country which measured the degree of agreement between the researchers and the peer reviewers.[3]

The next section of this article presents an overview of the main findings. We highlight the shared characteristics of poorly performing countries and examine the availability of information throughout the budget process. We then move to a discussion of the ability of the legislature and of the supreme audit institution (SAI) to provide effective oversight. Next, we present evidence that improving budget transparency is possible – across a range of country contexts – given sufficient political will. Finally, we put forward some recommendations for governments, civil society organisations and the international donor community on how to promote and facilitate greater transparency.

2. Main findings

The Survey finds that the average OBI score across the 85 countries surveyed is 39 out of a possible 100 (see Table 1). This finding indicates that, on average, the countries surveyed provide minimal information on their central government's budget and financial activities. Only five countries (France, New Zealand, South Africa, the United Kingdom, and the United States) make extensive information publicly available as required by generally accepted good public financial management practices. A further 12 countries provide substantial information to the public. The remaining 68 countries score poorly on the OBI. The 25 countries that provide scant or no budget information include low-income countries like Cambodia, the Democratic Republic of the Congo, the Kyrgyz Republic and Nicaragua, as well as several middle- and high-income countries such as China, Nigeria and Saudi Arabia. In 23 of the 25 poorest performing countries, the public cannot even see the executive's budget proposal before it is approved by the legislature. Instead, the public receives the annual budget as a *fait accompli*. Thus, those most directly affected by the ultimate decisions cannot have any meaningful input into the formulation or discussion of the government's budget policies.

2.1. Shared characteristics of poor performers

Countries that perform poorly on the OBI tend to share a number of characteristics which may point to some of the causes and consequences of the lack of budget transparency. These shared characteristics include geography, income, dependence on foreign aid or oil and gas revenues, and the nature of their political systems. Interestingly, however, in each category there are significant outliers, showing that greater budget transparency is possible in a wide range of different contexts and that no one set of circumstances can predetermine a country's level of budget transparency.

Table 1. **Distribution of Open Budget Index scores**

Budget information provided to the public	Number of countries	Average OBI score	Countries
Extensive (OBI score of 81-100)	5	86	France, New Zealand, South Africa, United Kingdom, United States
Significant (OBI score of 61-80)	12	68	Botswana, Brazil, Czech Republic, Germany, Korea, Norway, Peru, Poland, Romania, Slovenia, Sri Lanka, Sweden
Some (OBI score of 41-60)	27	51	Argentina, Bangladesh, Bosnia and Herzegovina, Bulgaria, Colombia, Costa Rica, Croatia, Egypt, Georgia, Ghana, Guatemala, India, Indonesia, Jordan, Kenya, Macedonia, Mexico, Namibia, Nepal, Papua New Guinea, Philippines, Russia, Serbia, Turkey, Uganda, Ukraine, Zambia
Minimal (OBI score of 21-40)	16	34	Albania, Azerbaijan, Ecuador, El Salvador, Kazakhstan, Lebanon, Malawi, Malaysia, Mongolia, Morocco, Niger, Pakistan, Tanzania, Thailand, Trinidad and Tobago, Venezuela
Scant or no information (OBI score of 0-20)	25	7	Afghanistan, Algeria, Angola, Bolivia, Burkina Faso, Cambodia, Cameroon, Chad, China, Democratic Republic of the Congo, Dominican Republic, Equatorial Guinea, Fiji, Honduras, Kyrgyz Republic, Liberia, Nicaragua, Nigeria, Rwanda, São Tomé and Príncipe, Saudi Arabia, Senegal, Sudan, Viet Nam, Yemen
Overall	85	39	

2.1.1. Geography

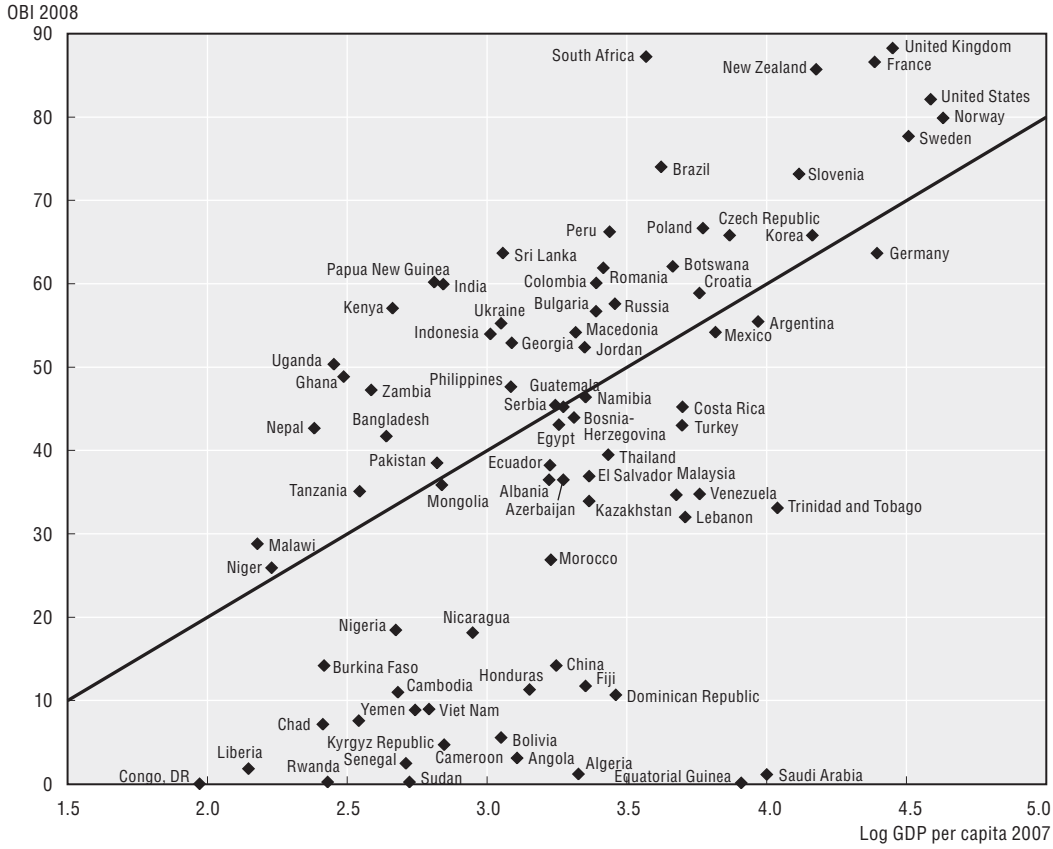
The region with the lowest average OBI score is the Middle East and North Africa, with an average score of 24 and with five out of seven countries releasing minimal or scant or no information. Within this group, Jordan scores well above its regional counterparts, but even its score is only 52 out of a possible 100. Sub-Saharan African countries also register generally poor performance. More than two-thirds of the countries surveyed from this region release minimal, scant or no information, and the average score for the region is only 25. Botswana and South Africa are the strong performers in sub-Saharan Africa: Botswana's score is 62, while South Africa, with a score of 87, is among the most transparent countries included in the 2008 OBI. If these two top performers are removed, the average OBI score for the sub-Saharan Africa region falls to a disappointing 20.

2.1.2. Level of income

Figure 1 shows the relationship between the 2008 OBI countries and their level of income (measured by GDP per capita). The upward sloping line in the figure represents the average relationship between a country's income and its OBI score.

The scatter plot shows that, for many of the countries in the sample, there is a positive relationship between a country's OBI score and its level of income, measured by a correlation of 0.5278. Countries that score high on the OBI generally are countries that have a relatively high level of income (*e.g.* France, the United Kingdom, and the United States). On the other hand, countries with low OBI scores tend to be poor (*e.g.* Chad, Democratic Republic of the Congo, and Liberia). In this case also, there are significant outliers. For instance, in spite of their considerable wealth, Saudi Arabia and Equatorial Guinea both perform very poorly on the OBI, registering scores of one and zero, respectively. In contrast, among lower-income countries, Peru and Sri Lanka both provide their citizens with a significant amount of budget information. In other words, a country's level of income does not seem to predetermine its level of transparency.

Figure 1. **Relationship between transparency and income**



2.1.3. Dependency on foreign aid

Countries that perform poorly on the OBI also tend to depend heavily on foreign aid to finance public spending. The average score for the 30 countries that received more than 5% of their gross national income (GNI) in foreign aid in recent years is 24, compared with a score of 62 for countries that did not receive any foreign aid over the same period. Evidence was also found that budget transparency worsens as aid dependency increases. For instance, the average OBI score among countries where aid is greater than 10% of GNI is just 22, whereas countries where aid is between 5% and 10% of GNI register an average OBI score of 28.

2.1.4. Dependency on natural resource revenues

The 2008 OBI also confirms that countries that are dependent on natural resource revenues tend to be less transparent. The lack of budget transparency is particularly serious in the 21 countries that depend on revenues from oil and gas extraction. Their average score is 23, which compares very poorly with both the overall average OBI score of 39 and with the average score of 44 for countries that depend on mineral resource revenues. However, the OBI results support suggestions that falling victim to the "resource curse" – the negative economic, social and political outcomes associated with significant natural resource exports – is not an inevitable consequence of hydrocarbon wealth.[4] For example, Colombia, Mexico and Norway all perform fairly strongly.

2.1.5. Political system

All of the 17 countries that provide extensive or significant budget information are regarded as democracies to one degree or another. For example, the Economist Intelligence Unit's "Index of Democracy" classifies nine of the 17 countries as full democracies and eight as flawed democracies. In contrast, the EIU classifies two of the 25 countries that provide scant or no information as flawed democracies, six as hybrid regimes, and 15 as authoritarian regimes.[5]

The shared characteristics of countries that perform poorly on the 2008 *Open Budget Survey* shed some light on possible explanations for the persistent lack of transparency around the globe. Yet, it is difficult to disentangle the impact of each of these various factors on budget transparency. For example, in a country that is poor, aid-dependent and with weak democratic institutions, lack of transparency might be caused by any of these factors, or by all of them together, or by some other underlying characteristic that has not been considered. Moreover, as argued above, simple correlations cannot be interpreted as causal links. In other words, entrenched poverty could contribute to a lack of transparency in some countries, whereas in others a lack of transparency could be hindering economic growth. Or both effects may be simultaneously at work. In order to shed some light on these issues, research using more sophisticated statistical analysis could be carried out.[6]

2.2. Access to key budget documents throughout the budget cycle

The *Open Budget Survey* identifies a set of key budget documents that should be made available to the public at different phases of the budget process in order to allow for effective accountability. Table 2 illustrates countries' performance in terms of seven budget documents identified by the "OECD Best Practices for Budget Transparency" (OECD, 2002). The table shows that the amount and quality of information produced at each stage of the budget process can vary considerably.

Generally, the budget formulation process remains closed in most of the countries surveyed. Only 30 out of 85 countries make a pre-budget statement publicly available, and in 12 of these countries only partial information is provided. Almost two-thirds of the countries (55) do not publish a pre-budget statement at all. Furthermore, in the executive's budget proposal only six countries publish all the information that is required by good practices. A further 17 countries publish a proposal with significant information. In contrast, 62 countries publish the executive's budget proposal with limited to no supporting information.

Table 2. **Quality of budget information at different stages of the budget cycle**

	Countries providing scant or no information (OBI scores 0-20)	Countries providing minimal information (OBI scores 21-40)	Countries providing some information (OBI scores 41-60)	Countries providing significant information (OBI scores 61-80)	Countries providing extensive information (OBI scores 81-100)
Formulation					
Pre-budget statement	55	0	4	8	18
Executive's budget proposal	24	10	28	17	6
Approval					
Enacted budget	4	11	0	30	40
Execution					
In-year reports	21	5	10	22	27
Mid-year review	63	5	4	3	10
Year-end report	37	18	14	11	5
Evaluation and audit					
Audit report	32	8	13	11	21

Moving on to the approval stage, almost all countries (81) surveyed make the budget publicly available once it has been approved. However, in four countries (China, Equatorial Guinea, Saudi Arabia, and Sudan) even the enacted budget is not made public. In total, 70 countries provide either extensive or significant information on the enacted budget, and only four countries provide scant or no information. The generally good performance on making the enacted budget publicly available is an important, positive finding. As long as the enacted budget is published, it is possible for civil society to engage in some level of monitoring of how the budget is executed.

Performance during budget execution is mixed. While 20 countries publish all three relevant reports, 39 publish two of them, and 15 countries publish only one of them. Eleven countries (Algeria, Democratic Republic of the Congo, Equatorial Guinea, Malawi, Nigeria, Pakistan, Rwanda, São Tomé and Príncipe, Saudi Arabia, Sudan, and Trinidad and Tobago) do not release any execution reports to the public at all. The countries surveyed perform somewhat better on in-year reporting than on mid-year or year-end reporting. However, the amount of information in in-year reports varies widely, and only 27 of the 85 countries provide comprehensive budget execution information in these reports. Very few countries provide extensive information in their mid-year reviews and year-end reports (ten and five, respectively). Of particular concern are the countries that provide scant or no information in their mid-year reviews or year-end reports, or do not produce these reports at all (63 and 37, respectively).

