# OECD Journal on Budgeting

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Foreword

The OECD Journal on Budgeting is a unique resource for policy makers, officials and researchers in public sector budgeting. Drawing on the best of the recent work of the OECD Working Party of Senior Budget Officials, as well as special contributions from Finance Ministries of member countries and others, the Journal provides insights on leading-edge institutional arrangements, systems and instruments for the effective and efficient allocation and management of resources in the public sector.

We are anxious to receive feedback from our readers. Your views on how to improve the Journal are welcome and can be sent to: The Editors, The OECD Journal on Budgeting, OECD, 2, rue André-Pascal, F-75775 Paris Cedex 16, France. Fax: (33 1) 44 30 63 34; e-mail: sbo.news@oecd.org.

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Budgeting in Chile

by

Jón R. Blöndal and Teresa Curristine*

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Introduction

In June 2003, the Budget Office of the Ministry of Finance of Chile requested the OECD to carry out a review of the Chilean budgeting system in a similar fashion as it does for its member countries. The OECD responded positively to this request, recognising that Chile is an established observer of the OECD Working Party of Senior Budget Officials and recognising the strong interest in the Chilean budgeting system expressed by members of the Working Party.

This report is divided into four sections. Section 1 focuses on the budget formulation process. Section 2 discusses the role of the legislature in the budget process. Section 3 reviews management issues. Section 4 is devoted to discussing performance and results reforms.

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

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

Finally, the mission would like to thank Mr. Jaime Crispi, Mr. Andrés Cooper and Mr. Juan Andrés Roeschman of the Budget Office for organising the mission’s visit and for their help throughout this review. The mission would also like to express its gratitude to Ms. Marcela Guzman of the Budget Office for her invaluable assistance with this review while she served at OECD headquarters in Paris on secondment.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisations or individuals consulted for this review.
1. Budget formulation

1.1. Introduction

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

![Nominal fiscal surplus/deficit 1987-2002](image)

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

Central government % of GDP

Why has Chile been able to accomplish this? The answer most likely lies in Chile’s tumultuous political and economic history over the past decades. In 1970, President Allende was elected and a comprehensive socialist economic programme was introduced. Banks, mines and many other foreign enterprises were nationalised. Workers’ “self-management” was introduced in other firms. A general economic malaise followed. Fiscal deficits reached over 15% of GDP; inflation reached an annualised rate of over 500%. In 1973, the military overthrew the democratically elected government. The socialist experiment of President Allende was reversed – and indeed Chile’s long tradition of statist economic policies. In 1975, a radical experiment with free market economics was introduced. The economy responded well to these policies and grew at very high rates until the early 1980s. In 1981, the international debt crisis led to severe economic problems in Chile – with high unemployment and the need for the government to bail out the banking system. In the ensuing years, Chile consolidated its economic reforms and economic growth ensued.1
Following the return to democracy in 1990, successive elected governments have maintained a strong commitment to sound economic management and fiscal responsibility. In this context, it should be emphasised that the political situation in Chile was quite unstable at this time. The sustainability of democracy was by no means assured and in order to ensure political stability, democratic governments stressed responsible economic policies recognising that this had been one of the main pretexts for the military’s take-over in 1973. The country had also witnessed the harsh consequences facing its neighbouring countries which had followed less responsible policies immediately following their return from military rule. It should also be noted that successive democratic governments have been served by very high-caliber economic teams.

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

1.2. Structural budget surplus rule

Starting in 2001, Chile adopted the fiscal rule that it would operate each year with a structural budget surplus of 1% of GDP. This is not enshrined in legislation but is rather a political commitment of the current government.

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

Central government % of GDP

Source: Ministry of Finance, Chile.
A structural budget balance aims to eliminate the effects of cyclical fluctuations of economic activity on the budget balance\(^3\), \(^4\). When the economy is performing above its long-term potential, the government should return a nominal surplus. When the economy is performing below potential, the government should return a nominal deficit. Over the cycle, these should balance each other out.

**Box 1. The private provision of traditional public services**

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

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

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

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

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

\(^*\) For further information, see “The Chilean Pension System”, OECD Journal on Budgeting, Volume 1, Number 1, 2001.
There were several reasons advanced in Chile for the introduction of this rule:

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

Box 2. Why one per cent?

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

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

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

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

During the first year of the use of the structural balance rule, these calculations were performed in-house by the Ministry of Finance. Some skepticism was voiced by the opposition and other commentators on this procedure, especially since it was difficult for non-specialists to understand the process.
To limit the possibility of irresponsible fiscal behaviour through the calculation of these reference levels, and to increase the credibility of the new policy framework, the Ministry of Finance established two independent panels after the first year to carry out the forecasts. As is discussed later, these forecasts take place about two months prior to the presentation of the budget proposal to the Congress.

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

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

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**Box 3. Copper Stabilization Fund**

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

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

The structural budget surplus rule has effectively superseded the functions of the Fund, and it can now be viewed as redundant to a large degree.
This committee estimates the average long-term (ten-year) price for copper as the reference price. Again, the panel meets twice during the budget season. Each panel member submits an estimate which is published anonymously. The two extremes are discarded and a simple average of the 12 remaining forecasts is used. No consensus is sought.

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

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

The fiscal rule requires adjustments within the year in order to keep to the target. The fact that the Chilean government has in fact done so has greatly enhanced its credibility. For example, tariffs were reduced significantly in 2003 following the signing of the Free Trade Agreement with the European Union. In order to compensate for the loss of revenue, measures were immediately taken to reduce expenditures within the year.\(^5\) Again, it should be emphasised that this refers to the performance of actual revenue and expenditures against the calculated structural balance. Errors in the calculation of the structural balance itself would not be known until well after the fact when more information becomes available to judge the structural-cyclical components of the budget.

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

1.3. Annual budget cycle

The Chilean budget cycle is divided into two very distinct phases. The first focuses on a critical examination of ongoing programmes and updating baselines. The second focuses on funding new programmes and expanding ongoing programmes through a central Bidding Fund. This is, however, subject to the availability of resources. For example, there was no second phase at all in the formulation of the 2004 budget.
1.3.1. Phase I: Updating baselines for existing programmes

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

These reviews include a systematic assessment of the performance and results of programmes. These assessments are carried out by a special unit within the Budget Office and are discussed in detail in Section 4 of this report.

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

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

As is discussed in Section 3, the Chilean government is divided into ministries and agencies. The maximum amounts are set for each ministry and each agency at the same level of detail as the budget. The maximums are,
however, sent to the minister responsible and he/she can make any adjustments – i.e. reallocate between organisations – before forwarding them on to the agencies. Practices in this field vary across ministries, but in most cases the ministries simply pass the maximums on directly to the agencies without any adjustments.

Ministries and agencies can challenge the maximum amounts that they are issued but, as this is very rarely successful, such challenges are exceptional. This indicates the power of the Budget Office and the support it has from the Minister of Finance and the President. It is also important to bear in mind that these maximums only refer to ongoing programmes, not to new programmes.

1.3.2. Phase II: The Bidding Fund

The second phase of the budget formulation process focuses on the Bidding Fund for new initiatives. As noted, the size of the Fund varies with the economic cycle, and no Fund was used for the 2004 budget. In general, however, the Budget Office strives to ensure that the Fund is sufficiently large to be relevant in political terms. This has meant a Fund that is about 2.5% of total spending on average in recent years. Again, the Bidding Fund is financed by a critical examination of existing programmes in the first phase and the added resources provided by a growing economy. The discussion below refers to the years when the Fund is in operation.

Box 5. Role of medium-term projections

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

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

The document is not used as a tool for resource allocation. The Budget Office uses it to evaluate the overall trend in public revenue and expenditure to see how the trend is compatible with the over-reaching goal of maintaining the structural fiscal rule. As such, the document assists in determining the availability of total resources. The May update provides guidance on resource availability until the independent panels on the structural balance meet in August to finalise the level of resources available.
The launch of the Bidding Fund in 2000 was an effort to improve the quality of budget submissions from line ministries. First, it was designed to counter the incremental nature of the traditional budget process by having line ministries prioritise (rank) their requests for funding new initiatives. Second, it was designed to improve the technical quality of the funding requests which had varied greatly from ministry to ministry and were often deficient. Improvements were accomplished by giving the Ministry of Planning the role of assisting line ministries in completing their bids in accordance with standards set by the Budget Office. This process is discussed further in Section 4 of this report. The reason for this arrangement is that the Budget Office found it incompatible with its role to assist line ministries in submitting requests for new funds. It should be emphasised that the Ministry of Planning has no decision-making authority over the bids.

This second phase of the budget formulation process starts in the first half of August with bilateral meetings between the Budget Office and line ministries. At these meetings, the submissions to the Bidding Fund are presented and discussed but no decisions are taken. These meetings are led by the relevant sectoral analyst from the Budget Office, and include the under-secretary of the line ministries and the directors-general of the ministry’s agencies together with
their finance staff. The length of the meetings varies but they often last two to three days per ministry, depending on the number of its agencies.

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

The Budget Office analyses the various bids that have been submitted based on two criteria. The first is the technical quality of the bid. The second is the consistency of the bid with the political priorities of the President. The latter is ensured (promoted) by an explicit system for communicating those priorities. First, the President will communicate these in his annual State of the Nation address to the Congress. Second, the staff of the President (Presidential Secretariat Ministry) will hold bilateral meetings with each minister to discuss the President’s priorities for the budget. These will first have been discussed thoroughly with the Minister of Finance and the budget director.

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

The last step of the budget formulation process is for the Budget Office to finalise the budget documentation and to put the budget on the appropriate price level, as all discussions will have taken place on the previous year’s budget price levels. The budget document itself is a streamlined input oriented document. The Budget Office also produces supplementary documents presenting additional information on performance and results for each of the 18 sectors of the government. See Section 3 for a discussion of sectors.

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**Box 7. Budgeting for the military**

One of the legacies of military rule in Chile is that the military receives 10% of the gross revenue of the government-owned copper mining company (CODELCO) for equipment purchases. This amounts to about 0.4% of GDP and is treated as an off-budget transaction. In fact, it was only in 2003 that a new law required for the first time the publication of how the military spends this money. The military may also borrow directly in order to finance equipment purchases. The Budget Office limits the amount of borrowing to what can be serviced with the proceeds of the 10% copper revenues. This borrowing is, however, not publicly reported.
1.4. Conclusion

Chile has an outstanding record of fiscal responsibility and a sophisticated budget formulation process. The structural budget surplus rule appears to function well in Chile’s political environment although it is too early to draw any firm conclusions regarding its sustainability. All the early indications are however positive. The independent panels dedicated to calculating the structural balance are especially noteworthy, although the inherent uncertainty of such calculations is surprisingly little discussed in Chile.

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

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

Chile does not have a medium-term expenditure framework in the same sense as applied in OECD member countries. Chile already has the foundation for such a system with the internal documents currently used for macroeconomic purposes. It would be relatively simple to use it more actively for resource allocation purposes. This would greatly aid in the transparency of fiscal finances as well as promoting accountability.

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

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

2. Role of the legislature

2.1. Introduction

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

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

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

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**Box 8. The National Congress**

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

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

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

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

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

There is no discussion of the budget in plenary session of either chamber of the Congress upon its introduction. The budget is automatically referred to the Budget Committee. The Budget Committee is unique in that it is a joint committee of both chambers of the Congress. In the past, this committee was a temporary ad hoc committee formed each year and operating only for a short period of time immediately following the introduction of the government’s budget proposal. Effective in 2003, the Budget Committee has become institutionalised as one of the permanent committees of the Congress and will therefore operate year-round. The Budget Committee consists of 26 members, drawn equally from the Senate and the Chamber of Deputies.

As noted, the budget is referred automatically to the Budget Committee without prior action in either house in plenary session. During the first week of October, the Minister of Finance introduces the budget by making an address to the Budget Committee highlighting the state of the economy and major policy decisions contained in the budget. The following day the budget director makes an address to the Budget Committee highlighting the various

Box 9. Constitutional restrictions on the role of the Congress

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

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

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

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

The President sets the agenda of the Congress by giving priority status to bills that he desires and gives the Congress a specific number of days to consider them.
technical aspects of the budget. Each of these meetings lasts for approximately a half-day with members of the Committee asking questions of the minister and the budget director following their presentations. The budget director will also have had meetings with the Budget Committee and informal meetings with each political party represented in the Congress to provide information ahead of the introduction of the budget.

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

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

The budget is then referred to both the Chamber of Deputies and the Senate where it is discussed very briefly and then approved in a series of ministry-by-ministry votes. Numerous amendments are still proposed at this stage by members of the Congress, but some are dismissed as out of order.

Box 10. Congressional budget timetable

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last day of September</td>
<td>Budget proposal presented to the Congress. Budget referred automatically to the Budget Committee.</td>
</tr>
<tr>
<td>First week of October</td>
<td>Minister of Finance makes policy address to the Budget Committee. Budget director makes technical address to the Budget Committee.</td>
</tr>
<tr>
<td>October-November</td>
<td>Budget Committee forms five sectoral sub-committees to scrutinise the budget proposal.</td>
</tr>
<tr>
<td>Mid-November</td>
<td>Budget Committee finalises report on the budget proposal. Budget approved by the Congress.</td>
</tr>
<tr>
<td>November</td>
<td>Protocol signed between Budget Committee and Budget Office.</td>
</tr>
<tr>
<td>1st January</td>
<td>Start of fiscal year.</td>
</tr>
</tbody>
</table>
(ineligible) and others are voted down by the government's majority. If the votes from both chambers do not coincide, a special committee of both houses is formed. This special committee will make a proposal which must be voted without amendment in both chambers. The budget is generally passed in late November. It would appear to be a matter of pride for the Budget Committee to have enacted the budget in as short a period of time as possible.