Finally, the OBI results show that transparency during the evaluation and audit stage is rather poor. In 27 of the countries surveyed, the audit report is not made publicly available at all. In six of these countries (Cameroon, Equatorial Guinea, Liberia, Morocco, Niger, and Serbia), audit reports are not even produced. Nevertheless, 21 countries publish comprehensive audit reports. These countries span diverse contexts, again demonstrating that good performance can be achieved in most situations if the political will exists. Delays in releasing audit reports reduce the opportunities for civil society to use audit information to advocate for improvements in government performance. Unfortunately, 48 countries do not publish audit reports within the recommended time frame. For instance, India, Mexico and Romania all release their audit reports more than 12 months after the end of the fiscal year.

Beyond the seven key budget documents identified by the OECD best practices, the Survey also examined whether countries produce "citizens budgets" or simplified summaries of the budget produced in languages and through media that are widely accessible to the public. Citizens budgets can help to bolster public engagement in the budget process by broadly disseminating budget information and generating greater understanding. Of the 85 countries in the 2008 OBI, 68 do not publish citizens budgets, even though they would require no further data or analysis to produce. However, 17 developed and developing countries do produce a citizens budget, with Croatia, El Salvador, Korea and Ukraine among those that have recently started doing so. Several countries also post these citizens budgets on line.[7] In some countries, governments and civil society collaborate in producing citizens budgets.

3. Ability of the legislature and of the supreme audit institution to provide effective oversight

As noted in the introduction, the 2008 *Open Budget Survey* also included questions on the ability of legislatures and of supreme audit institutions (SAI) to provide effective oversight. The responses to these questions were averaged to create two additional sub-indices that measure the overall strength of the legislature and the SAI in each country. Though these indices are less comprehensive than the OBI, as they are based on fewer

questions, they nevertheless provide a useful overview of the capacity of oversight institutions across the 85 countries surveyed.

3.1. Key findings for legislatures

The average score for the legislature sub-index is 42 out of a possible 100. A critical factor contributing to this overall score is whether the legislature has adequate time to carefully consider the executive's budget proposal. The OECD best practices recommend that the executive provide a detailed budget proposal to the legislature at least three months prior to the start of the fiscal year. However, less than half of all countries surveyed (32 out of 85) meet this deadline. In 17 countries, the budget proposal is received less than six weeks before the start of the budget year, preventing a thorough legislative review. Given the limited time legislatures have to review the budget proposal, it is not surprising that 66 of the 85 countries surveyed do not hold public hearings in which civil society organisations can testify on the budgets of individual government departments.

Moving on to budget execution, in 49 of the 85 countries surveyed the executive does not seek approval from the legislature when it shifts funds between administrative units. This situation seriously limits the legislature's power to ensure that public funds are spent in line with the approved budget. Furthermore, in almost one-third of the countries (27 out of 85) the legislature does not have the opportunity to approve supplemental budgets until after the funds are spent. This situation is particularly problematic in countries with large and frequent supplemental budget requests such as the Kyrgyz Republic, Malawi, Mexico, Sudan and Yemen. This practice allows governments to use supplemental budgets to hide controversial or unpopular spending.

3.2. Key findings for supreme audit institutions

The average score for the SAI sub-index is 45 out of a possible 100, only marginally higher than that for legislatures. One of the most important measures of SAI ability to provide effective oversight is its independence from the executive branch. Unfortunately, in 26 countries surveyed the executive can remove the head of the SAI from office without the consent of either the legislature or the judiciary. Furthermore, in 38 of the 85 countries it is the executive, and not the legislature or the judiciary, that determines the yearly budget allocation for the SAI. In 24 of these countries, the Survey's researchers felt that funding for the SAI was below the level of resources needed to fulfill its mandate. Legal and financial dependence on the executive may cause the head of the SAI to withhold reports that are critical.

The SAI mandate usually prevents it from playing a direct policy or political role. As a result, for the SAI audits to have practical impact, the legislature needs to follow up on the findings and recommendations. However, in 17 of the countries surveyed the legislature does not follow up on the work of the SAI at all, while in a further 20 countries, legislative follow-up is minimal. Furthermore, in 64 countries the executive does not reveal what steps, if any, it has taken to address audit recommendations. In addition, in 64 countries neither the SAI nor the legislature report to the public on actions taken by the executive to address audit recommendations. This situation makes it easier for the government to ignore audit recommendations.

More encouragingly, in many countries SAIs have some procedures in place to tap the public as a source of information. In 46 countries surveyed, the SAI maintains formal mechanisms of communication with the public to receive complaints and suggestions on the agencies, programmes or projects that it should audit. However, in 31 countries the SAI

has limited decision-making power over what it should audit. Thus, even though the channels for engaging civil society might exist, a significant number of SAIs might not be able to use these channels effectively.

3.3. Lack of transparency and weak oversight institutions

There is significant overlap in terms of the countries with the weakest oversight institutions and those with the lowest OBI scores. In other words, effective formal oversight institutions are lacking exactly where they are most necessary, in those countries where public access to information is limited and where the oversight institutions could provide an indirect channel for budget accountability. The Survey findings therefore indicate that in many countries the public is effectively excluded from both direct and indirect participation in the budget process, and has very limited opportunities for holding the government accountable for the use of public resources.

As with the OBI, it is worth noting that there are some good performers with respect to the strength of formal oversight institutions within poorly performing regions. For instance, South Africa and Zambia register 73 and 53 respectively on the SAI sub-index, significantly higher than the average for countries in sub-Saharan Africa. In both countries, the SAI enjoys a fair amount of independence, as the heads of the SAI may only be removed by the legislature or judiciary and the SAIs have full discretion to decide which audits to undertake. South Africa also fares rather well in terms of legislative strength, scoring 67 out of 100. This score reflects the fact that South Africa's Ministry of Finance holds extensive consultations with a wide range of legislators as part of its process for determining budget priorities. In addition, South Africa's legislature holds public hearings on the medium-term budget policy statement, as well as on the individual budgets of central government administrative units (ministries, departments and agencies).

4. Improving budget transparency

As with most processes for institutional change, sustainable improvements in budget transparency are likely to take considerable time. Increasing transparency can involve reforming laws, regulations, rules and procedures, as well as changing practices. Such processes can be painfully slow and may encounter many setbacks, including political meddling. Yet, the *Open Budget Survey* shows that it is possible for budget transparency to improve rapidly in a variety of contexts, through a combination of political will, civil society pressure, and other internal and external factors.

4.1. Improvements since 2006

Of the 59 countries that were surveyed in both 2006 and 2008, the great majority saw their overall budget transparency score change, mostly in a positive direction. The only two countries whose score did not change were New Zealand and the United Kingdom. The average 2008 score for the 59 countries that were also included in the 2006 OBI is 48, a slight improvement over the average 2006 OBI score of 46 for the same countries.[8]

Egypt experienced the most significant change between 2006 and 2008, seeing its OBI score jump 25 points from 18 to 43. This improvement primarily reflects the fact that the finance ministry has, for the first time, made the executive's budget proposal widely available to the public. Egypt's higher OBI score also reflects a major 2007 constitutional amendment that increases the time allotted to the legislature for considering the budget and that enables the legislature to vote on the budget line by line. Egypt's case illustrates how a country can

improve its OBI score simply by publishing data that it already produces but withholds from the public. The 2006 *Open Budget Survey* noted that Egypt produced but did not make available the executive's budget proposal until after it was approved by the legislature. The government's effort to make this document available prior to approval allows the Egyptian public to analyse the document while it is being discussed in the legislature.

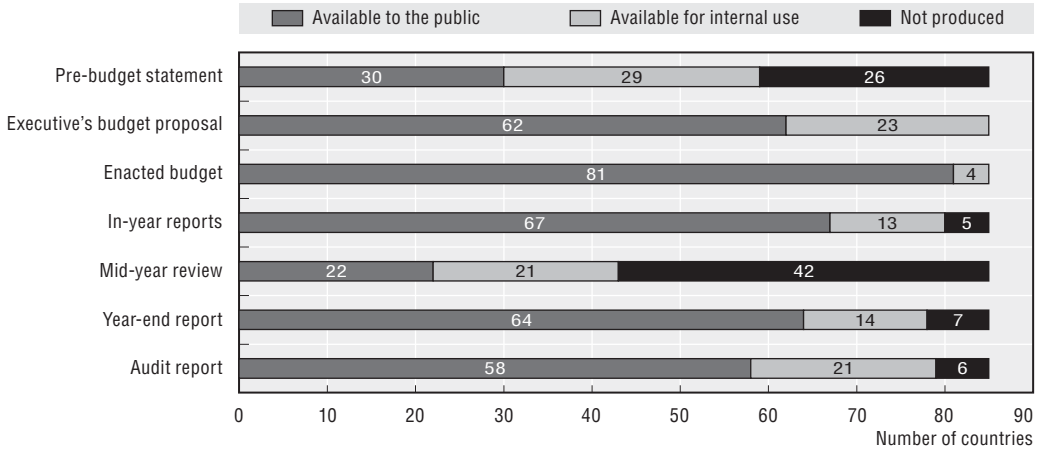
In other countries, significant improvements in budget transparency either were influenced by the activities of civil society groups or have created opportunities for greater civil society interventions. For instance, Croatia saw a 17-point improvement in its OBI score, from 42 in 2006 to 59 in 2008. This improvement is largely the result of the introduction of multi-year estimates in budget documents, including in the executive's budget proposal. This development is part of ongoing efforts within the Ministry of Finance to meet the requirements for accession to the European Union. Notably, the work of CSOs like the Institute of Public Finance (IPF), which conducted the research for Croatia in both 2006 and 2008, has shaped some of the debates around budget transparency in the country. The IPF conducted a range of advocacy efforts connected with the 2006 Survey, the presentation of which was attended by the Deputy Minister of Finance who declared that he was eager to work to improve Croatia's transparency score. The IPF also helped the ministry improve its website and worked with legislatures at the national and local levels to enhance their understanding of the budget, producing budget and tax guides and leading training workshops.

4.2. Strategies for improving civil society access to information

The examples above show that improvements in budget transparency are possible across a range of contexts. In fact, there are many ways in which governments can improve access to budget information, such as publishing information produced for internal purposes, using the Internet, publishing citizens budgets and adopting freedom of information legislation.

Survey researchers found that a significant number of governments (51 of the 85 surveyed) produce at least one budget document for internal purposes or for their donors, that they do not release to the public (see Figure 2). This fact shows that many countries could quickly and cost-effectively boost budget transparency by publishing information that they already produce.

Figure 2. **Availability of key documents**



Afghanistan provides an illustrative example. It scores only 8 out of 100 on the 2008 OBI. However, Afghanistan already produces a pre-budget statement, an executive's budget proposal, and an audit report. Were the Afghan government to release all three of these documents to the public, its OBI score would increase significantly, reflecting expanded opportunities for public engagement in Afghanistan's budget process. Sudan is another extreme case. It scores 0 on the 2008 OBI because it does not release any of the key budget documents to the public. However, Sudan actually does produce seven of the eight key budget documents covered in the Survey, although the quality and comprehensiveness of these documents may vary. Still, making these publicly available would boost Sudan's transparency considerably. The fact that so much information is produced but not made publicly available suggests that many governments choose not to be transparent, rather than not having sufficient capacity to produce and disseminate greater budget information to the public. It also suggests that donors could play a more active role in encouraging greater transparency in recipient countries.

Even when a document is "publicly available", it may not be accessible to all members of the public – that is, it may only be available on request or may require payment for obtaining a copy. Posting budget documents on the Internet could help address this problem by providing simultaneous access to multiple users at low cost. Table 3 shows that 68 of the 85 countries surveyed post the enacted budget on the Internet, but fewer post the other documents.

Table 3. **Online availability of key budget documents**

	Number of countries making the document available on line
Pre-budget statement	27
Executive's budget proposal	49
Citizens budget	13
Enacted budget	68
In-year reports	63
Mid-year review	18
Year-end report	50
Audit report	50

In many developing countries, a very limited portion of the population has access to computers and the Internet. Low incomes and low literacy levels further limit the ability of many people to access information provided on line. A citizens budget can help bridge this gap, especially if it is disseminated in languages and by means that are accessible to the majority of the population, including newspaper inserts or radio presentations in local languages. As noted above, a small but growing number of countries surveyed produce citizens budgets, including high-income countries like New Zealand and Norway, as well as low- and middle-income countries like El Salvador, Ghana and India.

Finally, the majority of the countries surveyed (55 out of 85) have codified the right to access budget information in law. However, having a law on the books does not guarantee that it will be upheld in practice. In only 13 of the 55 countries that have freedom of information laws is it generally possible in practice to get the information. For the remaining 42 countries, the right to information exists but the law does not work effectively.

5. Conclusions and recommendations

The 2008 *Open Budget Survey* paints a rather disappointing picture of the state of budget transparency around the world. In the vast majority of countries surveyed, the public does not have access to the comprehensive, timely and useful information needed to participate meaningfully in the budget process and to hold the government to account for the management of public resources. However, the Survey also offers grounds for hope. A number of countries in the Survey have started to improve their budget transparency performance over the past two years. There are good performers within each region, level of income, and level of aid or natural resource dependency. The Survey also finds that many more governments could quickly improve budget transparency at low cost, for example by making publicly available the budget information that they already produce but do not release to the public. Other actions that governments should take include:

- Disseminating budget information in ways that make it understandable and useful to the wider population, for example through the radio and in languages spoken by the majority of the population.
- Institutionalising mechanisms for public involvement in the budget process, including public hearings during budget formulation and at regular intervals throughout the budget cycle.
- Introducing relevant reforms to improve the independence and capacity of the legislature and of the supreme audit institution to play their formal oversight role.

In aid-dependent countries, donor agencies and international financial institutions (IFIs) can also play an important role in improving budget transparency, for example by requiring that governments make publicly available any budget information that governments provide to the IFIs. Other actions that donors could take include:[9]

- Increasing the transparency of aid flows and avoiding off-budget funding. This could be done by channeling aid through local budget systems. Where this is not possible, donors should provide information on aid flows in formats that are compatible with local budget systems, using government classification systems and respecting budget calendars.
- Supporting the building of effective public finance information systems that can enhance the capacity of the government to produce accurate and timely budget information.
- Increasing technical assistance and funding to civil society, legislatures and supreme audit institutions as part of a comprehensive package of efforts to improve budget accountability and oversight.

Finally, civil society organisations can also play a more active role in improving budget transparency, for example by using the 2008 Survey findings to undertake further research and to develop advocacy strategies that identify specific, constructive suggestions for governments to improve budget transparency and public participation in the budget process. Other actions that civil society organisations should take include:

- Using existing freedom of information laws to access budget information for analysis and advocacy purposes.
- Producing and disseminating simplified versions of key budget documents, ensuring wider access to budget information.

- Supporting the work of the legislature and the SAI, for example by providing training and information, acting as whistle-blowers, and conducting joint and parallel audits.
- Working with the media to enhance the quality of coverage of budget issues by providing targeted training and timely information.

Notes

1. All data collection was completed on 28 September 2007, so no events or developments occurring after that date are reflected in the Survey results.
2. In addition, 61 country governments were invited to comment on the completed questionnaire. However, only five governments took advantage of this opportunity (El Salvador, Guatemala, Norway, South Africa and Sweden).
3. See *www.openbudgetindex.org* for a more detailed explanation of the research process and methodology.
4. For additional analysis of the OBI performance of resource-dependent countries, see Heuty and Carlitz (2009).
5. One country was not classified. See Kekic (2006).
6. In a preliminary analysis carried out by a group of graduate students from the London School of Economics, income levels and the strength of democratic institutions are the two variables that appear significant in association with differences in budget transparency. See Gallego-Cuervo *et al.* (2009).
7. For example, see those produced by the governments of New Zealand (*www.treasury.govt.nz/budget/2007/execsum*); India (*www.indiabudget.nic.in/ub2007-08/keybudget.htm*); and South Africa (*www.finance.gov.za/documents/national%20budget/2007/guide.pdf*).
8. The average score for all 85 countries in the 2008 OBI is 39, much lower than the average score for the 59 countries that were also included in the 2006 OBI. This lower average score primarily reflects the very low scores of most of the 26 countries included in the 2008 OBI that were not part of the 2006 OBI. The average 2008 OBI score for the 26 new countries is 21. These countries included several of those that provide scant or no information on their budgets, such as China, Equatorial Guinea and Saudi Arabia.
9. A more comprehensive overview of recommendations for donors can be found in an IBP Budget Brief (see Ramkumar and de Renzio, 2009).

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Fixing Fair Value Accounting

by
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The concept of fair value accounting was introduced in 1993 to make financial statements easier to compare and balance sheets more reflective of real values. This article discusses the true consequences of fair value accounting and its impact on the stability of financial institutions.

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It has been almost two years since the financial crisis began, and debate about fair value accounting has only intensified. The banks and others contend that fair value accounting is responsible for their apparent weakness and instability, while accountants and investor advocates argue that the truth – the facts about the banks' assets – is the ultimate cause of their problems.

It seems to me that there are two fundamental questions that should be addressed in this debate, and neither has received sufficient attention. First: is fair value accounting, as it is currently structured, the appropriate way to present the financial reports of depository institutions such as commercial banks? I will argue that it is not, and therefore will also seek to answer the second question: how can the fair value accounting system be maintained where it still has value, while reducing the adverse effects that arise from unusual market movements?

It is impossible to do justice to something as complicated as fair value accounting in a few paragraphs, but I shall try to outline briefly the principal elements of the system that have caused most of the fuss. The foundational ideas of fair value accounting were adopted in 1993 by the United States Financial Accounting Standards Board (FASB) in "Statement of Financial Accounting Standards 115" (FAS 115). The rule is applicable only to the valuation of securities, including mortgage-backed securities and other securities backed by assets. It covers debt securities of all kinds, but not whole loans.

FAS 115 divides financial assets into three categories: those held "to maturity", those held "for trading purposes" and those "available for sale". Each of these categories is treated slightly differently. Assets held to maturity are valued at amortised cost; assets held for trading are marked to market, with unrealised gains or losses included in earnings; and assets deemed available for sale are marked to market, with unrealised gains or losses excluded from earnings but included in shareholders' equity. This treatment allows unrealised gains or losses to affect the capital of banks. It is very difficult to categorise assets as "held to maturity" because they are subject in that case to severe restrictions on sale. As a result, most financial institutions, including banks, hold these assets either in "available for sale" or "trading" categories.

When assets are held in either of these two categories, they must be marked to market – if there is a functioning, liquid market. If there is no active market, then a variety of other methods can be used for valuation. Whether an active market is present or absent is a question of judgment, and accountants will say that any market price – even one derived from a distress or liquidation sale – is one of the elements that must be used in determining asset values. Banks and other financial intermediaries argue that accountants give too much weight to these distress prices, while accountants say they are only following the FASB rules. In a report at the end of December 2008, the staff of the United States Securities and Exchange Commission (SEC) largely sided with the accountants, concluding that fair value accounting had not caused the financial problems of the banks and others, and rejecting the idea of a wholesale revision of fair value accounting.

If you think financial accounting is simply a way of recording the results of business operations, think again. Financial accounting is a highly conceptual art in which many objectives and perspectives compete for priority. In this discussion, I will distinguish between the earnings perspective and the stability perspective. If we are interested in emphasising earnings, we would choose one system of valuing assets – marking assets to market – and if we want to focus on stability, we would choose another: amortised cost. The assets are the same, of course, only the way we look at them is different. It's like the uncertainty principle in physics, which posits that it is not possible to measure both the position and the momentum of a quantum particle at the same time; the properties are there in the particle but cannot be measured simultaneously.

Because accounting cannot give us all perspectives at the same time, we have to make a choice about which perspective we want to see. With the development of the global securities markets and widespread interest in equity investment, the potential of companies to produce earnings has become the fact that is of most interest to the most people, and thus the principal focus of financial accounting. Fair value accounting is a corollary of this significant development. What the market would pay for a company's assets at a given point in time is a better indicator of whether it is adding shareholder value than simply measuring the difference between the costs of those assets and the returns they are yielding. As the FASB noted in FAS 115: "Fair value portrays the **market's estimate** of the present value of the net future cash flows of those securities, discounted to reflect both the current interest rate and the market's estimate of the risk that the cash flows will not occur" (paragraph 40; emphasis added). I will come back later to the question of whether this is actually what the market is doing in putting a value on asset-backed securities.

Since the focus of fair value accounting is on earnings, it is logical to ask whether a firm's earnings potential should be the only way to evaluate financial firms. For some business models, what they can earn may not be as important to know as their financial strength – their potential for stability or instability. Financial institutions of this kind (banks and insurance companies come to mind) might be better described by their financial reports if greater weight were placed on the elements of their makeup that signal stability or instability rather than their earning capacity. This raises the question of why fair value accounting was adopted for all financial firms and not just for those for which earnings – rather than stability – were important. Or perhaps why firms were not given a choice about how they would value their assets.

I can identify three fundamental goals of accounting that are likely to have influenced the choice of fair value accounting for all financial firms. One of these objectives is to minimise what is called management bias. Management has an obvious incentive to inflate the value of a company's assets, and many ways to do it. Marking a company's assets to market is an effective way of taking this element of financial statement manipulation out of management's hands. The tight restrictions on moving assets into or out of the held-to-maturity category are intended to enforce this objective. In addition, there is a strong element in accounting theory that favours treating similar assets in similar ways. Financial intermediaries such as banks, securities firms, finance companies, hedge funds and insurance companies all hold similar assets, and accounting theory would say that insofar as possible these assets should be given the same values irrespective of the kind of financial institution that holds them. Finally, another of financial accounting's goals is comparability – the idea that investors should be able to compare the results of companies that are competing for capital. If comparability is possible, capital will

be allocated more efficiently. If two firms hold the same assets, but value them differently, comparability is impaired. Comparability is of particular importance if the underlying goal of accounting today is to provide information about earnings potential. In that case, the differences between how companies earn their returns should be minimised.

These objectives are worthy, but they have costs – mostly not considered and unintended. One consequence that has been covered extensively in the media is the huge loss of asset values in financial firms that are holding asset-backed securities. This problem has afflicted all financial companies but has been particularly troubling for banks, which of course have demand deposits and other very short-term liabilities. Here is where emphasising earnings over stability begins to have an effect. While equity investors in banks are justifiably interested in their earnings, depositors, lenders and counterparties are not. They are interested in whether the bank is solvent and likely to be financially stable over the long term. It is difficult to see why a depositor or a credit default swap counterparty would be interested in whether a bank could sell all its assets at a given point in time for a certain value. What the depositor or counterparty wants to know is whether the bank's return on assets is sufficient to allow it to meet its obligations as they fall due under most foreseeable circumstances. The way to know whether a bank is a stable going concern is to understand the sources and quality of its cash flows, not the market value of those assets.

Fair value accounting assumes that the market can make this cash flow assessment accurately. In the statement I quoted earlier, the FASB expressed the view that "fair value portrays the **market's estimate** of the present value of the net future cash flows" on assets held by banks. How could the market know this? The answer is, it does not, and it cannot. The market does not know what the cash flows are to specific portfolios of mortgage-backed securities held by banks. Market participants might know that the cash flows are not what they should be – that the losses are greater than expected – but they cannot value these securities in any more sophisticated way.

In fact, in the current crisis it is the market's ignorance concerning the cash flows on these portfolios that has been the source of the crisis and of the losses that the banks have registered. When it became clear that there were greater losses on mortgage-backed securities than their triple-A ratings implied, the market for these and other asset-backed securities basically collapsed and has been closed for about 18 months. Liquidity in this market has disappeared. Under these circumstances, there are few buyers for these assets, not because they believe assets are "toxic" – that's the media's word – but because it is not clear that they will ultimately be able to resell the assets when necessary. What the market knows is not the value of the portfolio's discounted cash flows, but only that buying these assets creates a huge liquidity risk for the buyer.

When the banks mark to market, they follow two steps. First, they estimate the net realisable value of their portfolios of asset-backed securities. This involves discounting the cash flows on these assets. Then, under fair value accounting, they have to take a haircut on these values that takes into account the price at which they could sell the assets. When the market is not functioning, of course, this haircut is very large. This is important because it suggests that the huge decline in the value of bank assets is not due to a commensurate decline in the cash flows on the bank's portfolios of asset-backed securities – although some decline there has certainly occurred – but rather to the market's judgment about the risk of resale by a purchaser. It is this risk that – when combined with fair value accounting – has forced the writedowns in bank assets.

A hint of the true situation was contained in remarks by Vikram Pandit, the Chief Executive Officer of Citibank (Citi), in testimony before the United States Congress in February 2009. He noted that Citi marks to market and "those marks are reflected in the losses we've taken, as well as in our income statement and balance sheets". But he went on to point out that the bank has a duty to shareholders: "the duty is if it turns out [the assets] are marked so far below what our lifetime expected credit losses are" – *i.e.* their net realisable value on a discounted cash flow basis – "I can't sell [them]." In other words, the writedowns caused by fair value accounting may have driven some Citi assets below their value under discounted cash flow analysis. This will have made Citi look substantially weaker than the real value of its assets – their net realisable value – would suggest. In effect, fair value accounting has turned a liquidity problem in the asset-backed market into a solvency problem for the world's banks.

That is only one of the major unintended consequences of fair value accounting. Another may be putting banks or insurance companies – firms that are expected to be stable and prudential in their behaviour – into earnings competition with securities firms and hedge funds. It is fashionable in Washington today to refer to securities firms, hedge funds, and other financial intermediaries as part of the world of "shadow banking". This is one of those phrases that obscures more than it reveals, but one of the things it reveals is that most commentators who use the term do not really see any material difference between banks and other financial intermediaries. This, as I suggested, is also the perspective of the accounting standards that are now applicable to banks.

But banks actually are different – a difference always recognised by government policy. Banks may hold assets that are similar to those of other intermediaries, but there the difference ends. Banks are generally backed directly by governments, through deposit insurance, lender of last resort facilities, and exclusive access to the payment system. Other enterprises have none of these advantages. Bank deposits can be withdrawn or transferred on demand and, by creating credit that draws on these facilities, banks directly affect the money supply. The liabilities of other financial intermediaries do not have that unique characteristic. Because of the nature of their liabilities, banks cannot easily match the maturities of their assets and liabilities. In fact, one of their unique roles is converting short-term liabilities into longer-term assets, so that depositors can have the advantages of highly liquid assets but also returns that are closer to the yields on longer-term assets. Other intermediaries serve important purposes, but not these. In other words, banks have unique elements that seem to make their stability potential more important than their earnings potential.