As noted above, even if the government's budget proposal (or one amended in accordance with the restrictions mentioned in Box 9) was not approved by 30 November, the government’s original proposal would nonetheless become law according to the Constitution. However, this has never happened and would appear today to be considered politically unacceptable. This opens the way to behind-the-scenes negotiations whereby the government itself decides to introduce amendments to the budget that are desired by the Congress. Similarly, members of the Congress have conditioned their vote on unrelated legislation – for example, the Free Trade Agreements – upon desired changes in the budget. The frequency of such behind-the-scenes interventions is, however, said to be rare.

The Congress can also place restrictions on individual appropriations, for example by mandating that a certain part of the total appropriation be spent on a specified activity. This respects the constitutional provision that the total appropriation not be increased and at the same time demonstrates the will of the Congress. These restrictions are, however, also rare. (These restrictions are further discussed in Section 3.)

Box 11. Audit

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

It is a most unusual body in that it acts not only as an audit office but also pre-approves all expenditures and staff actions in order to ensure their legality. The case for modernising this office and re-launching it as a modern auditor-general body appears appealing. As an office of the legislature, it would also assist the legislature with its oversight duties in holding the government accountable. In such a reformed model, the pre-approval of expenditures and staff actions would no longer be performed by the body.
Box 12. **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 operates on several cascading levels. A Spring Fiscal Policy Bill is presented to parliament in April, five months before the budget is submitted to parliament. The Bill proposes limits on the aggregate level of government expenditures and government revenues. Parliament debates these aggregate limits and enacts them into law in early June. Again, there are no restrictions on parliament’s ability to amend the government’s proposal. The Bill has created a vehicle whereby debate in parliament can focus on the appropriate size of the public sector and the economic impact of various combinations of aggregate revenues and aggregate expenditures. The budget – which is presented in September – must be in conformity with the aggregate level of revenue and expenditures as approved in the Spring Fiscal Policy Bill. The budget as presented to parliament is divided into 27 expenditure areas. Parliament debates and approves by late November the level of aggregate expenditure for each of the 27 expenditure areas. Again, there are no restrictions on changes as long as the total voted in the Spring Fiscal Policy Bill is respected. Finally, parliament decides in late December on the level of individual appropriations within each of the 27 expenditure areas. Parliament can make any changes to individual appropriations within the aggregate level of expenditure for each of the 27 expenditure areas.

A strong division of 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. It has essentially been given the role of “policeman” of the parliamentary budget process. Individual appropriations within an expenditure area are the concern of the relevant sectoral committee of parliament. For example, the Health Committee would recommend the allocation within the relevant expenditure area for health. (The 27 expenditure areas reflect the committee structure of parliament.) Involving the sectoral committees in this way also supports the use of performance information by parliament.

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

* For a description of such a system in operation, see “Budgeting in Sweden”, OECD Journal on Budgeting, Volume 1, Number 1, 2001.
The Budget Committee is assisted by a secretary, who is mainly responsible for ensuring that the rules of procedure in the Congress are adhered to in the discussion of the budget. An embryonic budget research office has also recently been established with a professional staff of three analysts. It should also be noted that think tanks associated with political parties are very active in policy research and that each member of the Congress receives a stipend to purchase technical assistance.

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

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

2.3. Conclusion

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

The Congress at present has a limited institutional capacity to consider the budget, as shown by the fact that a permanent Budget Committee was only established in 2003. By not further developing its institutional capacity, the long-term risk may be that the Congress would regain a stronger role in the budget process but without the institutional features to promote fiscal discipline and responsibility.
The efforts to provide improved budgetary information to the Congress are commendable, including the commitment to conform to the OECD Best Practices for Budget Transparency. Accountability of the government to the legislature could also be improved by re-launching the Comptroller-General of the Republic as a modern audit office and as an office of parliament.

3. Management

3.1. Introduction

Management practices in Chile are presently being modernised at a very rapid pace. This section reviews reforms undertaken in the area of organisational structures, human resource management, and financial management. A special emphasis is placed on managerial flexibility in Chile.

3.2. Ministries and agencies

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

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

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

First, the notion of sectors was introduced. This entails formalising the groupings of organisations around a minister into a ministry and agencies. There are 18 sectors, matching the number of ministries. This was largely a presentational issue but the implication was clear. Ministries were to be responsible for policy making and co-ordination, whereas the agencies would be responsible for policy implementation. The results of this reform vary greatly between sectors as they depend on how the ministries have decided to operationalise this reform.

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

Third, and most recently, it was recognised that some of the agencies were actually policy-making in nature, rather than simply engaged in policy implementation. This resulted in 25 agencies being classified as policy makers (or “centralised”) and 140 agencies as policy implementers (or “decentralised”). The former category includes the Budget Office; the latter category includes general service delivery, enforcement activities, and regulatory commissions. By recognising the 25 agencies as being special, tensions will be removed from the overall system and the remaining 140 agencies will fit better into the modern ministry-and-agency structure being developed in Chile.

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

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

As part of this new reform, directors-general will sign contracts with their ministers concerning the goals of the agencies. This is discussed further in Section 4.

3.3. Managerial flexibility

There are two aspects to managerial flexibility. The first is the legal detail of budget appropriations. The second is the various central management rules on implementing the budget, notably in the field of human resource management. Chile’s position in these areas is discussed below.
3.3.1. Budget appropriations

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

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

The second type is restrictions for specific appropriations. These generally earmark parts of a larger appropriation for specific projects. This can be viewed as simply a pragmatic approach to programme budgeting. These restrictions generally originate in the Ministry of Finance as well. In other cases, they originate in the Congress. As detailed in Section 2, the Congress cannot increase spending for any programme, but can use its power to reduce spending to force agreement with the executive to mandate that a certain amount within a larger appropriation be spent on a certain project using this form of restriction. It should be noted that these are relatively few at present.

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

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**Box 13. The contingency reserve**

The budget contains a contingency reserve. The amount of this reserve has been as high as 7.8% of total expenditures, but is now equivalent to 1.8% of total expenditures. The purpose of the contingency reserve is to fund legislation that the Congress may enact after the introduction of the budget. An outstanding example is that the Congress approves salary increases for government employees in special legislation in late December each year.
very cumbersome and time-consuming procedure. As a general statement, however, the level of detail of appropriations allows quite wide managerial flexibility.

3.3.2. Human resource management

Chile has two types of human resource management system operating side by side. The traditional system, known as planta, is highly inflexible. About 60% of government workers are in this system. The remaining 40% are hired on contracts, the contrata system, which is flexible. The traditional system is composed mainly of older workers. Over 50% of public employees have less than ten years experience and most of these are contract employees. It should be noted that the numerical ceilings on staff (posts) apply for both the traditional and contractual workers.

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

Similar to the reformed process for appointing directors-general, the government is introducing reforms to the hiring and promotion of staff in the planta system. Promotions are to be competitive, with positions being advertised and an independent panel reviewing the candidates. If no suitable persons are available within the organisation, the position may be re-advertised and opened to persons from outside the organisation. At the same time, the government launched an incentive package for the early retirement of older employees. This applies to the planta system. The government intends that a reformed planta system will reduce the reliance on the contrata system.

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

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

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

3.4. Financial management

A number of reforms are underway to improve financial management in the Chilean government. At present, all government accounts are maintained in a government-owned commercial bank, the Banco del Estado. Taxes to the government can be paid to any commercial bank which then has three days to forward the payments to the government's account with the Banco del Estado. All government ministries, agencies and regional offices maintain their own bank accounts at the Banco del Estado. There are some 5 000 accounts in all, as separate accounts are often opened for individual projects. Each entity makes its own payments from this account following approval from the Comptroller-General of the Republic. There is no central payment system. A daily statement is prepared by the Banco del Estado showing the revenues deposited and payments disbursed each day. This statement is not made publicly available.

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

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

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

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

An annual financial report is prepared and is available three months following the close of the fiscal year. As it is based on the audited monthly reports, this document is not specifically audited by the supreme audit institution. The annual report is publicly available.

A capital charging system is being implemented in three phases. In phase 1, a comprehensive asset register is being assembled. Phase 2 will see the valuations of those assets and phase 3 will see the levying of a capital charge. This is expected to be implemented in 2005-06.

The government’s budgeting and financial reporting system is presently on a cash basis. Chile is adopting the Government Finance Statistics (GFS), which is on an accrual basis, as the basis for its budgeting and financial reporting. The GFS is, however, a statistical framework and not an accounting framework, and poses important conceptual challenges.7

3.5. Conclusion

It is clear that Chile is undertaking a large number of initiatives to modernise the management of the public sector. Chile is very well placed to re-launch the government’s organisational structure as a modern ministry-and-agencies model. Managers enjoy a high degree of flexibility in the operation of their institutions and this flexibility would appear to be exercised in a responsible manner.

The depoliticisation of the appointments for directors-general of agencies and the move to a merit based system – rather than a seniority based system – for the promotion and hiring of officials are reforms of huge importance. The government’s apparent objective of increasing the reliance on the planta system – at the expense of the contrata system – needs however to be implemented with caution. The contrata system has served the government well and is a very established part of the Chilean government. A more urgent reform would appear to be the need to improve the conditions of contract employees if their contracts are not renewed, i.e. by giving them severance payments in line with private sector practices.
The financial management reform agenda is especially ambitious. The reforms to the cash management system – especially the activities of the Banco del Estado – are urgent. The introduction of a capital charging system will improve asset management as well.

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

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

4. Accountability for performance

4.1. Introduction

This section examines the development and use of performance information in the budget process. It is divided into four sub-sections: 4.2 describes four different approaches used by the Ministry of Finance to assess the performance of agencies and programmes; 4.3 examines the integration and use of performance information in the budget process; 4.4 assesses the methods for reporting on performance; and 4.5 discusses the mechanisms used to report on performance to the legislature.

4.2. Performance programmes of the Ministry of Finance

The Ministry of Finance has a highly developed albeit complex system for obtaining information on the performance of agencies and programmes which combines performance measurement with evaluations. The Ministry first began experimenting with performance indicators in the budget process in 1994. A decade later, there are five different tools used by the Ministry to focus its public sector on performance. A special unit called the Management Control Division within the Budget Office of the Ministry of Finance works on designing and implementing performance systems and on the subsequent monitoring of line ministries’ results. Table 1 sets out the different performance information tools and their date of introduction. Each of these tools will be discussed in more detail.

4.2.1. Performance indicators

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

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

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

The number of agencies taking part in this programme has gradually increased. By the 2004 budget, 132 agencies were participating and they produced a total of 1684 performance indicators (averaging 12.8 per agency). Table 2 gives details on the total number of performance indicators produced between 2001-04.

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

The 2002 budget included 537 performance indicators; these were reported in the first quarter of 2003. In the second round of evaluating performance results, the agencies reported 73% of them, with a 69% compliance rate within a range of 95-100% (see Tables 5 and 6).
Table 2. **Number of performance indicators, 2001-04**

<table>
<thead>
<tr>
<th>Functions</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>%</td>
<td>Number</td>
<td>%</td>
</tr>
<tr>
<td>General</td>
<td>53</td>
<td>19</td>
<td>82</td>
<td>15</td>
</tr>
<tr>
<td>Social</td>
<td>113</td>
<td>41</td>
<td>266</td>
<td>50</td>
</tr>
<tr>
<td>Economic</td>
<td>109</td>
<td>40</td>
<td>189</td>
<td>35</td>
</tr>
<tr>
<td>Total</td>
<td>275</td>
<td>100</td>
<td>537</td>
<td>100</td>
</tr>
</tbody>
</table>

Number of agencies

<table>
<thead>
<tr>
<th>Functions</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>%</td>
<td>Number</td>
<td>%</td>
</tr>
<tr>
<td>General</td>
<td>72</td>
<td>109</td>
<td>111</td>
<td>132</td>
</tr>
</tbody>
</table>

* Classified according to the Functional Classification of Expenditure, Estadísticas de las Finanzas Públicas, Budget Department, Ministry of Finance.

Table 3. **Performance indicators, 2004**

<table>
<thead>
<tr>
<th>Functions</th>
<th>Effectiveness</th>
<th>Efficiency</th>
<th>Economy</th>
<th>Service Quality</th>
<th>Total</th>
<th>Per cent</th>
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</thead>
<tbody>
<tr>
<td>General</td>
<td>170</td>
<td>45</td>
<td>56</td>
<td>47</td>
<td>318</td>
<td>19%</td>
</tr>
<tr>
<td>Social</td>
<td>405</td>
<td>118</td>
<td>123</td>
<td>157</td>
<td>803</td>
<td>48%</td>
</tr>
<tr>
<td>Economic</td>
<td>273</td>
<td>70</td>
<td>96</td>
<td>124</td>
<td>563</td>
<td>33%</td>
</tr>
<tr>
<td>Total</td>
<td>848</td>
<td>233</td>
<td>275</td>
<td>328</td>
<td>1 684</td>
<td>33%</td>
</tr>
</tbody>
</table>

Per cent

|         | 50% | 14% | 16% | 20% | 100% | 100% |

* Classified according to the Functional Classification of Expenditure, Estadísticas de las Finanzas Públicas, Budget Department, Ministry of Finance.