Given these substantial differences, is it a sensible policy to ask banks to compete on the same financial playing field with securities firms and hedge funds? When we have created this competitive accounting environment, perhaps we should not be surprised that banks hired Wall Street traders and leveraged themselves to the hilt. There is such a thing, of course, as risk-adjusted earnings in which companies' results are judged not by their absolute amount, but by the risks they took to earn these returns. Investors, in theory, should be happy with lower returns from companies that take fewer risks. Maybe this works from the standpoint of thoughtful and prudent investors, but what is the effect on banks' managements when securities firms are producing much higher returns, and when compensation depends on matching the other guy's earnings results? Are they satisfied to tell investors – and are investors satisfied when told – that, although their bank's earnings are lower than other financial institutions, they were produced by more conservative

activity? Isn't there a temptation, since financial results are reported in the same way, to try to match those higher returns?

Banks had a head start on this goal when, as asset values climbed in the mid 2000s, fair value accounting allowed them to write up the value of their assets. The more assets they put in their trading accounts, the more risks they were taking – but the more unrealised gains from asset appreciation enhanced their bottom lines. This adds some context, and some bitter comedy, to the classic statement of Chuck Prince, the Chairman of Citibank, who famously remarked as the bubble began to slow: "As long as the music is playing, you've got to get up and dance. We're still dancing…"

So, my conclusion about fair value accounting is that it should not be applied without distinction to all financial institutions. While there is some value in uniformity of disclosure and achieving among the financial reports of financial institutions, we lose more than we gain by doing so. Even more salient is the fact that what investors want to know about commercial banks is just not as important for the success of banks – and the economies that depend on them – as what depositors, lenders and counterparties need to know. Risk takers such as securities firms and hedge funds should be judged by their returns, but banks are different and should be judged by their likelihood to remain stable in economic storms. This calls for valuing their assets in a way that focuses on their stability, not on their earnings potential.

Thus, except for assets held in trading accounts – that is, acquired or held for the purpose of sale – asset-backed and debt securities held by banks should be valued on the basis of their discounted cash flows. An alternative would be to allow banks to choose how their assets will be valued, as long as they disclose the method they have chosen and cannot move between the different methods without very good reason.

Assuming that banks are exempted – or at least have the option to choose – in what way should fair value accounting be modified in order to make it work better for those still bound by it?

First, accounting should reflect broader interests than the goals of investors and accountants. In other words, to paraphrase Clemenceau on war and generals, accounting is too important to be left to the accountants. Yes, accounting practitioners would like to make financial statements more comparable across financial institutions, and this accords with the desires of equity investors. But a more important issue, as we now know, is making sure that the financial statements of financial institutions of all kinds are not distorted by unanticipated moves in market prices. The same issue arises in connection with another accounting objective, preventing management bias. This can be accomplished by insisting woodenly on market prices, but at too heavy a cost. Earnings management is an endemic problem throughout accounting – nonfinancial firms have always managed their earnings and still do – so a fix with much broader applicability is required.

Second, fair value accounting is highly pro-cyclical. We can now see how the mark-to-market effect of fair value accounting has caused a downward slide in asset values, and how this decline has evolved into a dangerous downward spiral. But it is important to note that rising asset prices have the opposite – and equally pro-cyclical – effect. As market values rise for homes, stocks, commodities, or any item that has a readily available price, more and more credit becomes available to carry these assets. As more credit is available, more money is chasing fewer assets; prices rise and risk premiums fall.

Under fair value principles, a rise in the value of assets is recognised in earnings if the assets are held for trading, and recognised in the institution's capital or equity position if the assets are treated as available for sale. In both cases, the growing earnings and strengthening capital induce more borrowing and the acquisition of more assets, so the upward spiral – also known as a bubble – continues. Given the fact that we human beings are prone to irrational exuberance when values are rising and to irrational pessimism when they are falling, it would seem that using an accounting system that exacerbates those flaws in our nature would not be good policy. If anything, accounting – which has always been dominated by a principle of conservatism – should operate counter-cyclically, suppressing the effect on both balance sheets and income statements of rapid and substantial changes in asset values. There is nothing about fair value accounting that has this effect.

While banks, and probably insurance companies, should be exempted from fair value accounting, some way should be found to suppress the pro-cyclical effects of market prices on other financial institutions. As long as the focus on earnings is the dominant purpose of accounting, these risk-taking institutions should still be subject to fair value accounting. But some restrictions should be placed on its scope. The most fruitful way is to focus on the question of when there is actually a functioning market.

For example, we could specify that mark-to-market accounting for assets would be suspended if, during any three-week period, it reflects less than 20% or more than 150% of the dollar value of trading that was the weekly average in the preceding year. Fair value accounting would then become applicable again when trading is again at least 80% or not more than 120% of that annual index figure. Obviously, there is no magic in these numbers, but they suggest one way that pro-cyclicality could be addressed for the financial institutions to which it is still applicable.

In any event, if we retain fair value accounting in its current form after the current crisis is behind us, we will always be living on the edge of another financial abyss.

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Dynamic Scoring

by
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Dynamic scoring – taking full account of all the economic effects of policies when estimating their budgetary effects – is almost self-evidently attractive. But it is formidably difficult to achieve. This paper assesses the key conceptual and practical challenges it poses and considers the pros and cons of adopting it. The objective should be to provide more useful information while being robust to the political debate.

* Stuart Adam and Antoine Bozio are Senior Research Economists at the Institute for Fiscal Studies, London. Financial support from the ESRC Centre for the Microeconomic Analysis of Public Policy at IFS is gratefully acknowledged. The authors thank Barry Anderson, Richard Blundell, Mike Brewer, Robert Chote, Carl Emmerson, Guy Laroque, Gemma Tetlow, officials at HM Treasury and at HM Revenue and Customs, and participants at the 2009 annual meeting of the OECD Working Party of Senior Budget Officials for useful discussions and comments. Any errors and omissions are the responsibility of the authors.

1. Introduction

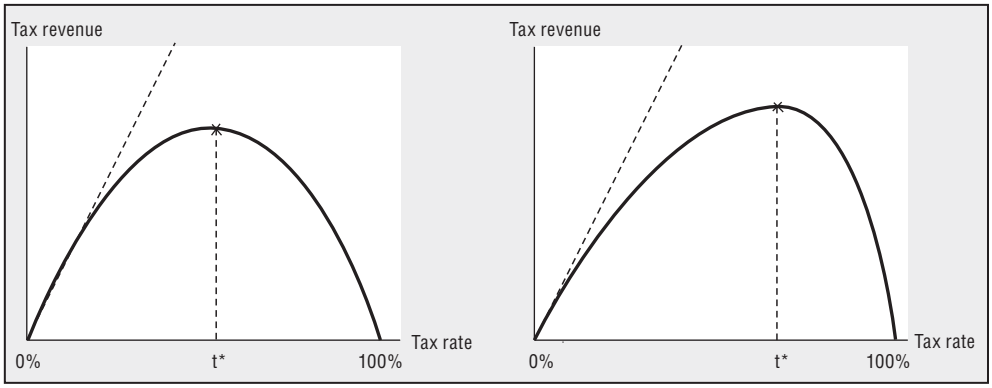
Dynamic scoring means taking full account of all the economic effects of policies when estimating their budgetary effects. Taxes and government spending have multifaceted economic effects. Individuals may respond by changing their behaviour in innumerable ways: whether they work and how hard, when they leave education, what they buy, how much they save and in what form, how much risk they take, and how they run their business, to name but a few. These responses can themselves have further economic effects, by changing supply, demand and market prices for goods and services. Reforms might also prompt a response from other policy makers. All of these affect the government's revenue and outgoings, so the full chain of consequences will determine the actual cost of tax and spending proposals.

Dynamic scoring is the attempt to estimate these full revenue and spending effects. There is little doubt that if we could come up with a perfect measure of all the effects that budget proposals have on the economy – individually or collectively – it would be desirable information for policy makers. The difficulty is that coming up with this perfect measure would require answering virtually every question, theoretical and empirical, that has ever been asked in economics. Obviously we can never have such a complete understanding of economic life. But this does not mean that any attempt to account for the economic effects of policies in the scoring process should be abandoned. Rather, the best practice to adopt must be decided by weighing advantages against disadvantages, given the current state of knowledge.

The debate about dynamic scoring started in the United States and focussed mainly on estimating the budgetary effects of tax cuts. Proponents of dynamic scoring claimed that traditional scoring techniques undermined the case for tax cuts, as the feedback effects of tax cuts, with strengthened incentives, were not taken into account. This was most famously illustrated in the form of the Laffer curve, supposedly drawn on a cocktail napkin by economist Arthur Laffer. The Laffer curve shows how revenue from a tax changes as the rate of the tax changes (Figure 1). The idea is that two points are known: if the tax rate is zero, revenue will be zero; and if the tax rate is 100% no one will undertake the taxed activity (typically thought of as work) and tax revenue will also be zero. Given that some revenue will be raised with tax rates between 0 and 100%, the Laffer curve simply states that a revenue-maximising tax rate must exist between 0 and 100%. The theory itself is unarguable as far as it goes, though it leaves open the crucial question of where the curve has its peak as well as what happens in more complicated settings, such as when behavioural responses can affect revenue from other taxes as well and when behavioural responses change over time. Moreover, it ignores the complexity of actual tax systems which consist of taxes on many different tax bases and often apply different rates of tax to different bands of income (or profits, bequests, asset values, etc.).

Proponents of dynamic scoring – often also proponents of tax cuts – argued that static scoring biased the political debate against tax cuts by presenting costs of these measures that did not represent their true (less costly) effect on the public finances. Since these early

Figure 1. **Possible Laffer curves**



debates, academics have entered the argument with a less partisan tone (*e.g.* Auerbach, 1996, 2005; Gale, 2003; Leeper and Shu-Chun, 2006; Mankiw and Weinzierl, 2006). Economists have been keen to stress that the dynamic scoring debate could not be restricted to the scoring of tax cut proposals, and that the likely economic effects were not as straightforward as the early proponents suggested (Orszag, 2002). Dynamic scoring had to be defined in a more refined way, acknowledging three main issues.

First, what should be the scope of dynamic scoring? Budget proposals encompass not only taxes but also an expenditure side which also has effects on behaviour and the economy at large. Education spending, for instance, could promote human capital accumulation and innovation and have a long-term impact on growth that could potentially make this spending self-financing in the long run. But tax and public expenditure are not the only policy instruments of a government: in principle, all laws could be subject to dynamic scoring. For instance, health and safety regulations might be costly for businesses to implement, reducing profits, employment and tax revenue. Or they might lead to a healthier and more productive workforce, with the opposite result.

Second, the language of choosing between "dynamic scoring" and "static scoring" breeds misunderstanding. The contrast between dynamic and static approaches gives the false impression that current (static) scoring techniques do not allow for any economic effects of reforms, when in fact normal practice in the United States and the United Kingdom (among others) does allow for some behavioural responses, such as shifting income between forms that are taxed differentially. The framing in terms of static *versus* dynamic also suggests that a single cost figure, chosen between these two, is the central requirement for budget policy debates. Yet some academics have suggested that, on the contrary, the focus should be more on producing dynamic analyses rather than headline numbers (Gale, 2003). These would stress the possible economic effects of policies with all the uncertainties that surround these estimates. The debate thus evolved from a dichotomous choice between static and dynamic scoring to a more subtle discussion around the proper incorporation of dynamic revenue analyses into official budget documents. Should there be an official "best guess" for each budget proposal? How should uncertainties surrounding these estimates be incorporated?

Third, we need clarity as to what the outputs of scoring – dynamic or otherwise – represent: only the budgetary impact of proposals. If people misinterpret costings – for example, treating them as measuring economic stimulus or effects on tax burden (the

welfare loss to taxpayers) – then dynamic scoring can exacerbate rather than alleviate the misperception (Auerbach, 2005). A tax cut or a spending increase that succeeds in improving economic performance represents a larger economic stimulus or reduction in the tax burden, but dynamic scoring will reduce its apparent size by taking into account the feedback in higher revenues.

In this article, we first consider the conceptual and practical difficulties that must be overcome in order to present conclusive dynamic costings of budget proposals (Section 2). Section 3 then discusses the trade-offs and institutional arrangements that can make dynamic scoring either a step forward or a step backward on the path to improved budgeting procedures. Section 4 concludes.

2. The requirements of dynamic scoring: conceptual and practical difficulties

This section describes the issues that would have to be addressed in order to provide ideal dynamic revenue estimates. From the most basic, no-response case, to the ideal full-understanding-of-the-whole-economy case, there are various barriers that the would-be dynamic scorer must overcome. Each requires considerable knowledge and understanding of the functioning of the economy. If recent advances in applied economics have transformed our understanding in some of these areas, others remain on the research agenda and some are only distant targets.

2.1. Defining the reform

The starting point for any costing must be to specify the proposal properly.

In order to score a reform, the counterfactual must first be defined: what would a "no reform" baseline look like? The revenue impact of putting a particular set of policies in place must be measured relative to some unreformed policies. But it is not always obvious what "no reform" means. For example, suppose that a government announces the level of the state pension for the forthcoming year. The cost depends on whether an unchanged level of the state pension would have been the same as the previous year's in nominal (cash) terms, or in real (inflation-adjusted) terms, or as a fraction of average earnings. There is no right answer to this question, but some baseline must be chosen and this choice can make a big difference to the reported budgetary effects of policies.