Table 4. **Types of performance indicator in 2004**

<table>
<thead>
<tr>
<th>Functions</th>
<th>Process</th>
<th>Output</th>
<th>Result</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Intermediate</td>
<td>Outcome</td>
</tr>
<tr>
<td>General</td>
<td>116</td>
<td>124</td>
<td>48</td>
<td>30</td>
</tr>
<tr>
<td>Social</td>
<td>224</td>
<td>394</td>
<td>122</td>
<td>63</td>
</tr>
<tr>
<td>Economic</td>
<td>173</td>
<td>261</td>
<td>117</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>513</td>
<td>779</td>
<td>287</td>
<td>105</td>
</tr>
</tbody>
</table>

Per cent

|         | 30%   | 46%   | 17%   | 6%   | 23%   | 100% |

Table 5. **Performance indicators reported and fulfilled in 2002**

<table>
<thead>
<tr>
<th>Functions</th>
<th>Number of indicators</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agreed</td>
<td>Fulfilled</td>
</tr>
<tr>
<td></td>
<td>Reported</td>
<td>Not reported</td>
</tr>
<tr>
<td>General</td>
<td>52</td>
<td>27</td>
</tr>
<tr>
<td>Social</td>
<td>187</td>
<td>79</td>
</tr>
<tr>
<td>Economic</td>
<td>155</td>
<td>37</td>
</tr>
<tr>
<td>Total</td>
<td>394</td>
<td>143</td>
</tr>
</tbody>
</table>
4.2.2. Evaluations

The Budget Office makes use of evaluations as an important tool for stimulating performance and assisting in resource allocation. Currently there are three types of evaluation: desk evaluations, impact evaluations, and comprehensive spending reviews. Since the establishment of the programme in 1997, a total of 151 evaluations have been conducted, the vast majority being desk evaluations. The annual public expenditure of programmes that have been evaluated is approximately 27% of total government spending. In addition, three comprehensive spending reviews have been completed. The annual spending of these agencies is 4.5% of total government expenditure.

An interministerial committee oversees all evaluations. The members of this committee include representatives from the Ministries of the Presidency, Planning, and Finance. The national Budget Office is accountable for the execution of all evaluations.

The following process is used to conduct desk evaluations. The Ministry of Finance submits a proposal to the Congress with the names of the programmes and agencies it wishes to evaluate in the coming year. After the programmes have been agreed with the Congress, external consultants are chosen to conduct the evaluations through a process of public bidding. The consultants carry out evaluations based on a logical framework methodology and procedural guidelines established by the Management Control Division of the Ministry of Finance. The evaluation reports contain results and recommendations which can vary from advice to eliminate the programme to requests to introduce minor changes. Since the establishment of the evaluation programme in 1997, the agencies being evaluated have participated in the process by commenting on the intermediate and final reports, including the recommendations. Additionally, since 2000 the relevant agency and the Budget Office have officially agreed on commitments to improve performance based on these recommendations.

<table>
<thead>
<tr>
<th>Degree of compliance</th>
<th>Economic</th>
<th>General</th>
<th>Social</th>
<th>Total</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>95%-100%</td>
<td>99</td>
<td>37</td>
<td>134</td>
<td>270</td>
<td>69%</td>
</tr>
<tr>
<td>90%-94%</td>
<td>14</td>
<td>6</td>
<td>16</td>
<td>36</td>
<td>9%</td>
</tr>
<tr>
<td>89%-80%</td>
<td>15</td>
<td>3</td>
<td>12</td>
<td>30</td>
<td>8%</td>
</tr>
<tr>
<td>&lt; 80%</td>
<td>27</td>
<td>6</td>
<td>25</td>
<td>58</td>
<td>15%</td>
</tr>
<tr>
<td>Total</td>
<td>155</td>
<td>52</td>
<td>187</td>
<td>394</td>
<td>100%</td>
</tr>
<tr>
<td>Per cent</td>
<td>39%</td>
<td>13%</td>
<td>47%</td>
<td>100%</td>
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</tr>
</tbody>
</table>
The process is similar for impact evaluations with two notable differences. Another methodological approach is used and these evaluations are contracted out either to research institutions or to universities rather than to external consultancies. Since it involves more field research and data collection, this type of evaluation is expensive and time consuming. Given these cost implications, it tends to be used for programmes which represent a large amount of public spending that have not been evaluated or for programmes where previous desk evaluations have failed to reach conclusions on outcomes.

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

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

The recommendations from the 71 programmes evaluated between 2000-03 have resulted in 25% of these programmes introducing a major redesign or institutional changes, 38% undergoing substantial design modifications to some components and/or internal management procedures, and 26% improving their information systems and making minor changes to management processes. In addition, 11% of these programmes were eliminated in the light of their results and/or because their objectives no longer responded to new requirements (see Table 7 for more details).

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

4.2.3. Management Improvement Program (MIP)

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

In 2001, when performance indicators were removed from the MIP and re-introduced into the budget, the MIP changed to focus on assessing progress in managerial systems. By 2004 these managerial systems included: human resources; quality of customer services; planning, control and territorial management; financial management; and gender focus. Each of these areas is divided into systems, and progress in every system is measured in stages 1 through 4 or 1 through 6. By 2004, MIP functioned in 88 centralised agencies and 89 decentralised agencies.

This programme operates in the following way: the Ministry of Finance prepares a general framework including areas, systems and stages. This is discussed and approved by the interministerial committee. This is sent to each agency which prepares its proposal according to the framework, stating the overall stage in each managerial system it wishes to reach by the end of

<table>
<thead>
<tr>
<th>Categories</th>
<th>Percentage of programmes</th>
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<tbody>
<tr>
<td>Major programme redesign and/or institutional changes:</td>
<td></td>
</tr>
<tr>
<td>Programmes needing substantial reformulation or deep changes in design, internal management processes and/or re-location to other agencies, with the aim of adapting to new diagnostic elements and/or ensuring more coherence and better integration among lines of action.</td>
<td>25%</td>
</tr>
<tr>
<td>Design modifications of some components and/or internal management procedures:</td>
<td></td>
</tr>
<tr>
<td>Programmes needing mainly design modifications to some components or activities and/or internal management processes. Among the most important are: review of focalisation criteria or methodological tools; improvements in information, follow up and monitoring systems; improvements in internal and external co-ordination among staff and/or agencies involved; improvements in management procedures in relation to financial transfers within the different level of responsibility with respect to execution.</td>
<td>38%</td>
</tr>
<tr>
<td>Minor modifications:</td>
<td></td>
</tr>
<tr>
<td>Programmes requiring minor adjustments such as improvements in information, follow up and monitoring systems, fine-tuning some aspects of design and/or internal management process.</td>
<td>26%</td>
</tr>
<tr>
<td>Programmes cuts:</td>
<td></td>
</tr>
<tr>
<td>Programmes that have reached the end of their previously-defined execution period, or whose results no longer justify their budget allocation.</td>
<td>11%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
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</table>
the year. These proposals are submitted to the Ministry of Finance, where they are reviewed by a specialist network. The proposals are then sent to the interministerial committee for approval. This committee consists of members from the Ministries of the Interior, Presidency, and Finance. If the proposal is approved by the committee, agencies will prepare a decree that sets out their new commitments for the coming year. This decree is issued by the relevant ministry and approved by the committee.

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

4.2.4. Bidding Fund

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

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

These bids are sent to the Ministry of Planning where they are reviewed and graded. They are then included in the relevant ministry's formal budget proposal. The Ministry of Finance makes a short list of programmes taking into account the technical criteria and most importantly their relevance to government priorities. This list is sent to the President and it is part of the discussion on the total budget proposal. The President makes the final decision on which programmes will receive funding. This process is described in more detail in Section 1.

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

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

In the subsequent financial years, if a programme remains a high priority and performs well in terms of achieving results and developing relevant new indicators, it will generally be included in the agency's baseline. As discussed in Section 1, there was no Bidding Fund for the 2004 budget due to lack of resources. In terms of performance, the Bidding Fund helped to motivate agencies to introduce indicators for new programmes, to extend indicators to existing programmes, and — when indicators already existed — to attempt to improve them.

4.3. Performance information in the budget process

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

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

There are also separate meetings within the Ministry of Finance to discuss the results of evaluations. If the results and recommendations of these evaluations have consequences for allocation, decisions are taken in these meetings and discussed with agency heads at the preparation stage of the budget. If there are no implications for allocation, the results and recommendations are discussed with agencies after the Budget Bill has been sent to the Congress. These discussions aim to develop a formal agreement on how the agency will implement the recommendations.
The preparation stage of the budget process takes places after ministries have received their baseline and submitted their proposals to the Ministry of Finance. At this stage, one-on-one technical committee bilateral meetings are held with the ministerial under-secretary, the head of each agency and the head(s) of the relevant budget sectoral division(s), in which staff from the Management Control Division also participate. In each meeting, the relevant agency’s budget proposal is discussed along with its past performance, proposed performance goals, and targets. There are several smaller meetings to examine the details of goals and targets.

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

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

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

The Chilean approach to performance budgeting is a sensible one. It recognises that it is often not possible to routinely reward good performance through the budget allocation process, but performance motivation is achieved through a carrot and stick incentive structure. The carrot comes from the MIP system discussed in sub-section 4.2.3: it provides pay incentives for employees and teams to improve processes which will assist in achieving goals. The stick comes from the view, expressed by line ministries interviewed for this study, that the Ministry of Finance would reduce funding or even possibly eliminate
programmes if performance did not improve. In practice the elimination of programmes is a rare course of action. However, the fact that this has happened in a few cases, and that the Ministry of Finance has both the power and the willingness to take this action or to reduce funding, serves as an incentive for ministries to improve performance.

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

4.4. Reporting on performance to the Ministry of Finance

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

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

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

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

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

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

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

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

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

**4.5. Reporting on performance to the legislature**

The legislature receives information on the performance of agencies and programmes from the Ministry of Finance in three different forms: the Comprehensive Management Reports, information on performance indicators, and reports from programme evaluations.
Annually the Ministry of Finance sends a Comprehensive Management Report on each agency to the Budget Committee in the Congress and relevant sub-committees. Performance indicators, targets, and goals are incorporated into the information reports sent with the Budget Bill to the Congress. Progress against these targets and goals are included in the Comprehensive Management Report. The Budget Committee also receives final programme and agency evaluation reports.

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

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

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

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

The first issue has been partly addressed: since July 2003 the Budget Committee has been running throughout the year. This provides more time to examine performance information, and during interviews for this study the Budget Committee expressed an interest in doing so. The second factor reflects constitutional features which are difficult to alter, although some internal process adjustments may prove useful.

**4.6. Conclusion**

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

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

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

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

Notes
1. It should be emphasised that the discussion of military rule applies only to their economic policies and no other inferences should be drawn from it. Many of the economic reforms were also refined and made sustainable following the return to democracy.
2. This rule applies to the national government only. It should, however, be noted that the sub-national level of government is small in Chile.
3. For further information on calculating structural budget balances, see “Structural Budget Balances: A Methodological Note” in OECD Economic Outlook – Sources and Methods.
4. For a technical description of Chile’s fiscal rule, see Marcel et al. (2003).
5. In addition, the rate of value-added tax was raised from 18% to 19% to compensate for the loss of revenue.
6. In exceptional circumstances, the management of an agency is vested with a collegium, or in a board of directors.
7. For a detailed listing of these differences, see the information on harmonisation of public sector accounting at www.imf.org/external/np/sta/tfhpsta/index.htm.
References
Legislatures and Budget Oversight in Latin America: Strengthening Public Finance Accountability in Emerging Economies

by

Carlos Santiso*

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1. Introduction: Legislative budgeting, government accountability and fiscal prudence

Reforming budgetary institutions for effective government is a critical task for emerging economies. Strengthening the role of parliament in the budget process is an integral part of the restoration of democracy throughout Latin America, which requires a re-equilibration of executive and legislative prerogatives in public policy. The role of legislatures in public budgeting and public finance management has nevertheless been largely overlooked in the first stage of economic reform. This is starting to change, as the contribution of legislatures to the budgetary process is currently being re-evaluated, both in developed and, more recently, in developing countries. It is increasingly being recognised that parliaments have a critical role to play to strengthen economic governance, improve transparency in public finances and ensure government accountability. Enhancing legislative scrutiny of the budget and oversight of its execution is increasingly considered as a means to strengthen government accountability and curb corruption (OECD, 2002; G8, 2003). The international financial institutions are particularly keen to promote greater transparency in public finance management and to improve governmental financial information systems in emerging economies.

Legislative budgetary institutions perform critical accountability functions in public budgeting. They help enforce ex ante accountability, ensuring that budget allocations adequately reflect policy priorities; concurrent accountability, overseeing the execution of the budget by the executive; and ex post accountability, holding government to account for performance and results. Henceforth, in theory at least, parliaments constitute central agencies of state restraint and external accountability in public finance management (Schedler et al., 1999; Mainwaring and Welna, 2003). In practice, however, legislatures in emerging economies have often failed to adequately and responsibly perform these accountability functions. What then explains this disjuncture between the potential contribution of legislatures to public budgeting and their actual role?

Legislative budgetary institutions have largely been neglected in the first stage of economic reform and modernisation of financial administration. After decades of fiscal mismanagement, first-generation reforms have focused on improving transparency and efficiency in governmental financial administration within the executive branch (Dorotinsky and Matsuda, 2002). In
the course of the 1990s, Latin American countries have undertaken significant efforts to upgrade their public finance management and financial information systems. However, less attention has been paid to the simultaneous need to strengthen the mechanisms of integrity and accountability in budget management beyond the executive branch. Latin American legislatures are typically characterised by operational, administrative, and resource problems that limit the fulfillment of their legislative, representative, and oversight responsibilities.