Defining a "no reform" baseline is necessary whatever scoring methodology is adopted. But in the case of dynamic scoring, it is worth paying particular attention to one aspect of it: the financing of reform.

An increase in spending or a tax cut is not a full description of a reform: it must be paid for somehow. The universal convention is that a spending increase or tax cut really means a deficit-financed spending increase or tax cut: in other words, the reform is defined relative to a counterfactual baseline in which the reform does not happen and borrowing is correspondingly lower.

But the borrowing used to finance a giveaway can have economic effects of its own. Debt must be serviced and ultimately repaid. If the economy is on the "wrong side" of the Laffer curve for the reform in question, the debt can be repaid from proceeds of higher growth. But otherwise, borrowing now means tax rises or spending cuts in future: "There is no such thing as a 'permanent' tax cut if the tax cut induces reductions in revenue" (Auerbach, 2005, p. 422).

Future tax rises might reduce economic growth just as much as present tax cuts increase it, reversing any dynamic gains. And just as taking account of their effect on economic performance might make tax cuts look cheaper, it might also make the future tax rises needed to balance the books look larger. This explains why dynamic scoring need not make deficit-financed tax cuts or spending increases any more attractive. Taking account of the economic effects of the measure may mean that a given tax cut requires less borrowing, but it also means that this reduced borrowing still needs just as large a tax rise to repay. This point is worth emphasising. Proponents and opponents of dynamic scoring alike often assume that it would facilitate tax cuts and spending increases by reducing their reported cost. But this ignores the fact that a deficit incurred today is harder to repay once one takes account of the negative economic feedback effects of future tax rises and spending cuts: the borrowing reported may be a smaller number but it ought to be no more palatable. In principle, dynamic scoring need not make deficit-financed tax cuts or spending increases as a whole more attractive; rather, it makes policies with strongly positive economic effects look more attractive relative to policies without them – as indeed they should. If in practice the adoption of dynamic scoring did create a tendency towards deficit-financed tax cuts and spending increases, it would be not an inherent feature of dynamic scoring, but a result of the failure to acknowledge financing as an integral part of any reform, and so the failure to apply symmetric logic to that side of the ledger.

More subtly, the awareness of extra debt and the expectation that it will need to be repaid may affect how people respond to the overall deficit-financed giveaway. The government is not just proposing an immediate tax cut or spending increase; it is also implicitly proposing a future tax rise or spending cut, to which people might respond today in anticipation. In Section 2.4, we return to the issue of how expectations can influence people's current behaviour.

Once the "no reform" baseline is defined, there is a simpler sense in which the proposal to be scored (dynamically or otherwise) must be specified: is the objective to provide an overall costing for a whole raft of measures contained in (say) an annual budget, or to provide costings for each individual measure separately? In the latter case, it must further be specified what constitutes an individual measure. This is not always obvious: for example, is a proposal for a one percentage point increase in main and higher rates of income tax a single reform, or is the increase in each rate a separate measure? Is building three new roads and a railway line one measure, two measures or four measures?

If costings are provided separately for different measures within an overall package, careful attention must be paid to potential interactions between the different measures. For example, suppose a government proposes both to increase the rate of income tax and to reduce the threshold above which tax is charged. This pair of measures will typically raise more revenue than the sum of what each would raise alone: a rise in income tax will raise more if it applies to a wider band of income, or (equivalently) widening the income band will raise more if the tax on the extra income brought into tax is charged at a higher rate. These interactions become more complex the more economic effects of the reforms are incorporated, but they are present even in simple cases.

How should such interactions be treated? One possibility is to score each measure as if it were the only one being introduced; another is to score each measure as if all others were already in place. These approaches have the advantage of being consistent between measures; but they have the disadvantage that adding up the costs of each measure will

not yield the cost of the package as a whole, because the interaction term – in the example above, the difference between old and new tax rates on the extra income brought into tax – will be counted twice (if the scoring assumes all other measures in place) or not at all (if the scoring assumes no other measures in place).

A third possibility, which does make the total budgetary effect of the package equal to the sum of its constituent parts, is to score the measures one at a time. For example, United Kingdom budgets list the measures proposed in some (essentially arbitrary) order, and score each measure on the assumption that the ones higher up the list are in place and those lower down are not.[1] However, the problem with this approach is that it is not consistent between measures: someone looking to see whether the tax rate increase or the threshold reduction raises more revenue might get a different answer depending on the order in which the government decided to list them. There is no perfect solution to the treatment of interactions, but it raises a question for those who produce costings and invites caution in those who interpret them.

2.2. The "mechanical" effects of policies

The simplest budgetary effects of policies are those that arise before allowing for any economic response at all to the policies: if a tax rate doubles, revenue doubles; if the government buys twice the number of widgets, widget spending doubles. We call this the "mechanical" effect of policy on the budgetary position; its defining feature is that all behaviour is assumed to be unaffected by the policy.

It is often straightforward to estimate the mechanical effects of policies. The mechanical cost of reducing a tax rate from 40% to 30% on an unchanged base is simply a quarter of the baseline revenue; to estimate the mechanical cost of exempting an income source, commodity or business sector that is currently taxed, we can simply look at the revenue currently collected from taxing that income source, commodity or sector.

Even mechanical costs are not always so easy to calculate, however. When broadening a tax base or introducing a new tax, the size of the base to be taxed is not always known. This has been starkly demonstrated in the United Kingdom in the context of proposals in 2007 to tax non-domiciled residents on income earned (and kept) abroad. Such income was not previously taxed, and foreign domiciliaries were not obliged to report it, so no one knew how much foreign income they had. Costing the different parties' proposals for taxing it was therefore largely guesswork even before trying to assess the likely responses in terms of tax planning, migration, work effort and evasion, let alone any knock-on effects of these on the wider economy. Government and opposition costing of the same policies differed by a factor of about seven.[2]

On the spending side, similarly, the mechanical budgetary effects of stopping existing activities or changing the salaries of existing employees are often straightforward to estimate but the cost of new activities is not always known: the inputs needed to provide proposed services, or the cost of procuring those inputs, may not be known with certainty in advance.

Aside from limitations on data availability, however, there is a more fundamental difficulty with estimating the mechanical effects of policies: in some contexts, the very idea of no change in behaviour is incoherent. If households experience a tax cut, the increase in their real disposable income must, by definition, be either spent or saved. To assume that both spending and saving are unchanged is not merely implausible, it is nonsensical. But if the increase in disposable income is spent, the government might levy

VAT on the purchases; if it is saved, the government might levy income tax on the interest. In this particular case, one could avoid dealing with these consequential effects on other taxes by assuming that the extra disposable income is saved in an untaxed form, *e.g.* stuffed under a mattress. However, this seems rather casuistic – it would be hard to argue as a matter of principle that saving behaviour is unchanged – and even this "solution" is not always available: if a tax on share transactions were cut, then (even without any effect on the number of share transactions, etc.) companies trading shares would have money "left over" and their taxable profits would be higher, so the government would recoup some of the revenue from the tax cut in higher corporate income tax receipts. There is no corporate-level equivalent here to stuffing income under the mattress.

The principal reason to look beyond the mechanical effects of taxes is simpler, however: the assumption of no behavioural response is just unrealistic. To score policies as if the Laffer curves of Figure 1 were only straight lines would not give a true impression of their budgetary impact. Taxes do affect behaviour. The nature and magnitude of the economic effects of taxation can be debated, but such effects certainly exist and in some cases they can be large.

2.3. First-round behavioural responses

The first step away from purely mechanical scoring is to account for the incentives that policies create. The most familiar example is an increase in income tax inducing people to work less, thereby reducing their taxable income and offsetting the mechanical revenue increase from the tax rise.[3]

However, the array of possible responses to tax and spending policies is bewildering. Even restricting attention to the channels through which income tax can affect people's taxable income, we can think not only of how many hours per year they work, but also, for example:

- how much effort they put into earning commissions/bonuses, achieving promotion, etc.;
- whether they choose a better-paid (but perhaps less enjoyable) job;
- whether and how soon they return to work after having children;
- when they retire;
- how much current income they sacrifice in order to undertake education and training and increase their future earnings;
- how much of their remuneration is simple salary and how much is in the form of (possibly tax-privileged) fringe benefits;
- how much they save and in what form (pensions, housing, bank accounts and shares may all be taxed differently);
- whether they set up a business, or take more risks with their business, or change the legal form of their business so that it is subject to corporate instead of personal income tax, or change how much they pay themselves in salary, how much in dividends, and how much they retain in the company;
- how much time and money they invest in tax planning and avoidance;
- how much income they illegally hide from the tax authorities;
- in which country they live.

The list could be much longer, and corresponding lists could be drawn up for almost any change to tax policy and most changes to spending policy as well. If university tuition fees increased, for example, it might affect how many people went to university, how much they borrowed, whether they worked part-time while studying, and so on. Estimating the size of these multifarious responses has long been a central focus of empirical microeconomic research, and the profession has made big strides in recent years, aided by a massive rise in computing power which (along with advances in econometric methodology) has made statistical analysis of large datasets dramatically easier and more productive.

The task of estimating the revenue effects of policy changes has also been helped by the realisation that it is not always necessary to estimate each of these behavioural responses separately. The "new tax responsiveness" literature emphasises that one can capture all of the effects listed above by estimating a single parameter – the overall responsiveness of taxable income, or "taxable income elasticity" – without needing to know how much of the change in taxable income is driven by hours of work, how much by tax avoidance, how much by migration, etc.[4] Taxable income elasticities are not informative about the underlying nature of the economy, but they capture all the information needed to estimate the effect of a tax change on the revenue from the tax in question. Taxable income elasticities are what are implicitly encapsulated in the Laffer curve: the shape of the Laffer curve simply reflects how the size of the tax base (and therefore revenue) changes as the tax rate changes, irrespective of exactly what aspect of behaviour is causing this change in the tax base.

For some purposes, however, a single taxable income elasticity is not enough. Some of the responses listed above will affect only income tax revenue; others will also affect revenue from corporate income taxes, social security contributions, indirect taxes, etc. So to estimate the effect on all revenues – not just revenues from the tax changed – would require a more disaggregated exercise. Similarly, some of these responses will themselves have significant economic effects with further revenue implications (discussed below); others merely reclassify income and will not.[5]

Furthermore, the use of taxable income elasticities does nothing to address the many other difficulties in estimating even first-round behavioural responses to policy reforms.

First, and most importantly, taxable income elasticities address the multi-dimensionality of responses to reforms; they do nothing to address the multi-dimensionality of reforms themselves. Most reforms do not simply change a tax rate that has been changed many times before, or replicate a previous spending item; they adjust the tax base in a complicated and obscure way, or introduce a reform affecting only some groups of the population, or spend money in a new and slightly different way. One would therefore need to have a tax base elasticity in respect of each of these features of policy, not just an elasticity with respect to the tax rate. The effect on behaviour of changing detailed provisions is rarely studied; little is known about the effects of changing even headline rates of most smaller taxes (estate taxes or transaction taxes, for example); and much less is known about responses to government spending programmes than about tax programmes. Indeed, the taxable income elasticity approach has rarely been applied beyond personal income tax at all.

Second, responses vary enormously across the population. Every individual is different, and some groups are (on average) systematically different from others. The labour supply of mothers is much more responsive to taxation than that of working-age

men without children; and even amongst mothers, those with a young child are much less responsive than those with only older children. Responsiveness is often estimated only for a particular group affected by a particular change, and these estimates may not be applicable to a policy applied to a different group.

Third, many important responses have long-term rather than short-term effects on revenues. In general, long-run responses are larger than short-run responses because they give more time for responses to occur and time for more kinds of responses to emerge. Some people might change their work patterns or form of remuneration quickly, but others will only do so slowly. Some changes will consist not of the same people changing their behaviour over time but of later cohorts behaving differently from earlier cohorts. And some responses (such as choices over education, occupation and pension saving) will naturally have effects on revenue several years or even decades later. Long-run responses can be just as important as short-run responses, but they are:

- harder to estimate, since they can only be seen much later and often require following the same people over a long period (during which the people may experience many other changes that must be disentangled);
- a less reliable guide to scoring current policies, since recent estimates necessarily relate to changes made in the more distant (and hence less comparable) past;
- harder to incorporate into deliberation, since scoring tends to use a relatively short horizon, and it is difficult to know how to value effects on revenue in the far future.

A moment's thought about how to estimate the revenue effects of a change in the minimum legal age for smoking or drinking alcohol (or of a change in their tax treatment, or of an information/advertising campaign) brings these problems into focus. Estimating the immediate impact on revenue from alcohol and tobacco taxes would be difficult enough; incorporating the eventual impact on state healthcare and pension costs would be a monumental task, but these would surely be major fiscal consequences of the proposal.

More prosaically, a cut in capital gains tax often leads to a sharp increase in taxable capital gains in the short run through increased realisations (asset sales), strongly offsetting the mechanical loss of revenue. Usually, though, this effect dies down after one or two years. The effects of the tax cut on more fundamental behaviour like risk-taking, choosing investment levels and deciding to start a business take longer to materialise and are much less well measured. But it would be misleading to assume that realization elasticities capture all the effects of the reforms.

Fourth, even where the responsiveness of behaviour or tax bases has been most studied, there remain considerable dispute and uncertainty surrounding it. All empirical estimates rely on untestable assumptions, and not all studies yield the same results, so there is always room for uncertainty and disagreement about the "true" answer. For example, recent surveys of the empirical literature on labour supply (Blundell and MaCurdy, 1999; Blundell *et al.*, 2007; Meghir and Phillips, forthcoming) suggest that the economics profession is much closer to a consensus than twenty years ago but that there is still considerable variation in estimates. And in other well studied areas, such as the impact of taxing the return to saving, opinion is much more divided (Poterba *et al.*, 1996; Engen *et al.,* 1996; Attanasio and Wakefield, forthcoming).

Finally, on the rare occasions when it is widely agreed how responsive a group of people has been to changes in a particular policy lever in the past, it does not follow that the same group will respond in the same way in future. The effect of increasing a tax rate

from 50% to 60% may be different from increasing it from 20% to 30% (or from 20% to 24%, the same proportional increase in tax rate; or from 20% to 36%, the same proportional reduction in net income). Even an increase from 50% to 60% might have different effects at different times: behaviour changes, and (more importantly) circumstances and the structure of the economy change. More specifically:

- The way people respond can change: for example, Blau and Kahn (2007) present evidence that married women's labour supply has become less responsive over time, perhaps as gender roles have evolved. This makes it difficult to predict future responses based on past data.
- People might respond differently to reforms depending on the macroeconomic context. Estimates made in a boom might not be good predictors of the response to a similar reform in a recession.
- Responsiveness to one policy lever depends on the other policies in place. For example, the degree to which people can respond to tax rises by shifting their income (or expenditure) into tax-privileged forms depends on how many such allowances and reliefs are in place. Recent literature has emphasised the availability of such opportunities as a key factor explaining differences in estimated taxable income elasticities over time and across countries.

As an illustration of some of these issues, Goolsbee (1999) applied a consistent methodology to several United States tax reforms. The reforms were quite different, and the policy and economic contexts in which they were introduced were also very different; correspondingly, Goolsbee found very different taxable income elasticities in the different cases.

Incorporating first-round economic effects accurately in the scoring of proposals, then, is a formidable challenge. In some areas, empirical economic research has risen admirably to this challenge, generating estimates that are much more credible and robust than those available twenty or thirty years ago. But the degree of understanding of these behavioural effects is still very variable, with likely responses to some policies much better understood than others. And first-round behavioural responses are far from the only economic effects of policies.

2.4. General equilibrium and macroeconomic effects

First-round behavioural responses capture the direct response of an individual (or firm) to the incentives created by a policy change. But if many people change their behaviour, the result may not just be the sum of their individual responses; they can collectively have an effect on the wider economy, with further budgetary implications. The following subsections introduce some of the key concepts for understanding these wider economic effects and the difficulties they pose for scoring, without trying to draw them into an overarching theoretical framework.

2.4.1. Second-round effects and general equilibrium

The first-round behavioural responses to policies can themselves have further (second-round) effects by changing market prices for goods and services, wages, interest rates and so on. If a policy induces a change in supply or demand for a particular product, the price of that product will change, feeding back into further changes in supply and demand. Furthermore, since different sectors of the economy are linked, supply, demand and price for other products will also change; and these will in turn feed through into

further knock-on effects. The successive knock-on effects work their way through the economy, leading to a new "general equilibrium" state of the economy. All of these knock-on effects have budgetary implications for the government. The overall fiscal position depends on how the reform affects the full range of activity in the economy: the general equilibrium impact of the reform.

To see how general equilibrium effects might alter the costing of a policy, we return to the example of an income tax cut and suppose that the first-round effect is to increase hours of work. The equilibrium in the labour market might be affected in several ways. First, the increase in labour supply might lead to a decrease in wages which will counteract the positive impact of the tax cut. This potential decrease in wages might lead to an increase in taxable profits and an increase in firms' labour demand which will lead to a new equilibrium in these markets which can be quite different from the simple first-round effect which assumes everything else constant. All of these changes will affect tax revenues.

Understanding these general equilibrium effects is particularly difficult, as one needs to know not just one taxable income elasticity or a set of elasticities, but the full structure of the economy and how all parts respond to changes in all other parts. Economists have developed general equilibrium models of economies, starting with Harberger's 1962 study of corporate income taxes and becoming much more sophisticated in recent years. General equilibrium modelling is complex and difficult; but studies in different contexts have repeatedly highlighted how different the effects of policies can be when multiple-round effects are taken into account: see, for example, Fullerton and Rogers (1993). This study also stresses how uncertain the second-round effects tend to become, as they depend on the interactions between many different hard-to-estimate parameters.

2.4.2. Aggregate demand: crowding out and multipliers

If households receive tax cuts, they will spend some of it and save some of it. But the amount they spend is additional income for the firms that sell them the goods, and the firms might hire extra employees to produce the extra goods and might buy more inputs from their suppliers. The firm's owners, employees and suppliers might all spend part of their extra income, generating yet more demand for other firms. And so it goes on, with extra tax collected at each stage of the process too: the extra goods sold are subject to VAT, the extra income is subject to income tax, the extra profits are subject to corporation tax. This effect does not get infinitely large: at each stage some of the income is saved rather than spent, so the additional boosts to demand get successively smaller further down the chain. And the effect on domestic output is further limited, as some of the demand is for imports, boosting foreign rather than domestic output. Nevertheless, the boost to aggregate demand and GDP can potentially be much larger than the initial giveaway: an effect known as the multiplier, which is a crucial component of Keynesian economics.

Multipliers also apply to public spending. Transfers obviously have a similar effect to tax cuts, and increases in public sector salaries can be traced through in much the same way. If the government buys more widgets, it immediately recoups any VAT charged on the widgets and income tax on the extra incomes of widget producers, and increased demand for widgets will feed through into increased demand elsewhere in the economy – again with a slice of tax taken at each stage.

In principle, each policy can have a different multiplier attached, as different people will tend to save (or import) different proportions of increased income, and different parts

of the economy fit together in different ways. And for revenue purposes, not all of the additional income and spending will be taxed at the same rates.

However, not all stimulus to demand will be equally effective. Consider the case of the government buying more widgets. If the widget makers and their tools would otherwise have been idle, there is a genuine boost to demand, output and revenue. But if the resources (including people) used to make widgets for the government would otherwise have been productively employed making something else in the private sector, then the income tax on what they earned and the VAT on what they produced would have been received anyway; widget makers' spending elsewhere in the economy would have happened anyway; and there is no overall addition to output and revenue. The public sector is merely "crowding out" other (private sector) activity rather than adding to it.

The extent of crowding out and the size of multipliers will depend, amongst other things, on the state of the economy and on expectations.

2.4.3. Inflation and the state of the economy

If the economy is operating well below its full capacity, as in a recession, fiscal stimulus can bring idle resources into use and increase output. But if the economy is already operating at full capacity, a stimulus to aggregate demand is likely to be relatively ineffective, as there is little scope to produce more. Instead, the main effect of increased demand for the same quantity of goods will be to raise their prices: inflation.

Thus the effectiveness – and implications for revenue – of fiscal stimulus policies of the kind currently being adopted around the world will be very different in a recession from in a boom. And every recession is different, making forecasting all the more difficult.

2.4.4. The effects of economic openness

The general equilibrium and macroeconomic implications of policies are rather different for small countries in the context of a high degree of international mobility of goods, capital and people. To the extent that prices of mobile products and factors of production are determined in integrated global markets, they may be little affected by the policies of a single small country, in which case general equilibrium effects are less of an issue (though the international movements that help to equalise prices across countries also add an extra dimension to first-round behavioural responses). And in a truly frictionless world, almost all of a small country's purchases would be imported and almost all of its output exported, so that stimulus to domestic aggregate demand would have a negligible impact on domestic production.

Of course, some countries (notably the United States) may be large enough that their domestic policies significantly affect world prices. More importantly, despite the trend towards globalisation, the world is still far from frictionless – and in some areas, barriers to mobility can be very large indeed. Financial capital moves across borders more easily than workers can; consumer electronics can be imported and exported more easily than haircuts.

Thus, in some cases globalised markets may make the general equilibrium and macroeconomic consequences of policies a less important obstacle to dynamic scoring (though first-round behavioural responses may be correspondingly more important), but the importance of the international context will vary greatly between policies and will require careful judgment.

2.4.5. *Expectations*

People's behaviour depends a great deal on what they expect to happen in future.

Perhaps the simplest and most powerful illustration of the effect of expectations concerns how much of a giveaway people spend and how much they save. We noted in Section 2.1 that the full description of a reform includes the change in government borrowing needed to finance the measure. Government debt must be serviced and eventually repaid; meeting these costs implies raising taxes or cutting spending in future to finance today's giveaway. Of course, the future tax rises or spending cuts will have economic effects in future just like those discussed so far; but the expectation of those future measures can also have an impact today. If people anticipate a future tightening, they might save some of today's giveaway in preparation for having to pay these higher future taxes (or compensate for lower future government spending). In the extreme case, 100% of the giveaway might be saved, so that fiscal tightening or loosening has no effect at all on GDP (a situation known as "Ricardian equivalence"). In practice, full Ricardian equivalence is unlikely to prevail, but certainly a partial effect along those lines is to be expected, and its magnitude is important for understanding the economic (and therefore revenue) effects of policies. As in so many cases, the magnitude of this effect might depend on the measure introduced and the circumstances. But how foresighted people are, and what future measures today's announcements lead them to expect, are other critical determinants of the revenue effects of policies.

Ricardian equivalence is just one example of the importance of expectations. Expectations of inflation and other aspects of economic performance also matter; and in general, the choice of what to assume about how people's expectations are formed can have a significant impact on what predictions for the economic effects of government policies emerge from macroeconomic models (Page, 2005).

2.4.6. *Reactions of other policy makers*

The economic effects of policy makers' tax and spending choices do not depend only on the reactions of individuals and firms; they also depend on the reactions of other policy makers. The most important player here is the monetary authorities, who adapt their policy in response to the fiscal measures announced by the government – perhaps to reinforce the effects of the fiscal policy or (more typically) to offset its effects on aggregate demand and inflation. Monetary policy, like fiscal policy, affects households' spending decisions, firms' investment decisions and, ultimately, revenue. As with expectations, macroeconomic forecasts (and therefore revenue forecasts) are sensitive to what is assumed about how monetary policy responds to fiscal policy.

Other policy makers' reactions can also matter: foreign governments, sub-national and supra-national governments and international organisations might all respond to a policy reform in a way that accentuates or offsets its budgetary impact. This has been seen, for example, in successive cuts in statutory corporate income tax rates, with each country responding to neighbours' tax rate reductions. The success of a country's tax rate cuts in attracting mobile corporate profits and increasing revenue depends on whether others follow suit. Anyone attempting dynamic scoring must consider what to assume about others' responses to the reform.

2.4.7. The dangers of extrapolation

As with the estimates of individuals' responsiveness discussed in the previous subsection, characteristics of a whole economy estimated using past data may not be replicated in a different context. Most of the dynamic scoring debate has focused on the United States. But the United States has been the subject of vastly more empirical economic research than any other country. Estimates of the effects of tax reforms in the United States cannot simply be extrapolated to other countries, both because household and firm behaviour may respond differently and because changes in behaviour may have different macroeconomic consequences (Myles, 2009). Predicting the economic effects of tax reforms in other countries involves much more tenuous assumptions and guesswork than it does in the United States. Similarly, estimates made at a particular time will not necessarily be applicable at other times. This is particularly pertinent during the current economic downturn: policies might have a different impact during a recession from at other times. Indeed, reforms are often introduced precisely because they are particularly suitable for the particular time in question.

A more extreme version of this problem questions whether it is actually possible to construct a properly specified macroeconomic model. The "Lucas critique" (Lucas, 1976, 1990) is that any policy change modifies the parameters of macroeconomic models so that it is inherently impossible to incorporate all possible policies: it is impossible to have appropriate empirical estimates of the effects of policies for each particular context, as either they have never been tried or the macroeconomic conditions would be different.

2.4.8. The integration of microeconomic and macroeconomic approaches

At present, microeconomic and macroeconomic models are only weakly integrated. Microeconomic models can be used to examine the detailed effects of carefully defined policies on individual and firm behaviour, but macroeconomic models are simply not detailed enough to incorporate these subtleties. Macroeconomic models incorporate feedback effects that microeconomic models neglect; but they deal in high-level variables such as investment and exports, without readily distinguishing between forms of investment subject to different depreciation regimes for tax purposes, for example, or yielding separate retail spending forecasts for differently taxed goods.[6] Insofar as micro- and macroeconomic analyses are brought together, they tend to involve judgment and *ad hoc*, "off-model" estimates and adjustments. The micro foundation of modern macroeconomics largely relies on the behaviour of a representative person and falls short of the richness of empirical microeconomic research. Linking microeconomic and macroeconomic models in an articulate way is still very much on the research agenda.