The second wave of budgetary reforms currently underway is thus broadening its reach to include those institutions participating in the governance of the budget beyond the executive. In this second stage of reform, the contribution of legislative budgetary institutions, such as parliamentary budget committees, legislative budget offices and general audit offices, is being re-evaluated. However, what explains the effectiveness of legislative budgetary institutions in emerging economies remains under-theorized. There continues to be great controversy as to what the most appropriate role of legislatures ought to be in public budgeting. The prevailing economic orthodoxy warns against the dysfunctional fiscal effects of unrestrained legislative budgetary powers and consequently favours the insulation of economic policy making in the executive branch. Nevertheless, recent experience also demonstrates the risk to public budgeting of excessive executive discretion, when the latter is not adequately balanced with effective mechanisms of internal restraint and external accountability. A key challenge for governance of the budget in emerging economies thus concerns the ability of institutional arrangements to adequately combine democratic accountability and fiscal prudence.

This paper explores the effectiveness of legislative budgetary institutions in contemporary Latin America. It provides an overview of the current debate on the strengthening of the role of parliaments in public budgeting, as well as a review of the main constraints and conditions for effective and responsible legislative budgeting. It illustrates the challenges of legislative budgeting in presidential systems of government characterised by executive predominance in the budget process and weakly institutionalised mechanisms of accountability. Furthermore, the paper underscores the inherent risks to budget governance of unrestrained executive discretion and the insulation of economic policy. While it is yet too early to assess the impact of legislative activism on budgetary outcomes and fiscal discipline, the paper reveals increased legislative activism in public budgeting in recent years. However, the contribution of Latin American legislatures to budget oversight remains inhibited by structural factors related both to the internal organisation of parliamentary work and the broader external context of executive-legislative relations. Legislative budgeting requires the capacity to discharge budgetary functions effectively and responsibly, as well as the existence of an enabling environment that allows it.
Ultimately, the governance of the budget reflects a delicate balance between executive power and legislative oversight.

The concept of the governance of the budget is used to underscore the institutional dimensions of public budgeting in emerging economies and the political economy of public finance accountability. The budget is a pivotal instrument of public policy and a critical arena for political bargaining between the executive and the legislature. It is, essentially, a political process (Wildavsky, 1964 and 1992). As Scartascini and Stein (2004:2) emphasise: “Understanding the budget process and the incentives of the multiple agents that participate in this process is a key ingredient for any fiscal reform seeking long lasting results in terms of improvements in fiscal discipline and efficiency in the use of public resources.” While our knowledge of the dynamics of public budgeting within the executive has considerably improved in recent years, the interaction of budgetary institutions has, until recently, been the subject of less systematic scrutiny.

In Latin America, there exists an important gap between the formal powers and the actual role of parliaments in public budgeting. A first set of factors explaining this gap are internal to the legislatures themselves, related to deficiencies in the structures, processes and procedures of legislative budgeting, as defined by constitutional rules, legislative norms and parliament’s internal rules. The factors essentially relate to organisation, resources and capacity. A second set of factors are external to the legislatures, linked to the formal and informal rules shaping executive-legislative relations, the presidential nature of the political system, the over-reliance on executive decree authority, skewed electoral incentives, and a fragmented political party system. These two sets of factors interact in different ways along the different stages of the budget cycle. Evaluating what explains the behaviour of parliaments in public budgeting thus requires considering the capacity, ability and willingness of legislators to exercise their budgetary powers effectively and responsibly.

The paper argues that parliaments have a critical role to play to bridge the accountability gap in public finance management. Legislatures help ensure government accountability in public finances, by approving budget allocations, overseeing budget execution and controlling budget performance. The paper posits thus that sound public finance management and accountability require finding an adequate balance between executive and legislative prerogatives in the different phases of the budget cycle. While executive dominance in public expenditure management is more likely to ensure fiscal prudence, legislative oversight is critical to provide effective checks and balances and enforce accountability in the formulation, execution and control of the budget.
The paper is structured in four sections. Section 2 briefly reviews the contemporary debate on budgetary institutions in the first stage of economic reform. Section 3 analyses the scope of legislative budget authority in Latin American emerging economies, while section 4 discusses the constraints and conditions for the effective exercise of legislative budgetary powers. Section 5 offers concluding remarks.

2. Budgetary institutions and government accountability

2.1. Hierarchical budget institutions and fiscal discipline

Finding the most adequate balance between executive and legislative prerogatives in budget policy making is a critical challenge for emerging economies struggling to consolidate their democratic institutions. In theory, increased legislative budgetary powers ought to enhance transparency, accountability and integrity in public expenditure management. Risks nevertheless exist, as effective legislative budgeting requires the capacity to discharge budgetary functions in an effective and responsible manner (Wehner, 2001 and 2004; Krafchik and Wehner, 1998). There is great controversy as to what the most appropriate role of parliaments ought to be in budget policy making, as immature legislatures and unstable party systems are often the source of dysfunctional economic governance, budget deficits and fiscal imbalances. At the same time, however, unconstrained executives and autocratic presidents have tended to abuse their constitutional authority and delegated powers, left largely unchecked by amenable parliaments. The use, misuse and abuse of executive discretion in public budgeting have often led to serious economic mismanagement, pervasive corruption and state capture.

The prevailing consensus posits that legislative activism in public budgeting tends to be dysfunctional in fiscal terms, leading to greater budget deficits and public debt. Bradbury and Crain (2001) find that government spending tends to rise with the number of legislators, although bicameralism dampens this effect. Exploring the influence of budgetary institutions on fiscal performance in Latin America, Alesina et al. (1999) show that the nature of budget procedures strongly influences fiscal outcomes. Stein et al. (1998) find similar results for other measures of fiscal discipline. Consequently, it is argued, “hierarchical” budget systems that “concentrate power in the finance minister, vis-à-vis other ministers, and in the executive vis-à-vis congress” (Stein et al., 1998:3) tend to provide stronger procedural incentives for promoting economic prudence and ensuring fiscal discipline. Such views, which have significantly influenced economic policies in Latin America in the 1990s, also counsel giving greater independence to the institutions of economic governance, in particular central banks, tax authorities and regulatory agencies.
The core argument linking institutional arrangements to fiscal performance resides in the “common pool” dilemma of public budgeting: while the costs are borne by the general fund, benefits go to specific groups, sectors, or localities (Wingast et al., 1981). As a result, overspending and undertaxation are likely results. This problem can be minimised by assigning control over the budget to agents with incentives to internalise the costs of the programmes financed by the state. Examples of hierarchical institutions are those that strengthen the power of the executive to impose fiscal restraint and hard budget constraints, such as limits on the size of deficits, debt ceilings or fiscal targets. The introduction of procedural and numerical budget constraints and the strengthening of transparency and integrity mechanisms can help mitigate some of those risks.

After the fiscal crisis of the state in the 1980s, many Latin American countries have rationalised their public finance management systems and strengthened the institutions of economic governance accordingly. They have upgraded their finance ministries, increased the independence of central banks and strengthened the autonomy of tax agencies. The move towards more hierarchical budgetary institutions was pioneered in Argentina under Carlos Menem (1989-99) and in Peru under Alberto Fujimori (1990-2000) (Stein et al., 1998). In Argentina, changes in the budget process were formalised in the 1992 Law of Financial Administration. The changes involved adopting quantitative spending limits for different ministries at the beginning of the process and forbidding parliament to propose amendments that would increase budget deficits. The 2000 Law of Fiscal Responsibility adopted in Brazil constitutes a more recent attempt at establishing numerical and procedural budget constraints.

2.2. Executive-legislative relations in public budgeting

Nonetheless, there are risks associated with hierarchical arrangements. They tend to allow for excessive executive discretion in public budgeting, especially in presidential systems of government, and thus impede the emergence and consolidation of institutions of accountability and self-restraint in governmental financial management. In most Latin American countries, the executive dominates the budget process, and legislatures have largely acted as “rubber stamps”. Unfettered executive discretion in public budgeting has not only hindered the consolidation of mechanisms of self-restraint in public budgeting, but has also tended to circumvent or neutralise the few mechanisms that existed. Indeed, the greatest risk of hierarchical budget institutions resides in their replicating the mechanisms of autocratic government in public budgeting in democratic regimes.

Clearly, a re-equilibration of executive-legislative relations in public budgeting is required to ensure greater government accountability in public expenditure management. In Brazil, the role of parliament in the budget
process was at the centre of the debates of the Constituent Assembly on the
draft constitution in the early 1980s. Restoring the powers of parliament in
public budgeting was considered as an integral part of the restoration of
democracy. Reflecting a compromise between executive and legislative
prerogatives, the 1988 Brazilian Constitution gave parliament great powers in
public budgeting and limited the discretionary prerogatives of the executive
OECD, 2003).

Unconstrained executive discretion has also tended to undermine the
credibility of the budget as an instrument of policy making and strategic
planning. The instability of budgetary institutions and fiscal rules has hampered
the consolidation of credible budget processes with predictable procedures and
enduring structures. Frequent alternations of authoritarian and democratic
regimes have been detrimental to the institutionalisation of parliamentary
structures and processes and to the emergence of stable legislative budgetary
institutions that provide the necessary checks on executive discretion.
Furthermore, since the restoration of democracy in the region in the mid-
1980s, legislatures have been dominated by majorities belonging to or associated
with the president's ruling party. The combination of presidential constitutional
powers and delegated legislative authority has reinforced vertical patterns of
power relations. Parliaments themselves remain largely unconsolidated.

3. Legislative budget authority: Legal framework

Legislative budgeting is a recent development in the history of Latin
American legislatures. It is indeed telling that the first budget formally
approved by the Argentinean legislature was that of 1990. Legislative budgeting
can be defined by the scope of budget authority and the effectiveness of budget
oversight. The legal framework for legislative budgeting only partly explains the
actual performance of legislatures in the budget process.

The ability of parliaments to effectively engage in the budget process in
the different phases of the budget cycle, namely its formulation, adoption,
execution, and control (Allen and Tommasi, 2001), is contingent on four sets of
variables: whether parliament is legally empowered to intervene in budgeting,
whether it is endowed with the required technical capacities, whether it
possesses the necessary political will, and whether the governance environment
is conducive.

3.1. Legislative budgetary powers

Compared to similar-sized economies, legislative budget authority is
severely constrained in Latin American presidential systems. Apart from
frequent episodes of authoritarian government, presidents have had
extraordinary budgetary powers under constitutional governments.
Constitutional provisions endow Latin American executives with uncommon
<table>
<thead>
<tr>
<th>Country</th>
<th>Year of constitution (amendment)</th>
<th>Only the president can propose the budget</th>
<th>Article 100.6</th>
<th>Article 147</th>
<th>Article 61(1)II(b)</th>
<th>Article 64</th>
<th>Article 346</th>
<th>Article 258</th>
<th>Article 78</th>
<th>Article 215</th>
<th>Article 313</th>
</tr>
</thead>
<tbody>
<tr>
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<td>1994</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
</tr>
<tr>
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<td>1997</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
</tr>
<tr>
<td>Brazil</td>
<td>1988 (1999)</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
</tr>
<tr>
<td>Chile</td>
<td>1990 (1997)</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
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<td>1995 (1997)</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
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<tr>
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<td>1993</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
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<td>1993</td>
<td>Yes, implicit</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes: Article 351</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Peru</td>
<td>1997</td>
<td>Yes: Article 64</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes: Article 64</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1999</td>
<td>Yes</td>
<td>Yes: Article 100.6</td>
<td>Yes: Article 147</td>
<td>Yes: Article 61(1)II(b)</td>
<td>Yes: Article 64</td>
<td>Yes: Article 346</td>
<td>Yes: Article 258</td>
<td>Yes: Article 78</td>
<td>Yes: Article 215</td>
<td>Yes: Article 313</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1998</td>
<td>Yes: Article 64</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes: Article 64</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Congress cannot increase the budget for any items or create new budgetary categories if no new budget is passed. Current budget remains in effect or president's proposal takes effect.

Source: Santiso, based on World Bank (2001:36).
powers in public budgeting. Furthermore, constitutions also give presidents significant leverage and bargaining power over legislatures. As a general rule, legislative budgetary powers are described in the constitution and the organic budget law. Parliaments’ internal rules and procedures contain provisions regulating the budget process within parliament. The executive has a predominant role in budget policy making. In the formulation stage, executive predominance tends to confine parliament to a secondary role. The parliamentary prerogatives are greater in the later stages of the budget process: parliament proposes amendments, adopts the budget, oversees its execution and controls performance.

The budgetary powers of Latin American presidents are significant, both in absolute and relative terms, despite the important variations that exist between countries. Assessing the budgetary powers of presidents in 23 presidential systems, Shugart and Haggard (2001) find that in seven of them presidents enjoy exclusive power over spending legislation and the legislature encounters severe constraints on amending presidential proposals. Table 1 captures the budgetary powers of presidents in ten countries in the region. In all ten cases, the executive is endowed with the exclusive right to initiate the budget process and propose a draft budget bill.

3.2. Legislative taxation powers

Interestingly, parliaments’ powers in tax policy tend to be greater than in public budgeting, reflecting the historical origins of legislative powers in public finance (Schick, 2002). In Peru, parliament is the only branch of government legally empowered to raise revenue through taxation and establish or modify taxes – except custom duty and excise rates. Furthermore, budget laws cannot include tax issues. The executive is barred from resorting to emergency decrees in taxation policy. However, there exist loopholes, as the legislature can, and often does, delegate its taxation powers. The dichotomy between taxation and budgeting powers also reflects the fact that taxation policy and the budget process are essentially separate processes. Indeed, an important shortcoming in public finance management resides in the disjuncture between revenue and expenditure policy.

In practice, however, the contribution of parliaments to tax policy and taxation reform tends to be constrained by the same institutional and capacity constraints that inhibit their role in public budgeting. Legislatures lack the technical capacity to articulate their own proposals and the political incentives to effectively engage in taxation policy. Tax reform initiatives thus tend to originate in the executive, which usually obtains the delegation of legislative authority it seeks. Faced with intractable collective action dilemmas and capacity constraints, parliaments willingly delegate their taxation authority to the executive branch, which proceeds to reform tax policy by legislative decree.
3.3. Executive dominance of budget formulation

While the executive dominates taxation policy *de facto*, it does dominate budget policy making *de jure*. It has a preponderant role in the formulation of the budget and the drafting of the budget bill and controls the execution of the budget. It is also the only branch of government that possesses the required technical capacity for doing so.

The central budget offices of the ministries of economy and finance are responsible for the general co-ordination of the budget drafting process within the executive and for overseeing its execution by spending agencies. They also are the supervisory agency for controlling public expenditure and managing government financial information. Access to and control over governmental financial information gives the central budget offices an undisputed advantage over both the legislature and the other ministries and executing agencies within government. The introduction in the late 1990s of integrated public finance management systems in many Latin American countries has significantly improved the reliability and credibility of government financial information (Dorotinsky and Matsuda, 2002). Furthermore, the laws of fiscal prudence and transparency adopted in many countries, such as Peru in 1999 and Brazil in 2000, establish guidelines for ensuring fiscal discipline and disciplining public finance management within the executive branch.

3.4. Legislative amendment powers

Once approved by the government, the draft budget bill is submitted to parliament for consideration. Two issues are important to take into account when assessing the role of parliament in the review and adoption of the budget: the time allocated to review the budget and the powers endowed to parliaments to review and amend the budget. Limiting both set of powers is a distinctive feature of “hierarchical institutional arrangements”.

The time allocated to parliament to review the budget and propose amendments varies greatly between countries, between 30 days in Mexico to 120 days in Honduras (Table 2). This is partly explained by the different institutional arrangements: as a general rule, federal states with bicameral legislatures tend to require more time to review the budget than unitary states with unicameral legislatures. The case of Mexico is an important exception (Cámara de Diputados, 2001). As the fiscal year generally corresponds to the calendar year, most legislatures must approve the budget in December. In Peru, for example, the executive branch must submit the draft budget bill by 30 August and parliament must approve it by 30 November, while in Mexico the federal government must submit its proposal by 15 November and parliament has until 31 December to approve the final budget.
During this period, the negotiations between the executive and the legislature occur within the standing budget and finance committee of parliament. Each spending agency must substantiate its budget requests to the committee. Once formally approved, the committee’s opinion is debated in the plenary. The proposed amendments are discussed with the executive, which considers them and produces a final budget bill (accepting or rejecting the proposed amendments). The approved budget law must be published in the official bulletin before the beginning of the fiscal year to become effective.

Latin American constitutions establish important restrictions on legislative amendment powers. In five of the ten cases included in Table 1 (Brazil, Chile, Colombia, Peru, and Uruguay), the legislature cannot increase the budget for any items or create new budgetary categories. Parliament is not allowed to create or increase public spending, except as it pertains to its own budget. Furthermore, if the budget is not approved by parliament by the set deadline, the current budget remains in effect in only four cases (Argentina, Costa Rica, Uruguay and Venezuela). In five other cases (Bolivia, Chile, Colombia, Ecuador, Peru), the executive’s proposal automatically becomes law, usually by legislative decree. Only in Brazil, the inability of the executive and the legislature to reach agreement over the budget leads to deadlock.

Table 2. **Time for budget review in Latin America**

<table>
<thead>
<tr>
<th>Parliamentary structure</th>
<th>Budget approval authority</th>
<th>Days allowed for reviewing budget proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Brazil</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Colombia</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Chile</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Paraguay</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Uruguay</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Bicameral</td>
<td>Both chambers</td>
</tr>
<tr>
<td>Mexico</td>
<td>Bicameral</td>
<td>Chamber of Deputies</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Unicameral</td>
<td>Legislative Assembly</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Unicameral</td>
<td>National Congress</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Unicameral</td>
<td>Legislative Assembly</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Unicameral</td>
<td>Congress of the Republic</td>
</tr>
<tr>
<td>Honduras</td>
<td>Unicameral</td>
<td>National Congress</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>Unicameral</td>
<td>National Assembly</td>
</tr>
<tr>
<td>Panama</td>
<td>Unicameral</td>
<td>Legislative Assembly</td>
</tr>
<tr>
<td>Peru</td>
<td>Unicameral</td>
<td>Congress of the Republic</td>
</tr>
</tbody>
</table>

Source: Gutiérrez et al. (2001: Chapter III).
These clauses give the executive extraordinary leverage over the legislature, as legislative inaction does not preclude the executive proposal from being adopted. The rationale behind these provisions is to avoid deadlock over the budget by establishing procedural constraints on parliaments’ budgetary prerogatives. This mechanism \textit{de facto} neutralises legislative obstruction and significantly diminishes the legislature’s bargaining power, as the legislature has no veto power over the executive’s budget proposal. It also creates a set of incentives shaping the bargaining process between the executive and the legislature in public budgeting. In those five countries where the executive’s proposal takes effect despite the opposition of parliament, the executive clearly has the upper hand and does not possess many incentives to genuinely negotiate, make concessions and reach compromises.

3.5. Legislative oversight of budget execution

Constitutions do nevertheless give parliaments an important role in the oversight of budget execution, the scrutiny of budget reallocation, and the review of public accounts. In practice, however, legislative oversight of budget execution is still embryonic in emerging economies. Legislatures exercise only a limited monitoring of the government’s compliance with budget rules and procedures. Largely unable to monitor compliance with the approved budget, they are even less able to monitor the performance of public expenditure and enforce results-based budgeting.

Parliaments do nevertheless possess a potentially powerful instrument to control budget execution and enforce \textit{ex post} accountability: the \textbf{annual discharge of government}. The accountability cycle of the budget process ends with the discharge of government and the certification of the state’s public accounts. Public accounts, which are prepared by the general accounting office, must be audited by the general audit office, which emits its opinion on their accuracy and reliability. The general accounting office is a technical body of the finance ministry responsible for maintaining the state’s accounting system and preparing the state’s public accounts every year following their execution. The public accounts committee of parliament considers the audited report on public accounts and the opinion of the general audit office. It reviews the accounts and emits its own opinion. The plenary subsequently considers the committee’s opinion and decides whether to discharge government.

The \textbf{review of public accounts} is a tool that parliaments in Latin America have seldom used effectively to hold government to account. This is explained by a series of factors rooted in the political economy of executive-legislative factors, including the dominance of the executive and the disincentives of parliaments to enforce government accountability. Institutional and technical considerations also partly explain the ineffectiveness of the legislative review
of public accounts. Legislative certification powers are often constrained by the ambiguity of constitutional provisions regulating this process. For instance, in Argentina, the likely consequences of the legislature refusing to discharge government are unclear. This has led to a paralysis of the certification process in the joint public accounts committee, when budgets and public accounts clearly were a fiction such as in 1995 following the Mexican “tequila crisis” of 1994. Indeed, in 2002, parliament was examining the public accounts of 1996. In other countries, the process may be denaturalised by “hierarchical institutional arrangements”. In Peru, a constitutional provision stipulates that if parliament fails to act on the public accounts reports within the imparted time, the public accounts committee’s opinion is transmitted to the executive for adoption by legislative decree. This constitutional clause, while providing for continuity in the budget process in the event of legislative inaction, nevertheless neutralises the oversight prerogatives of parliament in the certification of public accounts and the discharge of government. In practice, the Latin American public accounts committees have seldom refused to discharge governments or threatened to do so.

Furthermore, lags and inconsistencies in the timing and sequencing of legislative scrutiny also constrain effective government accountability. Often, the review of public accounts and the evaluation of the auditor general’s report take place at a time that does not always allow adequate feedback into the budget process. In Peru, for example, there is only limited opportunity for the external audit report of public accounts to inform the evaluation of the budget bill of the following year, and in practice it does not occur. The Peruvian parliament receives the reports on the previous year’s public accounts by 15 November and must approve the following year’s budget by 30 November. During that short period of fifteen days, the budget debate takes place in plenary, which further limits technical input into the process. The review and certification of public accounts by parliament take a further four months. In effect, the parliament’s review of the government’s budget proposal is largely dissociated from its control of the budget executed in the previous period, significantly weakening the accountability functions of legislative oversight.

4. Legislative budget oversight: Actual performance

As the preceding section has shown, the legal framework of public budgeting in Latin American countries imposes serious constraints on the role of the legislature in budget oversight. In recent years, however, parliaments have exhibited increased activism in public budgeting. The performance of legislatures in public budgeting is contingent on the scope of budgetary powers vested in parliament, the technical and advisory capacity available to it, and the incentives for legislators to effectively exercise their budgetary prerogatives. Assessing the actual configuration of powers vested in legislatures,
Krafchik and Wehner (1998) show that de facto amendment power depends on a second set of factors relating to the effective role of committees in the budget process. This role is determined by a combination of factors, including the scope of amendment powers, the time allocated to committee review, the organisation of committee involvement, and access to independent advisory and research capacities.

### 4.1. Budget credibility and transparency

There exists an important disjuncture between the legal framework for legislative budgeting and parliament’s actual performance. Compliance with fiscal responsibility legislation and multi-annual expenditure frameworks has often been weak, which casts doubts on their ultimate usefulness. While significant progress is being made, the general absence of enforcement mechanisms significantly hinders legislative budget oversight and affects the credibility of the budget as a policy instrument.

Recent research on budget transparency in Latin America has revealed the gap between the quality of the legal framework for public budgeting and adherence to it (Morón et al., 2003; IBP, 2003; Lavielle et al., 2003). According to the survey data reproduced in Table 3, while the quality of the legal framework for public budgeting in Argentina, Brazil, Chile, Mexico and Peru is generally sound, perceptions of budget transparency are poor, especially in Peru. Table 4 reveals that legislative oversight and external auditing are particularly deficient.

<table>
<thead>
<tr>
<th>Table 3. Budget transparency in Latin America</th>
<th>Aggregate index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of legal framework1</td>
<td>Perceptions index2</td>
</tr>
<tr>
<td>Out of 1 000 points</td>
<td>1 to 10</td>
</tr>
<tr>
<td>Argentina</td>
<td>700</td>
</tr>
<tr>
<td>Brazil</td>
<td>636</td>
</tr>
<tr>
<td>Chile</td>
<td>733</td>
</tr>
<tr>
<td>Mexico</td>
<td>507</td>
</tr>
<tr>
<td>Peru</td>
<td>598</td>
</tr>
</tbody>
</table>

1. The legal framework score is on a scale of 0 to 1000.
2. The index of perceptions is an average on a scale of 1 to 10, of not transparent to transparent.

Source: IBP (2003:5).
Furthermore, budget rigidity and inertia tend to limit the scope for exercising legislative budgetary powers. In Brazil, 90% of the budget is considered rigid as a result of constitutionally mandated expenditures, earmarking of tax revenues and mandatory expenditures. As the OECD (2003:4) notes: “The effect is to insulate a very large proportion of the budget from effective scrutiny each year.” Budget inertia is accentuated by the small size of Latin American budgets, in particular capital expenditures. The type of public spending on which parliament could potentially have the greatest influence – capital expenditure – represents only a small fraction of public expenditures. Current expenditures (public sector wages and pensions) and debt repayments (principal and interest) consume most of public spending. Nevertheless, capital expenditure allocation is strategic and subject to intense political bargaining. Recent research on public budgeting in Brazil reveals that executive-legislative bargaining over the execution of appropriation amendments and public investment projects can be used as an effective tool for building the ad hoc coalitions needed to pass legislation (Pereira and Muller, 2004).

Legislative budget oversight is further hindered by the gap between the approved and executed budgets. Optimistic assumptions on revenues and the weak execution capacity of sector ministries partly explain underspending in Peru, which can be as large as almost 15% of the approved budget as in 2000 (Santiso and García Belgrano, 2004; Mostajo, 2002). In order to stay within the fiscal limits agreed with the International Monetary Fund, the government is often forced to implement ad hoc reductions in expenditures.

Table 4. Budget transparency in Latin America
Disaggregate index

<table>
<thead>
<tr>
<th>Phases of the budget</th>
<th>Average score of 1 to 5</th>
<th>Most transparent</th>
<th>Least transparent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Chile</td>
<td>Mexico</td>
<td>Argentina</td>
</tr>
<tr>
<td>Formulation</td>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>3.36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>2.67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>2.57</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>2.47</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2.47</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approval</td>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>2.80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>2.79</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2.63</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>2.44</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>2.39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Execution</td>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>3.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>2.71</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2.40</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>2.38</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>2.36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oversight and auditing</td>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>3.07</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2.31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>2.27</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>2.19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>1.89</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic information</td>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>3.53</td>
<td></td>
<td></td>
</tr>
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<td>Argentina</td>
<td>3.15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>3.15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>2.75</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>2.66</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Santiso, based on IBP (2003:3).
Furthermore, executives often reassign expenditure during the execution of the budget. Budget reallocation is often abused to introduce important changes to the budget approved by parliament. This is reflected in both the quantity and the earliness of the changes introduced by the executive. Moreover, the recurrent use of off-budget expenditures throughout the 1990s, in particular in military, defense and intelligence spending, has damaged the reliability of the official budget. While providing flexibility in the management of public expenditures to adapt to unforeseen circumstances, the frequent recourse to executive decrees to reallocate budget appropriations not only undermines legislative oversight, but also weakens the integrity of the budget as an instrument of economic governance and strategic planning.