2.4.9. Level effects and growth effects

It is worth emphasising one feature that macroeconomic models do bring out clearly but that tends to be almost entirely overlooked in the day-to-day policy debate. There is a big difference between *a)* policies that temporarily increase the level of economic output, *b)* policies that permanently increase the level of output (temporarily increase the growth rate), and *c)* policies that permanently increase the growth rate:

a) might leave output higher than without the policy in (say) two years' time, but no higher in (say) 10, 20 and 30 years' time;

b) might leave output higher in two years' time, higher still in 10 years' time, and the same amount higher than in the absence of the policy forever after;

c) might leave output higher in two years' time, and over the decades the difference in output would get ever larger.

Whether a policy achieves *a)*, *b)* or *c)* is usually far more important than the magnitude of the effect on GDP in a single year, but it is the estimates of magnitude that attract most of the attention and often it is not even clear which of *a)*, *b)* and *c)* the results for a particular year represent. Even macroeconomic models with ten-year horizons or longer might barely register the difference between *b)* and *c)* in their tenth-year GDP forecasts. In some areas such as education, R&D and climate change policy, the important impacts on GDP (and thus the important feedbacks to revenue) can be many decades away.

Macroeconomic models can diverge radically on whether certain types of policy have a temporary or permanent effect on output and on growth. As an illustration, Cogan *et al.* (2009) compare the predictions of two different macroeconomic models for the impact on GDP of a permanent increase in government purchases.[7] The two models predict similar short-run impacts but thereafter the models diverge dramatically, with one predicting that this impact will dissipate completely within five years while the other predicts that it will continue throughout the forecast period. The paper was written in the context of the debate on a United States fiscal stimulus, and in such circumstances the policy debate might well focus almost exclusively on the effect of a stimulus in the first year or two of the policy. But in broader terms it would be hard to argue that the question of its likely impact over the following five years is less important for the merits of the policy.

Even where models agree on both the short-term and the long-term effects of policy, they often struggle to show how long the transition between them takes. There has been a debate in France concerning what effect the forecast increase in pensioner numbers will have on unemployment and the budgetary position. Most macroeconomic models forecast a sharp substitution in the labour force from retirees to unemployed in the short term, leading to a predicted decline in unemployment as the population ages and an ever higher fraction is retired (Ouvrard and Rathelot, 2006). On the other hand, in the long run an increased share of the population being retired is a reduction in labour supply that will reduce growth and weaken the public finances. The key question, on which only meagre evidence exists, is what the timing of these adjustments is.

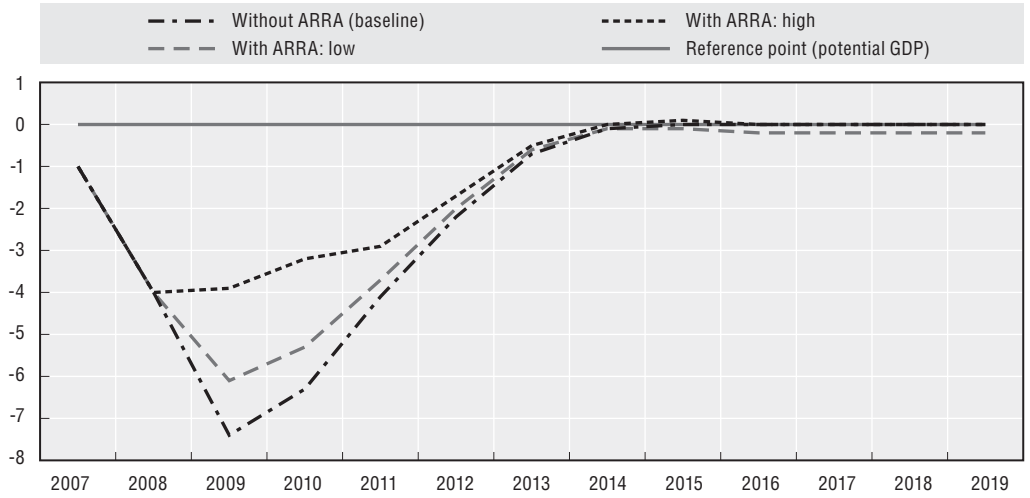
2.4.10. Choosing assumptions and models

In this subsection, we have introduced a raft of possible channels for economic feedback effects on revenues, highlighting the range of questions to which answers must be either estimated (with difficulty) or assumed in order to implement dynamic scoring. The example cited above points to the big difference that just the choice of macroeconomic model can make. The United States Congressional Budget Office (CBO) recently illustrated this more broadly, by estimating the impact of the recent United States stimulus package on GDP twice, once under a set of plausible-but-positive assumptions (covering many of the issues raised above) and again under a set of plausible-but-conservative assumptions. The results, shown in Figure 2, highlight both the importance of allowing for the economic effects of policies and the difficulty of doing so with any confidence.[8]

Given such disparities between the outputs from different models and assumptions, what is the best way forward? The most appealing approach in principle may be the

Figure 2. **Difference between potential GDP in the CBO baseline and actual GDP without and with the impact of the American Recovery and Reinvestment Act (ARRA) of 2009**

Percentage difference in the fourth quarter of each year



Note: The CBO January 2009 baseline projection of potential gross domestic product (GDP) is set as a reference point. The projection of actual GDP without the effects of the American Recovery and Reinvestment Act of 2009 (ARRA) is the CBO January 2009 estimate, as presented in *The Budget and Economic Outlook: Fiscal Years 2009-2019*. The projections of actual GDP with the effects of ARRA incorporated (the high and low estimates) reflect a range of assumptions.

Source: CBO (2009), "Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009", Letter from D. Elmendorf, CBO Director, to the Honorable Charles E. Grassley, Senate Committee on Finance, 2 March, CBO, Washington DC.

suggestion of Mauskopf and Reifschneider (1997): using several models and taking a weighted average of their results, with the weights reflecting some measure of their past forecasting success. But this is very demanding in terms of data and resource requirements.

3. Should dynamic scoring be used? Choices and trade-offs

The previous section outlined the formidable difficulties entailed in attempting to implement dynamic scoring accurately and highlighted how much is still unknown. However, the fact that dynamic scoring cannot be done perfectly does not imply that it should not be attempted. The choice, as ever, is between imperfect alternatives. If concerns about the difficulty of dynamic scoring were taken to be overwhelmingly compelling, it would imply not only that dynamic scoring should not be pursued, but that scoring should be purely mechanical – and even that would sometimes be problematic. Anything other than mechanical scoring involves accepting that a best guess at an ambitious question is at least sometimes preferable to a certain answer to a less interesting question, and that is not an unreasonable view. Although purely mechanical scoring is often used, both by governments and by independent analysts, it is certainly not standard practice to restrict attention to purely mechanical effects for official budgetary scoring.

To begin considering the pros and cons of dynamic scoring, it is helpful to remind oneself of the purpose of the process. The goal is to provide policy makers, other interested users and the public at large with clear and credible information about policy choices within time and cost constraints. This section explores in turn what might be conducive to credibility, clarity and practicality. But we should first clarify the question that is being addressed: what decisions face those who design the process?

3.1. Clarifying the question

3.1.1. Scoring versus forecasting

The subject of this article is estimating the budgetary impact of policy reform proposals. This should be distinguished from the related but different issue of forecasting revenues: forecasting the budgetary position is not the same as estimating the effect of reforms on the budgetary position. It is not essential for these two processes to include and exclude the same kinds of economic effects. Indeed, in practice they often do not.

In the United Kingdom, for example, official budget scoring of policies excludes most major economic effects of the reforms, merely including some (but not all) first-round behavioural responses. Thus it incorporates, for example, shifting of income or spending between differently taxed forms, but does not allow for any effect on overall levels of income or spending of the kind that would be caused by a labour supply response or a fiscal stimulus. In contrast, forecasts of the revenue raised from each tax and the amount spent in each area are intended to be genuine "best estimates" – in principle including all of the economic effects of policies discussed in the previous section. Whether in practice individual reforms do alter the Treasury's economic forecast (and therefore revenue forecasts) is likely to vary on a case-by case basis: the fiscal stimulus announced in the November 2008 Pre-Budget Report was reflected in GDP and revenue forecasts[9] but it seems doubtful that the macroeconomic forecasts are adjusted individually for every small policy announcement. However, treating reforms as having a negligible economic impact in practice is different from excluding them as a deliberate methodology.

The effect of this approach is that the United Kingdom Treasury implicitly answers many of the questions in the previous section: in adjusting (or failing to adjust) its revenue and spending forecasts in the light of changed policies, it takes an implicit view of the economic effects of the combined budget policies and of how these translate into budgetary effects. But by scoring the policies without allowing for most of these economic effects, the Treasury declines to separate out the effect of the budget policies from other influences on the economy, revenues and spending.

Revenue forecasts change from year to year, partly because of policy reforms but partly because of unrelated changes in the macroeconomic outlook and other factors. At present, all changes to revenue forecasts except the mechanical and shifting effects of policy announcements are lumped together as "forecasting adjustments" – the economic impact of policy reforms (beyond those allowed for in the scoring) are not separated out from other changes in the macroeconomic outlook, etc., and there is no indication of how much of the revision to revenue forecasts is attributable to policy reforms.

In the United Kingdom context, the question is not whether the overall effects of policy reforms on revenues should be allowed for in revenue forecasts – they already are – but whether they should be accounted for separately and attributed to the policies under consideration. This question has been brought into sharp relief by the announcement in the 2009 budget that a 50% top rate of income tax is to be introduced. The official scoring of this policy allowed for shifting and other responses (captured in a taxable income elasticity) to erode most of the mechanical revenue yield of the policy; but since it held total spending constant, it did not allow for further erosion through affected individuals' spending less and delivering less indirect tax revenue. The overall revenue forecast did (at least in principle) allow for this, so the omission of indirect tax effects from the scoring need not have meant that the estimation of total revenues was biased; but since any

reduction in the yield of indirect taxes was not attributed to the introduction of the 50% tax rate, the impression given of how much revenue was being generated by this tax increase for high earners was arguably misleading. The question at hand is whether any alternative approach to scoring would yield a less unsatisfactory outcome.

Current practice in the United States is similar, though not quite identical (CBO, 1995; Auerbach, 1996), and therefore the question for policy is similar there. Clearly policy makers are willing to speculate on the best assumptions to make and models to use in order to forecast what overall revenues will be in future under policies that have not yet been implemented. But it would undoubtedly be a braver decision to attempt to specify exactly what feedback effects are associated with each individual reform.

3.1.2. Individual measures versus packages of measures

With this in mind, recall that (as noted in Section 2.1) one can think of allowing for the economic effects of policies either when scoring each individual component of a budget or when scoring the budget package as a whole. One possible approach, then, would be not to adopt full dynamic scoring of each proposal in a budget, but to adopt it for the package as a whole, thus reducing the degree of precise disaggregation involved while still giving a scoring for the budget package as a whole that incorporates all economic effects. In the United Kingdom context (again, the United States is similar), this would essentially mean breaking down the overall "forecasting changes" reported in each budget into "forecasting changes as a result of changed policy" and "other forecasting changes".

3.1.3. What effects should be incorporated?

As noted in the introduction, presenting the issue as a binary choice between static and dynamic scoring is misleading. Clearly the two extreme options are "purely mechanical scoring" and "fully dynamic scoring". But in between there is a whole range of options as to what effects are incorporated and what is assumed to be unchanged by policy.

The split could be (as at present in the United Kingdom and the United States) to hold key aggregates fixed and allow for behavioural changes conditional on those aggregates – though even then the choice of what to hold fixed could be reviewed; or a split could be attempted between, say, first-round and other responses, supply-side and demand-side responses, or microeconomic and macroeconomic responses. All such splits are to some extent arbitrary and potentially confusing, making them rather unsatisfactory (albeit some more unsatisfactory than others, perhaps). But, as should be clear by now, purely mechanical scoring and fully dynamic scoring are imperfect options as well.

3.1.4. What results should be presented?

The outcome of the scoring process need not necessarily be a single bottom-line number. Given the difficulties and unknowns in incorporating economic effects, a crucial question is how to allow for uncertainty. There are many options here, including, for example:

- publishing both a mechanical costing (which might be estimated with some confidence) and a more speculative dynamic costing;
- publishing high and low estimates, as done by the Congressional Budget Office in Figure 2 above;

- publishing results generated by different models, as in the paper by Cogan *et al.* (2009) discussed in subsection 2.4.9;
- publishing fan charts (or confidence intervals) around a central estimate, as done by the Bank of England for its inflation and GDP forecasts;
- publishing a broader analysis of the likely economic effects of policies and their possible budgetary implications – perhaps including a discussion of what the big unknowns are – alongside the official scoring of policies.

3.1.5. *Uses and users of scoring*

Much of this article is written with a view to how official scoring of government policies is presented in annual budgets. This may well be the most important use of scoring, and it has certainly been the focus of the debate on the subject. But budgetary effects of reforms are forecast in other contexts too:

- Governments internally considering what policy to adopt.
- Opposition parties considering what policy to adopt.
- Scrutiny committees, independent analysts, media, etc., analysing actual, proposed and putative measures.
- Academics, non-governmental organisations, etc., doing research.

The pros and cons of different approaches might need to be weighed differently depending on this context. It would seem uncontroversial that academics should try to improve dynamic revenue estimation. These analyses could be used in the public debate, would follow the scientific requirements of peer review, and would therefore be subjected to a maximum of scrutiny and scope for improvement, while at the same time they are not required to be authoritative like official budgets and so could contain more experimental or speculative content.