4.2. Legislative budgetary institutions

The mechanisms of legislative oversight and financial scrutiny are being enhanced, reflecting the initiation of second-generation budgetary reforms. Deficient parliamentary structures and procedures weaken the ability of parliaments to effectively and responsibly exercise their budgetary prerogatives. Parliaments often lack the human and financial resources to effectively discharge their budgetary responsibilities. The lack of institutionalisation of parliaments themselves, as a result of repeated alternations between democratic and authoritarian regimes, is a major impediment to effective budget oversight, which requires parliamentary structures and procedures that are sufficiently institutionalised to counterbalance the executive’s overwhelming budgetary powers. In democratic periods, the presidential nature of government institutions and the autocratic modes of government used by democratically elected presidents have also hampered the institutionalisation of parliaments. Enhancing the role of parliaments in public budgeting requires strengthening legislative budgetary institutions, in particular budget and public accounts committees, legislative budget offices and legislative research capacities.

4.2.1. Legislative budget and public accounts committees

Strong and capable parliamentary committees enable legislatures to develop their expertise and fulfill their accountability and oversight functions in public budgeting. The budget and public accounts committees are strategic parliamentary committees. In Brazil, the Joint Committee on Plans, Public Budgets and Oversight, the Comissão Mista de Planos, Orçamentos Públicos e Fiscalização (COM), is a strategically important parliamentary committee composed of 84 members from both chambers. The Comissão de Fiscalização Financeira e Controle (CFFC) of the Brazilian upper chamber was established in 1995 and is responsible for overseeing the execution of the budget and certifying public accounts. This committee first appeared in 1936 in the
internal rules of parliament, which created 14 committees including the public accounts committee (Tomada de Contas).

However, in Latin America, budget and public accounts committees are generally weak, and the organisation of committee work often lacks the kind of institutionalisation that would allow specialised committees to effectively contribute to the budgetary process. The division of responsibilities between the different committees dealing with different facets of public finance (taxation, budgeting, oversight and control) remains unconsolidated and has fluctuated over time. These shortcomings are particularly detrimental to budgetary work, given its increasing complexity. For example, while in Peru three distinct parliamentary committees oversee public finances, in Venezuela these structures are sub-committees of the finance committee of the unicameral National Assembly. In turn, the organisation of legislative standing committees has an important impact on the incentives for inter-committee co-ordination and coherence. Furthermore, the internal composition of committees is proportional to that of parliament. Hence, the legislative majority has a decisive influence on the agendas and work plans of the budget and finance committees, which it generally chairs. Such institutional arrangements tend to lessen the incentives for legislative oversight since, as Messick (2002:2) says, “in all legislatures, it is the party or parties out of power – the opposition – that has the incentive to oversee government”. Indeed, in many Commonwealth parliamentary systems, public accounts committees are chaired by the opposition.

Deficient internal structures and procedures prevent parliaments from effectively and responsibly exercising their budgetary prerogatives. In many countries, such as Peru, committee members and chairs rotate every year, which negatively affects the continuity of their work and the institutionalisation of budget expertise. Furthermore, legislators as a rule attend several committees, which limits the time and energy they can dedicate to each one of them. The budget review process within legislative committees has seldom been institutionalised in permanent and stable rules. In Peru, the budget and public accounts committee sets its procedural rules and work programme every year. Nevertheless, important reforms are being considered and introduced to rationalise the role of legislatures in public budgeting. In Chile, for example, the Political Agreements for the Modernisation of the State (January 2003) made the Special Joint Budget Committee a permanent parliamentary committee.

4.2.2. Legislative technical advisory capacity

Budget and public accounts committees rely on technical advice to perform their tasks. In Latin America, however, legislative technical advisory capacity is weak, reflecting the embryonic nature of apolitical legislative advisory services in budgetary matters. While the number of staff assigned to
the budget and public accounts committees has tended to increase in recent years, albeit slightly, it remains inadequate to effectively engage in increasingly complex budgetary processes. Furthermore, budget and public account committees as such are seldom assigned permanent technical advisers with the required knowledge of legislative procedures and budgetary matters. Committee advisers are usually appointed on a short-term basis, usually renewable every year, by members of the committees. In fact, the political advisers of the legislators sitting in legislative committees carry out most of the advisory work. As a result, technical input in the budget review process tends to lack the sufficient technical substantiation required for impartial evaluation. The absence of a tenure-track civil service career for parliamentary staff is accentuated by the structural weaknesses of most Latin American civil services.

Parliaments nevertheless do have at their disposal limited resources for independent research, for example through legislative research offices and parliamentary libraries. Although not as well resourced as the Congressional Research Service and the Library of Congress in the United States, research and advisory facilities are being gradually strengthened in the region. In Brazil, the budget committee of the lower house of parliament is assisted by a research office consisting of about 35 professionals, which is however exclusively focused on providing advisory services to the committee. The public accounts committee of the Senate is also able to call upon the research and advisory services of the Consultoria Legislativa. In Peru, with the return to democracy in 2001, there are attempts at enhancing parliamentary capacity for independent research and analysis. With support from the Inter-American Development Bank (IADB) and the United States Agency for International Development (USAID,) a Parliamentary Research Centre (Centro de Investigación Parlamentaria, CIP) is being established. Similarly, in Colombia, the Legislative Modernisation Plan adopted in 2002, with support from USAID, includes provision for the creation of an office providing for general research and advisory support to parliament, the Oficina de Asistencia Técnica Legislativa (OATL).

4.2.3. Legislative budget research capacity

Access to independent information on budget performance is critical for legislatures to effectively oversee governmental financial management. While significant efforts are currently being made to enhance parliaments’ budget research capacities, information asymmetries between the executive and the legislative branches of government remain important. In general, budget and public accounts committees rely almost exclusively on the information provided by government agencies, which significantly constrains their ability to carry out independent budget reviews and adequately oversee budget execution.
While financial constraints partly explain the lack of budget research capacity, there are also political reasons why parliament has not purposefully sought to build such capacity. Timely and reliable access to independent budget information is strategic in the sense that it is the parliamentary opposition that has the greatest incentives to strengthen parliament’s capacities for independent budget analysis (Messick, 2002; Rubio Llorente, 1993). As Messick (2002:3) notes, “The majority in parliamentary systems has no need for – or interest in – information provided independently of government. Only the opposition does. And the more the opposition uses such information to criticize government, the greater the majority’s interest in abolishing or weakening the units that provide it.”

This situation is gradually starting to change as parliaments throughout the region recognise the strategic importance of their access to independent budget analysis, either from specialised policy think tanks or from their own research departments. Capable professional staff and institutionalised technical expertise within parliament itself are necessary conditions for legislatures to be able to exercise their budget oversight functions effectively and responsibly. The contribution of legislative budget offices to effective budget oversight is increasingly being recognised. Although not as powerful as the United States Congressional Budget Office, incipient legislative budget offices are gradually emerging throughout Latin America, reflecting an increasing recognition of the current weakness and, simultaneously, the potential contribution of parliaments to budget oversight. In Mexico, for example, the research and advisory capacities of parliament for independent budget analysis have been significantly enhanced with the establishment, in 1998, of a Centre for the Study of Public Finances (Centro de Estudios de Finanzas Públicas, CEFP) in the lower chamber of parliament. The Mexican parliament’s general research capacities were already relatively important by that time, with the Research and Analysis Service (Servicio de Investigación y Análisis, SIA) of the parliamentary library and the Institute for Legislative Research of the upper chamber of parliament (Instituto de Investigaciones Legislativas del Senado de la República, IILSEN) established in 1985 to provide general technical advice to the Senate.

Similarly, in Venezuela, an Economic and Financial Advisory Office (Oficina de Asesoría Económico y Financiera de la Asamblea Nacional, OAEF) was created in 1997 within the National Assembly, with support from the IADB, to enhance the technical advisory services of parliament in public finance. This new parliamentary structure was able to draw on the existing sources of legislative research and analysis, such as the Autonomous Service of Legislative Information (Servicio Autónomo de Información Legislativa, SAIL) created in 1994. Nevertheless, increasing tensions between the executive and the legislature since President Hugo Chávez took office have undermined the functioning of
this office. The OAEF was closed in February 2000 to be subsequently reopened in June of the same year, as part of the reactivation of the suspended loan by the IADB. In 2002-03, the office was under renewed pressure (Rojas and Zavarce, 2004).

Indeed, a main impediment to legislative budgeting often resides in parliament's incapacity to purposefully engage in the budget process, rather than the restraints put on its budgetary powers. Technical capacities are thus important considerations to take into account when assessing the performance of legislatures in budget oversight. A critical challenge for strengthening legislative budget oversight is that the parliamentary opposition, when it exists, has the greatest interest in and incentives for enhancing parliament's capacities for effective budget oversight, and consequently for strengthening legislative capacities for independent budget review. Henceforth, strengthening legislative budgetary institutions must necessarily be approached in the broader context of executive-legislative relations in presidential systems of government.

4.2.4. Legislative oversight and external auditing

The institutional linkages between public accounts committees and general audit offices are determinant for the effectiveness of legislative budget oversight. Improving these linkages is critical to anchor accountability in public finance and budget management (Santiso, 2004d; SIGMA, 2002). General audit offices are generally autonomous organisations with functional links to parliaments. They provide critical advisory services to parliaments, directly or indirectly, in the exercise of their accountability functions. At the same time, the effectiveness of audit reports largely depends on the follow-up parliaments give to them (or lack thereof). However, relations between supreme audit institutions and budget and public accounts committees remain deficient and often dysfunctional, characterised, at best, by polite disregard.

Relations between general audit offices and parliamentary public accounts committees vary according to the institutional arrangements for external auditing. Three distinct institutional models exist: that of an autonomous state institution, such as the Chilean and Peruvian Contralorías Generales de la República (CGR); that of an advisory body to parliament, such as the Argentinean Auditoría General de la Nación (AGN); and that of an independent institution with quasi-judicial powers, such as the Brazilian Tribunal de Contas da União (TCU).

Furthermore, securing the political independence of general audit offices is critical to guarantee effective external auditing of government finances (INTOSAI, 2001). Issues such as criteria guiding the nomination and removal of auditor generals and the length of their term in office, as well as the procedures regulating recruitment, promotion and dismissal of professional staff are critical
determinants of the effective independence of general audit offices. Predictable financial resources are also necessary, yet not sufficient for institutionalising supreme audit institutions and insulating them from political meddling. The political independence of general audit offices has often been compromised, however. Nominations of auditor generals and, consequently, of the general audit office’s staff, have tended to respond to political considerations. When government controls a majority in parliament, nominations often reflect political bargains. Furthermore, short terms of office that coincide with that of the president tend to reduce the incentives of auditor generals to exercise any political independence they may have. In Argentina, the constitution and the law on financial administration stipulate that auditor generals are appointed for an eight-year renewable term. However, in an effort to increase the independence of the AGN, an amendment to the constitution in 1994 established that the president of the AGN is to be chosen from the main opposition party. As a result, presidents of the AGN have changed as government majorities have changed. The extreme politicisation of the civil service has entailed high rates of staff turnover and thus has not allowed the consolidation of technical expertise and an “esprit de corps” within the institution. A highly prepared and recognised civil service, with stability of tenure and reasonable career prospects within the institution, is determinant for anchoring professionalism in external auditing of government finances.

Furthermore, the general unavailability of timely information on budget performance hampers effective financial accountability and limits effective budget oversight by the legislature. There is limited publicity of audit reports, which have often failed to be adequately followed up. Those institutions that ought to act upon audit findings largely ignore them. These considerations, in turn, question the capacity and willingness of parliamentary public accounts committees to effectively supervise the work of general audit offices and act upon the recommendations of the audits they perform. Reversing these trends will prove particularly challenging, but efforts are being made to enhance the functional linkages between the institutions participating in the national systems of integrity and contributing to the oversight of government finances.

Acknowledging these important shortcomings, Latin American countries are seeking to strengthen their external auditing functions with the support of international financial institutions (Santiso, 2004d). Important reforms have been introduced in recent years. In Mexico, for example, a general audit office, the Auditoría Superior de la Federación (ASF), was established in 1999 as an advisory body to the lower chamber of parliament, to assist the latter in the oversight of federal public finances and the review of federal public accounts. Shortly thereafter, in 2000, parliament approved the law on external accountability (Ley Superior de Fiscalización de la Federación). In Chile, the 2003 Political Agreements for the Modernisation of the State confirmed the political
consensus on the need to continue strengthening the general audit office, with the financial backing of the IADB.

4.3. Economic governance and budgetary decision making

Beyond the constraints imposed by institutional frameworks for legislative budget oversight, the presidential nature of political systems, coupled with an over-reliance on executive decrees, have been detrimental to the strengthening of the institutions of government accountability in public budgeting. In most Latin American presidential systems, the use of executive decrees in public budgeting is impressive both in absolute and relative terms, and legislatures exercise little oversight on presidential decrees (Carey and Shugart, 1998). The frequent use of urgency decrees to change budget appropriations and approve supplements adversely affects the quality of budget management. In Peru, for example, between January 1994 and March 2001, parliament passed 1 152 laws or legislative resolutions, while the president issued 870 decrees, 86% of which were urgency decrees. Of those 748 urgency decrees, 27% directly amended the budget and a further 41% had a clear effect on the budget or public finances (World Bank, 2001:60-62).

Nevertheless, the institution of urgency decrees is a double-edged sword, as there is an inherent trade-off between decisiveness and resoluteness in economic policy making (Santiso, 2004a; Haggard and McCubbins, 2001): when political systems allow for more decisiveness in economic governance by insulating economic policy making and extending the use of executive decrees, decisions can be as easily reversed as they can be adopted. Such institutional arrangements tend to generate erratic patterns of policy making. The cases of Peru under Alberto Fujimori, Brazil under Fernando Collor and Argentina under Carlos Menem are symptomatic of the dysfunctional effects of abusing executive decree authority.

The over-reliance on executive decrees is symptomatic of the insulation of economic policy making within the executive branch. A defining characteristic of first-generation market reforms implemented in the early 1990s is its emphasis on insulating economic policy making from political meddling (Pastor and Wise, 1999; Naím, 1995). Indeed, the insulation of economic policy making and the building of hierarchical budget institutions were both a reflection of the consensus in the early 1990s on how radical reforms ought to be implemented (Santiso, 2004b). Nevertheless, the manner in which first-generation economic reforms were implemented has often undermined the mechanisms of political accountability, external scrutiny and legislative oversight in public finance, sometimes unintentionally, but often purposefully (Santiso, 2003 and 2004a). The neutralisation of “veto points”, such as legislative oversight or judicial review, did facilitate the implementation of market reforms. Over time, however, the institutions of economic governance became vulnerable...
precisely because they were isolated, ultimately leading to dramatic cases of state capture, such as in Argentina during Menem and in Peru under Fujimori. Clearly, government by executive decree, while an asset in the initial phase of economic reform, progressively becomes a liability in the second phase of reform.

4.4. Political governance and legislative budgeting

Legislative behaviour and executive-legislative relations in public budgeting are necessarily intermediated by political parties and electoral rules. Stein et al. (1998) have indeed uncovered a statistically significant relationship between electoral systems and fiscal performance. Electoral systems characterised by a large degree of proportionality (i.e. large district magnitude) and political fragmentation (i.e. number of effective parties represented in parliament) tend to have larger governments, larger deficits and a more pro-cyclical response to the business cycle.

Research on the politics of budgeting in Brazil (Morgenstern and Manzetti, 2003; Figueiredo, 2003; Pereira and Mueller, 2002) shows that participation by the legislative branch in the budget process can only be understood when the political parties and electoral rules are taken into account. In Brazil, the inchoate nature of the political party system, and the fact that the executive dominates the budget process and controls budget execution, means that partisan participation in the budget process depends on the parties’ relations with the executive (Pereira and Mueller, 2002). The quality of the political party system and the incentives created by electoral rules are determinant variables to explain the effectiveness of legislative budget oversight. The role of the parliamentary opposition is particularly important, as “opposition parties have the greatest incentive to oversee government” (Messick, 2002:2). Ultimately, the degree of cohesion and discipline of political parties determines, to a great extent, the effectiveness of the institutions of accountability and the quality of executive-legislative relations.

The excessive fragmentation and volatility of political party systems in many Latin American consolidating democracies is detrimental to the effective exercise of legislative budget oversight. Parties lack the sort of internal coherence, cohesion and discipline that would allow them to act purposefully and consistently within parliament. Party fragmentation is compounded by a high degree of volatility of parties and, consequently, the short-term time horizons of legislators. Furthermore, when the ruling coalition holds a disciplined majority position in parliament, as is often the case in Latin American presidential systems, there exists a possibility of control dilution. Presidential systems marked by fused executive and legislative majorities tend to have inoperative systems for enforcing government accountability. As Messick (2002:2) notes: “When the interests of a legislative majority and the executive branch coincide, the majority has little incentive to oversee the executive”
and, as a result, “legislative oversight is often weak” (Manning and Stapenhurst, 2002:2). Interestingly, legislative budget activism in Mexico since the late 1990s is a direct result of the emergence of a parliamentary opposition as a result of the 1997 elections. The emergence of an effective parliamentary opposition, which ultimately succeeded in defeating the long-time ruling party in the general elections of 2000, has provided strong incentives for enhancing legislative budget oversight and increasing parliament’s capacities for independent budget review. As the case of Mexico clearly demonstrates, the emergence of credible parliamentary opposition significantly increases both the incentives and capacities for effective legislative budget oversight. Ultimately, effective and responsible legislative oversight requires the existence of a sufficiently effective parliamentary opposition and the strengthening of the legislative capacities for independent budget analysis.

The case of Mexico also underscores that the new patterns of executive-legislative relations that are gradually emerging throughout Latin America are having an important impact on the role of legislatures in public budgeting (Mainwaring and Welna, 2003; Morgenstern and Nacif, 2002; Haggard and McCubbins, 2001). Legislatures are gradually reasserting their budgetary powers, partly as a result of the emergence of more active parliamentary oppositions. Divided government, i.e. situations where the executive and legislative majorities do not coincide, is a new phenomenon in Latin America. It is an increasingly common one. It creates new confining conditions constraining executive discretion in public budgeting. In Mexico, for example, conflict over the budget has increased since the long-time ruling party, the Partido Revolucionario Institucional (PRI), lost its parliamentary majority in 1997 (Carbonell, 2002; Weldon, 2002). In Brazil, parliament has traditionally been the privileged arena for pork-barrel politics over budget appropriations and amendments (Samuels, 2002). Even in Argentina, a country characterised by relatively disciplined parties, public budgeting has been the subject of more conflict and bargaining than previously thought (Eaton, 2002; Jones, 2001).

5. Conclusions: The politics of public budgeting

The analysis of legislative budgeting in Latin America illustrates the constraints and conditions for enhancing the contribution of parliaments to budget oversight in presidential systems of government. The political economy of the budget process reveals that political and technical aspects interact in determining the effectiveness of legislative budget oversight along the budget cycle. Parliaments do possess important budgetary powers. However, they seldom exploit fully those few powers they have. Capacity constraints and information asymmetries tend to explain why parliaments do not exercise their budgetary power effectively, while governance constraints and the nature of executive-legislative relations tend to explain why they sometimes
do not exercise them responsibly. Parliaments' ability to establish their credibility as institutions of economic governance is thus contingent both on strengthening their budgetary capacities and on the existence of an enabling governance environment that allows it.

The core challenge remains to adequately combine increased legislative budget activism with the furtherance of fiscal discipline. As Schick aptly points out (Schick, 2003): “As legislatures enhance their budget role, one of the challenges facing budget architects will be to balance the impulse for independence with the need to be fiscally responsible. The future of legislative-governmental relations will be strongly influenced by the manner in which this balance is maintained.” Strengthening the capacities of legislatures to effectively engage in the budget process and assume their budgetary responsibilities certainly helps to minimise the dysfunctional effects of irresponsible legislative budgeting and to ensure a positive contribution of legislatures to fiscal discipline and prudence. The weakness of legislative budgetary institutions results in an inadequate access to independent budget analysis, the insufficiency of apolitical technical advice and the unavailability of timely information on budget performance. Redressing these shortcomings would require strengthening legislative structures and procedures, the legislative budget offices and the contribution of general audit offices to legislative budget oversight.

However, increasing technical capacity alone is likely to remain ineffectual as long as the right political incentives do not exist for it to be exercised effectively. Technical improvements can easily be neutralised or emasculated by adverse political economy constraints. Henceforth, rehabilitating legislative budgeting in Latin America is a typical “chicken and egg” problem: Should legislative capacity be built first or should it emerge as a result of increased legislative activism? The study of legislative budgeting in Latin America clearly demonstrates that capacities and incentives ought to be addressed simultaneously. The challenge of effective legislative budgeting in Latin American presidential systems is to move from a context of trade-offs between democratic accountability and fiscal discipline, to one of positive synergy and “virtuous circle”. Fiscal responsibility and democratic accountability are to be forged simultaneously.

This paper further underscores that that one ought to more clearly differentiate the contribution of legislatures to budget policymaking in the different phases of the budget. While the management of public expenditures ought to firmly remain within the purview of the executive, the role of the legislature is critical to ensure that government is held to account for the manner in which it allocates, executes and oversees public spending. Sound economic governance requires the effective and responsible oversight of the budget by the legislature. Furthermore, by strengthening the mechanisms of accountability in public budgeting, legislative budget oversight is likely to
enhance, over time, the credibility of the budget and provide effective restraints on executive discretion in public expenditure management.

Ultimately, the governance of the budget reflects a delicate balance between executive power and legislative oversight. The central challenge of legislative budgeting and budget policy making in Latin American presidential systems is how to retain the advantages of strong executive authority required to manage the economy and ensure fiscal discipline, especially in times of turbulence, while at the same time providing the institutional checks and balances that guarantee effective accountability (Santiso, 2004a and 2004b). In turn, the quality of the mechanisms of “vertical accountability” – in particular the nature of the political regime and the coherence of the political party system – greatly influences the efficacy of the institutions of “horizontal accountability” such as legislative oversight of the budget (O’Donnell, 1998; Schedler et al., 1999). Ultimately, the effectiveness of the mechanisms of “horizontal accountability” within the state ultimately depends on the effectiveness of the mechanisms of “vertical accountability”. Strengthening the institutions of legislative budget oversight and the agencies of public finance integrity is undoubtedly a structural challenge for Latin American emerging economies. It is nevertheless a critical one.

Notes


2. In 2003, in co-operation with the World Bank, the OECD carried out extensive comparative research on budget practices and procedures, including the role of legislatures in the budget process. The results of the first OECD budget survey cover about 40 countries – see http://ocde.dyndns.org.

3. In 2001, the International Monetary Fund adopted a Code of Good Practices on Fiscal Transparency, and a country’s observance of these standards is to be regularly assessed in the Reports on the Observance of Standards and Codes. These diagnosis instruments complement those of the World Bank assessing the quality of public finance processes, such as Public Expenditure Reviews and Country Financial Accountability Assessments.

4. Already in the 1920s and 1930s, the United States-sponsored “Kemmerer missions” helped establish central banks and upgrade the systems of government finance in the Andean countries.

5. There are important exceptions to this procedure, such as in Chile where the external audit office is also responsible for maintaining the national accounting system.
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Estimates for the Structural Deficit in Switzerland, 2002 to 2007

by

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1. Introduction

The new Swiss budget rule or “debt brake” is based on the idea or rather the aim that the structural deficit should be zero.¹ Therefore, the size of the structural deficit is of special importance for the conduct of fiscal policy under the debt brake. In 2003, it was estimated that there is a structural deficit in the order of CHF 3.5 billion, which represents about 7% of central government expenditure or under 1% of GDP. In comparison to the European Union deficit rule (Maastricht criteria) of 3% of GDP, this is of course a small number. However, this excludes the social security accounts, which are not included in the federal financial accounts in Switzerland. In addition, under the regime of the debt brake, the adjustment of a structural deficit has in principle to be immediate, which can be quite painful even for relatively small deficits. The adjustment can also be delayed, but this requires special provisions either through the law or through a decision of parliament to overrule the debt brake for extraordinary circumstances. The latter has to be supported by a qualified majority of both chambers of parliament.

Different methods are used to calculate the structural deficit. International organisations² like the EU, the IMF and the OECD have published recommendations for these calculations which implicitly or explicitly start from the assumption that government revenue can be decomposed into a structural and a business-cycle component. This is usually done by calculating the business-cycle component with the help of revenue elasticities and interpreting the rest as structural revenue. However, as we have shown elsewhere (Bodmer, 2004a), this disregards the irregular revenue component which, according to our own estimates, clearly dominates the business-cycle component. This irregular component is partly due to the idiosyncrasies of the Swiss tax system.³ Important factors behind it are the stamp duty and the withholding tax. Both have seen wild fluctuations especially since the mid-1990s. These had no or only a weak relation to the business cycle. Also, the possibility for firms to smooth their gains and losses over a number of years leads to strong fluctuations in the revenue from the corporate income tax.

We therefore suggest a different method for calculating the structural deficit. It is based on revenue rations, i.e. the revenues of the different taxes as percentage of GDP. This allows introducing additional insights and making judgments about the level of “normal” revenues. What is more, different scenarios can be calculated to obtain a range for the structural deficit. The
method also allows taking account of the automatic responses on the expenditure side: a sizeable part of central government expenditure is made up of transfers to the cantons, to the social security system and to a capital account for large projects in public transport. These transfers are directly linked to the revenue from certain taxes, which creates an automatism between revenues and expenditures.

The organisation of this paper is as follows: Section 2 sets out the issues and gives a short overview of different methods. Section 3 describes the methods used by the EU, the IMF and the OECD. Section 4 sets out our own method and discusses the behaviour of the underlying revenue series. Section 5 uses this method to make calculations for structural revenue for 2002 under a number of scenarios. Section 6 extends the method to include the automatisms on the expenditure side and make calculations for the years of the budget and the financial plan (2003-07). Section 7 repeats these calculations under the assumption of lower growth rates.

2. Methods for calculating the structural deficit

There is a large number of possible methods for calculating the structural deficit. Any method which provides estimates for structural revenue can also be used to calculate the structural deficit. We will discuss a number of them before turning to our own method. For what follows, it is useful to keep the following revenue decomposition in mind:

\[ T = T^* + T^c + T' \]

That is, total revenue is the sum of structural \((T^*)\), cyclical \((T^c)\) and irregular revenues \((T')\). In most methods, the cyclical revenue component is calculated by combining cyclical revenue elasticities with estimates for the output gap. The structural component is then obtained by deducting the cyclical component from overall revenue and interpreting the rest as structural revenue. In other words, it is assumed that the irregular component is zero. This is the most common method and is also used by international organisations. It will be discussed in the next section.

In the rest of this and the following two sections, we disregard the behaviour of expenditure. In principle, for this, a similar decomposition would have to be made into structural, cyclical and irregular components. However, when introducing the debt brake, it has been attempted to eliminate non-structural factors on the expenditure side. First, extraordinary expenditures (as well as income) due to one-off events such as the privatisation of Swisscom, the telecom firm, or the support of Swiss, the Swiss flag carrier, are no longer in the accounts. That is, these items will not be subject to the debt brake. Second, the unemployment insurance fund has been separated from the central
government budget. If the fund needs money to cover temporary excess expenses, these are now booked as credits and not as expenditures.