In addition to asking what methodology is the best to adopt, there are related questions that must be answered, which might themselves affect the appropriate choice of scoring methodology:

- Who performs the analysis? Is it done within government, by an independent official or semi-official body, or privately?
- Who can commission analysis? The government, opposition parties, committees of the legislature, individual legislators, sub-national authorities, the media, independent analysts, the general public? Can the analysts themselves take the initiative?
- Should requests and the results be confidential, publicly available, or made public if and when the policy in question is publicly announced/proposed?

3.2. *Credibility*

To be useful, budgeting procedures must be both credible and clear. This subsection considers the issue of credibility; the following subsection discusses clarity, before we turn to practical considerations.

For a budgeting procedure to be credible, scoring must be accurate and politically neutral – and it must be perceived as so.

3.2.1. Accuracy

The requirement for accuracy can be viewed in more than one way: giving an accurate answer to a closely defined question or giving an accurate impression of the ultimate object of interest. On the one hand, costings that simply ignore important economic effects of reforms may give an accurate answer to a question laden with caveats, but will bear little relationship to the real-world budgetary effects of policies, which is what really interests the users of costings. On the other hand, scoring that purports to give a detailed measure-by-measure costing incorporating all economic effects will soon be exposed for spurious precision which also cannot be trusted. Neither spurious accuracy nor ignoring important effects seems very attractive. This suggests a role for acknowledging uncertainty.

3.2.2. Neutrality

As described in the previous section, dynamic scoring requires making numerous modelling assumptions and essentially guessing the parameters for which no hard empirical evidence is available. As the complexity of the effects incorporated increases and the magnitude of the effects becomes more speculative, the degree of uncertainty around estimates can rise exponentially, and the amount of judgment and guesswork required rises with it. This opens the door to large controversies if these guesses are made – or perceived to be made – in a politically biased way.

Where there is no political debate about the policy, this might not be a major problem. But dynamic scoring is usually called for where there is a lack of political consensus. Proponents of tax cuts often argue that the economic effects are large. As noted earlier, health and safety regulations might be costly for businesses to implement, reducing profits, employment and tax revenue; or they might lead to a healthier and more productive workforce, with the opposite result. The nature and magnitude of these effects is likely to be exactly what proponents and opponents of regulations dispute. A body responsible for dynamic scoring is in effect asked to pass judgment.

Actual and perceived neutrality are both important. The acknowledged neutrality of cost estimates is vital. If a costing is disbelieved and disregarded, then the debate is conducted – and decisions made and analysed – with no empirical basis at all. Note that this is true whether or not the loss of trust is deserved, and that the implications of mistrust by different parties (government, cross-party, public) are different. Loss of actual neutrality is damaging even if trust survives it for a period, as the misleading information can result in bad decisions.

Requiring a single number for the scoring of proposals means that the scorer is asked to make a best guess. The larger and more controversial the unknowns and uncertainties, the more pressure there will be, the more accusations will be thrown, and the harder it is to justify the guess objectively rather than by prior views; correspondingly, the harder it is to maintain neutrality, to demonstrate neutrality, and to build or preserve a reputation for neutrality.

3.2.3. Transparency

Transparency is a necessary first step to building trust in the accuracy and impartiality of scoring. A complex process like dynamic scoring should not be perceived as a black box controlled in a hidden way for an unknown purpose. Transparency contributes to trust even if the process revealed is flawed, because delimiting the flaws rules out other unspecified

sleights of hand which are otherwise left to the imagination, and because wanting to conceal the process suggests that there is something to hide.

It is therefore essential to allow anyone to assess the relevance, plausibility and significance of the results. Government and opposition politicians as well as external institutions should be able to assess the process and to make their own estimates based on alternative assumptions and procedures. Alongside any estimates, a detailed description should be published of how the conclusions were reached and what definitions, assumptions, methodologies, estimates and models lie behind them. One should be able to understand quickly what kinds of economic effects are and are not incorporated and, on a more basic level, how the reform being scored is defined, in the sense of Section 2.1 (*e.g.* what is the "no reform" baseline). If some major assumptions underpin the estimates, they should be stated clearly and discussed. The uncertainties surrounding the estimates should also be described by the dynamic scorers at various steps. It is hard to envisage any principled argument against such transparency.

3.3. Clarity

Credible estimates are of little use if nobody understands them. The attempt to establish indisputable credibility of analysis is liable to lead to the provision of a multiplicity of numbers, simply to account for the predictable uncertainties surrounding estimates. Non-specialists might be confused rather than enlightened, and the information provided might become fuzzy instead of being improved.

It is difficult to discern general principles that would promote clarity. It is possible to tell competing stories depending on exactly what is believed about the nature of the policy debate and how much information people are capable of absorbing. For example:

- Perhaps, told that "X is the mechanical cost of the policy, but this will be lower insofar as it stimulates economic activity", people could recognise the uncertainty, reach their own judgment on how large the economic effect might be, and take an informed view accordingly. There would be scope for reasoned debate over the likely size of the economic effect, informed by academic research and competing models from many analysts with varying persuasions and reputations, and this could form the core of a debate over the merits of the policy. It could still be difficult for the layman to judge between the multiplicity of competing claims, but at least there would be a universally understood focus on which to hang the debate: "how much less than X will the policy really cost?"
- On the other hand, it is equally plausible that all nuances and caveats would be lost and that the only message that people would take in would be a cost of X. If the choice is between conveying that single number and an alternative single number – call it Y – which incorporates dynamic scoring as well as possible, then clearly Y, however uncertain, is a better guess at the "true" cost of the policy.
- If one can convey a number plus uncertainty, then it is not immediately clear whether the statement "X is the mechanical cost of the policy, but this will be lower insofar as it stimulates economic activity" is a better or worse option than "Y is our best guess at the true cost of the policy, but this may be an over- or under-estimate because we cannot be sure how much this will really stimulate economic activity". The former has the advantage of starting from a point on which all agree. The relative merits might depend on the degree of uncertainty: the merits of publishing a best guess might depend on how good it is.

Such stories are highly speculative, however, and certainly inconclusive. The route to clarity may depend on the institutional and political context in each country, and may be an area where research would be productive. One principle does seem compelling, however: consistency.

3.3.1. Consistency

Clarity requires a consistent methodology. Using dynamic scoring for some proposals but not others would make it difficult to compare proposals and therefore to reach accurate judgments. If the difference in methodology is not taken into account, it also breeds bias. Allowing for taxes to reduce growth but not for spending to increase growth biases decisions against tax-financed spending and encourages the dressing up of spending programmes as tax credits/rebates. Allowing for taxes to reduce growth but not for regulations to do so biases decisions against tax-based approaches to changing behaviour. Allowing for economic effects only when they can be estimated with certainty biases decisions against policies with uncertain effects even if they are desirable on balance.

Since there is large variability in our knowledge of, and ability to estimate, the economic effects of policies, the desire for consistency might suggest adopting as simple an approach to scoring as possible. And among consistent methodologies, either an approach which incorporates all economic effects or an approach which incorporates none is likely to be easier to understand than an approach which makes fine distinctions between what is and is not taken into account.

However, it is important to recognise that there are downsides to insisting on complete consistency. It is not unreasonable to suggest that a more sophisticated analysis, incorporating economic effects more fully and accurately, should be pursued either in cases where more is known about the likely economic effects of a policy or, for more important policies, where more money is at stake. Levelling down to achieve comparability between proposals is no easy choice and, again, the trade-off must be judged carefully.

3.4. Practical considerations

Dynamic scoring is a difficult activity. For it to be worthwhile it must not only be beneficial; the benefits must outweigh the resource cost of doing it. The United States Treasury and the Joint Committee on Taxation each produce several hundred revenue estimates each year (Gale, 2003). Adding dynamic revenue computations each time would require a huge increase in time and resources dedicated to scoring proposals.

It also matters whether dynamic scoring is more worthwhile than alternative uses of the resources. Perhaps collecting better data or extending research into taxable income elasticities or general equilibrium modelling would do more to improve the quality of analysis and policy making and so should take priority over introducing dynamic scoring. In principle, these are not necessarily alternatives – if both are worthwhile, both should be done – but at the very least there is an argument against pursuing multiple innovations simultaneously, and in practice dynamic scoring may be competing for funds with these activities more directly than it competes with education or pension spending.

Potential users of dynamic scoring must also consider the timeliness of analysis. Policy makers weighing up alternative policies may want to see analysis of putative policies very quickly, and may want analysis of successive variants in an iterative process. This is made harder if the more complex analysis takes much longer to produce. Those outside

government – independent analysts, competing political parties, and so on – who respond to a proposal or announcement may put a premium on speed as well as sophistication of analysis, as perceptions form quickly and the media agenda soon moves on.

4. Conclusions

To implement dynamic scoring perfectly would require answering almost every question ever asked in economics. It is not only unfeasible now, it will never be feasible. But perfection is too exacting a standard: to implement static scoring perfectly will never be feasible either. The questions are how much more inaccuracy and guesswork are likely to be introduced by trying to answer a more ambitious question, and how much more inaccuracy and guesswork are bearable before we abandon the attempt and scale back our ambitions. The former is a question of the state of economic knowledge; the latter depends on the purpose for which the estimates are being produced and on the institutional and political framework.

The economics profession has made huge strides in the past thirty years in estimating the empirical magnitudes that are relevant for scoring policies. Increased availability of data, advances in the methodology used to analyse the data, and above all massive increases in computing power have transformed the state of our knowledge.

Despite these strides forward, we must acknowledge the scale of our ignorance. We have no idea of the magnitudes of likely responses by households and firms to many of the kinds of tax reforms often proposed in the real world, and still less idea of likely responses to changes in public spending programmes and regulations. We have no macroeconomic model that even incorporates the main features acknowledged by all as desirable, and no consensus about which of the multiplicity of radically different models best captures reality.

The difficulty of implementing dynamic scoring accurately is not, however, sufficient reason for declining to attempt it. If there are important economic effects that we cannot measure with any precision, then accurate forecasts will not be the result; but "best guess" forecasts might still be preferable to simply ignoring many of the economic effects of taxation.

The difficulty of dynamic scoring means it has serious downsides. It would be costly and time-consuming. It would be difficult to do consistently across policies, and the greater use of assumption, guesswork and judgment required would make it harder to keep the scoring of policies out of the political fray and trusted as impartial. But the prize at stake should not be discarded lightly. If the hazards can be managed, dynamic scoring offers the promise of a more accurate picture of the budgetary consequences of policies and of more fairly reflecting the advantages of policies that enhance economic performance. We do not take a view on whether the potential advantages justify accepting the downsides.

There are also alternatives to opting for fully fledged dynamic scoring that are worth considering. These include giving more careful thought to exactly what is held constant and what is allowed to change short of full dynamic scoring, estimating the economic effects of whole packages but not individual measures, and exploring greater use of dynamic analysis to provide information on the possible economic effects of policies without necessarily adopting a bottom line of full dynamic scoring.

One unambiguous conclusion does leap out of our analysis, however: in the interests of credibility and trust in the process, and to enable outsiders to understand, evaluate, replicate and potentially improve upon the process used, scorers should be as transparent as possible about how their conclusions are reached: how the "no reform" baseline is

defined, what economic effects are and are not incorporated, what assumptions are made, what economic response parameters are estimated, and what models are used. The first step to improving the quality of analysis is to open it up to scrutiny.

Notes

1. "Where the effect of one tax change is affected by implementation of others, the measures are normally costed in the order in which they appear" (HM Treasury, 2009, p. 174).
2. The Conservatives estimated that their original proposal would raise GBP 3.5 billion ("Offshore Domicile Levy", Conservative Party, 1 October 2007). An HM Treasury estimate of GBP 0.5 billion for the same policy was attached to a letter from Nicholas Macpherson to George Osborne MP, 3 October 2007. Heated exchanges thereafter did little to resolve the disagreement, and later costings for policies in this area differed by a similar margin.
3. In fact, economic theory only partially confirms this common view. An increase in income tax leads to both a substitution effect and an income effect. The substitution effect is that the gain from one additional hour at work instead of at leisure is reduced, making it less worthwhile. This will lead to a substitution from paid work to leisure: reduced hours of work. The income effect is that the individual is poorer as a result of the tax increase and might react by working more to mitigate the loss of income. The overall response is thus theoretically ambiguous: whether people work more or less in response to an income tax rise is an empirical question.
4. The pioneer in this field has been Martin Feldstein (1995, 1999, 2006), for example. For a brief survey of the field in the context of income taxation, see Meghir and Phillips (forthcoming); and for a fuller discussion, see Slemrod (1998) and Saez *et al.* (2009).
5. Carroll and Hrung (2005) explore the implications of this for the use of taxable income elasticities.
6. See Altshuler *et al.* (2005) for an example of the aggregation problem in the United States.
7. The two models were those used by Taylor (1993) and Romer and Bernstein (2009).
8. For more information on this and previous experiments with official dynamic analysis in the United States, see Altshuler *et al.* (2005), CBO (2003, 2009) and Page (2005). Such experiments are rarer in the United Kingdom: for one unofficial attempt, see McWilliams and Wallace (2007).
9. "GDP growth in 2009 is forecast to be around half a percentage point higher than it would be in the absence of the discretionary action that the Government has taken" (HM Treasury, 2008, p. 24).

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