However, there is still one important group of expenditures where cyclical and irregular factors play a role. A part of tax revenue is earmarked for specific uses. First, the cantons get a fixed share of the income and corporate tax revenues as well as from the withholding tax. Second, a part of the revenue from the VAT flows into the state pension system. Third, parts of the VAT as well as the road transport tax go into a fund for capital expenditure in the road and rail system. This type of expenditure will pose a special problem for the calculations of the structural deficit, since the direct link between revenue and expenditure has to be taken into account when calculating the structural deficit. We will come back to this point.

Structural revenue can also be calculated using a statistical procedure which decomposes revenue into its different components. There are basically three statistical methods available which will be discussed in turn. The first and most simple statistical method would be to apply a filter like the Hodrick-Prescott filter to decompose the series into trend and deviations from trend. The trend component can then be interpreted as structural revenue while the rest is non-structural, i.e. both due to the business cycle as well as to irregular factors. The basic problem of this method is the well-known instability at the actual end of the series, i.e. a large fluctuation in the last available year will have a strong effect on the estimated trend. Applying this method, we have obtained an estimate for structural revenue of CHF 49 billion for 2002 (Bodmer, 2004a). Due to the unusually high revenues in the years until 2001, which are most probably not sustainable, this approach leads to very high estimates for structural revenue in 2002.

A second set of methods applies the structural time-series method as set forth, for example, by Harvey (1993) to decompose the revenue series into a trend, a cyclical and an irregular component. The trend is again interpreted as the structural component. This gives the desired decomposition in the most direct manner. Using this method, we have obtained an estimate of CHF 47.3 billion for structural revenue in 2002. Unfortunately, this method shares the end-point problem with the Hodrick-Prescott filter. However, the decomposition of the non-structural component into cyclical and irregular components allows some additional insights. Specifically, the irregular component dominates the cyclical component by about a factor of five, according to our estimates (Bodmer, 2004a). This indicates that the often-made decomposition of revenue into structural and cyclical components is problematic, especially if it is done by subtracting a business-cycle component from overall revenue and interpreting the rest as structural revenue. This also becomes clear when looking at the revenue series which will be presented in Section 4.
A third statistical procedure is to use an error-correction model. In the first stage, the co-integrating relationship is used to obtain a long-run relationship between revenue and GDP, together with the long-run revenue elasticity. This can also be used to calculate a trend or structural component, based on the in- and out-of-sample prediction of revenue. In the second step, the error-correction equation is estimated. This gives a short-run revenue elasticity and allows decomposition into a cyclical component and the rest.

Applying this method to data from 1950 to 2002, we have obtained very low estimates for structural revenue (Bodmer, 2004a). The problem is related to the tax increases of the second half of the 1990s. Specifically, for the years from 1997 onwards, estimated structural revenue lies markedly below actual revenue. The most important tax increases were related to the VAT. The replacement of the old turnover tax occurred together with an implicit rise in the tax rate. Two years later, rates were further raised to help finance social security. Also, revenues from capital taxes surged in this period. While the first is clearly a structural element, the second is probably a transitory phenomenon.

A simple remedy for the underprediction of the late 1990s is to include a period dummy when estimating the co-integrating relationship. However, since only a part of the revenue rise is related to structural reasons, this method is only partly justified and therefore ad hoc. When the co-integrating relationship is estimated nevertheless with a dummy for the period after 1995 (date of the introduction of the VAT), the following estimates are obtained: a long-run elasticity of about 1.1, a short-run elasticity of about 0.9 and structural revenue of about CHF 42 billion in 2002 (Bodmer, 2004a).

To avoid the problems of these approaches, we suggest another method which is based on revenue ratios, i.e. the relation between revenue and GDP for the most important taxes. Using this procedure, it is possible to apply qualitative information on the development of different taxes, for example, do we know which taxes were increased and which were decreased. For some taxes, especially the stamp duty and the withholding tax, we know that they are very volatile and that their large revenue in the last couple of years was due to special factors like the stock market boom and the change in bookkeeping practice. In our method, it is possible to account for such special events. The method is not purely mechanical, which is both a strength and a weakness. Certainly the main advantage is the possibility to add information about the behaviour of different tax bases and tax rates which is not accessible by purely statistical means. On the other hand, this introduces a certain arbitrariness. Not everyone will agree on what “normal” revenue ratios are. We try to correct this problem by using sensitivity analysis, i.e. by using a range of estimates. However, before turning to our own estimates, we will discuss the methods used by international organisations in more detail.
3. The methods of the OECD, the IMF and the EU

The IMF and the OECD calculate structural deficits of member countries in order to evaluate their fiscal policies. In the case of the EU, fiscal deficits are of additional importance since the Maastricht treaty requires a certain fiscal discipline of the members of the European Economic and Monetary Union. Specifically, there is an upper limit on the budget deficit of 3% of GDP. All three organisations have published recommendations on how to calculate the structural deficit. However, in the case of the IMF and the OECD, these published methods represent mainly guidelines. In practice, country analysts can adapt these methods to the idiosyncrasies of the particular country in question.

As mentioned earlier, the basic idea inherent to all these methods is a focus on determining the cyclical component of revenues and then subtracting this from total revenues in order to end up with structural revenues. We will describe the details of each method and then turn to a comparison of their results for Switzerland.

3.1. The OECD

The method of the OECD (as well as all others) starts out by defining the structural budget balance \( B^* \) as the difference between the sum of structural revenue components \( T_i^* \) and structural expenditure. The OECD makes a distinction between current expenditure \( G^* \) and investment expenditure (capital spending):

\[
B^* = \sum_i T_i^* - (G^* + \text{cap.spending})
\]

The structural component is the part that is independent of business-cycle fluctuations. In the case of revenue, this is conceptually straightforward. Methods differ somewhat in the treatment of expenditure. Current spending depends partly on business-cycle dynamics (e.g. social insurance, unemployment benefits, and so on). Capital spending on the other hand is completely discretionary and need not be adjusted. Therefore, a structural component must only be determined for the fluctuating part of expenses \( G^* \). The accounts of the Swiss federal government do not include unemployment benefits and other transfers. Nevertheless, the adjustment still makes sense in the case of Switzerland, considering that around 8 to 9% of expenditure is directly linked to revenue and hence depends on cyclical elements too. As already explained, a share of several federal taxes is legally bound to be transferred to the cantons, to the social security system and to a traffic fund.
Both structural revenue and expenditure are determined using specific, measured elasticities in relation to GDP:

\[ \frac{T_i^*}{T_i} = \left( \frac{Y^*_i}{Y} \right)^{\alpha_i} \] 

(3a)

\[ \frac{G^*}{G} = \left( \frac{Y^*_i}{Y} \right)^{\beta} \]

(3b)

These equations say that the ratio of a revenue or expenditure to its trend is equal to the ratio of GDP to its full employment level, to the power of its elasticity. Different revenue components have different elasticities. On the revenue side, the OECD makes a distinction between corporate taxes, personal income taxes, social security contributions and indirect taxes. Giorno et al. (1995) also report the methods as well as the estimates for the revenue elasticities for most OECD member countries (not Switzerland however).

On the expenditure side, the OECD uses an elasticity of –0.2, based on the elasticity of unemployment with respect to GDP and unemployment benefits with respect to unemployment. This is no longer necessary in the case of Switzerland since unemployment benefits have been separated from the federal accounts. Also, the OECD makes an adjustment for earmarked revenues which go to the cantons, the social security system and the traffic fund.

The value of the structural balance is very sensitive to the measure of the output gap. The latter directly determines the cyclical components since the structural components are determined as residual values (everything that is not cyclical). The full employment level of GDP is calculated through a production function approach. The OECD estimates that a difference of 1% in the output gap can change the value of the structural budget balance by around 0.5% of GDP. In the case of Switzerland, 0.5% of GDP would represent around CHF 2 billion.

Last, equations 2, 3a and 3b can be combined to obtain equation 4:

\[ B^* = \sum_i T_i \left[ \frac{Y^*_i}{Y} \right]^{\alpha_i} - G \left[ \frac{Y^*_i}{Y} \right]^{\beta} - cap.spending \text{ with } \alpha_i > 0, \beta < 0 \]

(4)
3.2. The International Monetary Fund

The IMF follows a similar approach as the OECD. However, it introduces a lagged component to capture the effect of income sources from the preceding year:

\[ T^*_t = T_t \left[ \frac{Y^*_t}{Y_t} \right] \left[ \frac{Y^*_{t-1}}{Y_{t-1}} \right]^{\varepsilon_{\text{lag}}} \]

The IMF does not explicitly include different revenue components, as the OECD does. However, in practice such a disaggregation is often made. Another difference is that the IMF links the cyclical component of expenditure to unemployment rather than to GDP:

\[ G^*_t = (G_t - UB_t) + UB_t \frac{u^*_t}{u_t} \]

Here UB represents unemployment benefits, u is the unemployment rate, and \( u^* \) is the natural unemployment rate (NAIRU). Again, the correction for unemployment benefits would actually no longer be required in the case of Switzerland. Equation 6 assumes a unitary elasticity of unemployment benefits with respect to the unemployment rate (unlike the EU and the OECD).

The term \((G_t - UB_t)\) represents discretionary spending that need not be adjusted. Therefore, on the expenditure side, this approach is identical to that of the OECD, aside from earmarked taxes. Last the structural balance is again calculated as the difference of structural revenue and structural expenditure:

\[ B^*_t = T^*_t - G^*_t \]

3.3. The European Union

The approach of the EU differs somewhat from the approach of both the IMF and the OECD. The EU first determines an output gap:

\[ \lambda_t = \frac{y_t - y^*_t}{y^*_t} \]

In order to determine the trend GDP, the EU uses a Hodrick-Prescott filter. In order to deal with the end of sample bias, the EU uses forecasts until \( t+4 \). Then the cyclical component of revenue is determined using tax ratios:

\[ \left[ \frac{x^c}{Y}_t \right] = \left[ \frac{T}{Y}_t \right] \cdot \eta \cdot \lambda_t \]

This formula does not seem very intuitive. However, for elasticities close to unity, the results will be similar to those of the previously mentioned methods.
Total elasticity ($\eta$) is determined by taking a weighted average of the elasticities of individual revenue components, which are based on estimates by the OECD:

$$\eta = \sum \frac{T_i}{T} \eta_i$$

(10)

In addition, the EU takes account of a one-year lag in the collection of the corporate tax, which alters equations 9 and 10 accordingly.

Then a cyclical part of expenditures is determined, based on cyclical variation of unemployment and the cost of unemployment benefits:

$$\frac{G^c_i}{Y_i} = c \cdot h \cdot \lambda_i = \frac{d(ub)}{du} \cdot \frac{du}{ub} \cdot \frac{du}{dy} \cdot \lambda_i$$

(11)

Here $h$ is the elasticity of unemployment with respect to GDP and $c$ is the elasticity of unemployment benefits with respect to unemployment. This is similar to equation 6 but uses multiplicative elasticities.

Last, the structural budget balance is again calculated by deducting the cyclical components from total revenue and expenditure and by applying equation 7.

3.4. A comparison

In a last step, it is interesting to compare the results of the three methods just described for Switzerland. We expect the methods to yield very similar results since they share a number of basic points. In all three methods, revenue is decomposed into structural and cyclical revenue, disregarding irregular components. The calculation of cyclical revenue starts from a measure of the output gap. The IMF and the OECD calculate this by using a production function approach, while the EU uses a Hodrick-Prescott filter. Short-run elasticities are then used to obtain the cyclical component of revenues. On the expenditure side, an adjustment is made for unemployment benefits. In the case of the IMF and the OECD, no other adjustments on the expenditure side are made. The OECD adjusts for earmarked tax revenues.

Next, we compare the different estimates. In making the calculations, we have followed the published guidelines. However, some of the necessary information is not available; for example, none of the three organisations publishes short-run revenue elasticities for Switzerland. There is some controversy on how high these elasticities are. The debt brake starts from the assumption that these elasticities are 1. Our own estimates, on the basis of data from 1950 to 2002, give elasticities of slightly below 1 (Bodmer, 2004a). The OECD uses elasticities of above 1 for most countries where such estimates are available (Giorno et al., 1995). However, the Swiss tax system has a number
of idiosyncrasies, one of which is the fairly high lags in tax collection. These tend to reduce the size of contemporaneous elasticities. In the calculations, we have therefore assumed revenue elasticities of 1 throughout. Following the new rules for the unemployment insurance fund, we have further assumed that unemployment has no effect on federal expenditure. Table 1 shows the results.

Unsurprisingly, both the magnitude and the general evolution of the structural deficit are very similar in all cases. The method of the EU yields somewhat different figures (especially in 2002 and 2003). This difference is mostly due to the fact that the EU uses a Hodrick-Prescott filter to calculate trend GDP whereas the IMF and the OECD use output gaps. As is known, the Hodrick-Prescott filter tends to bring trend GDP closer to actual GDP values than is the case with production function methods. There is also a small difference between the IMF and the OECD which is mostly due to the use of different output gaps. Also, the OECD adjusts for the earmarked tax revenue on the expenditure side.

Looking at the time pattern of the structural deficit, we can see large fluctuations, especially between 1997 and 2001. However, it would not be correct to interpret these as changes in the stance of fiscal policy. The reason for these peaks is the exceptionally high revenues in the years 1998 and 2000, especially due to very high revenues from the withholding tax. These changes were transitory and therefore should be called irregular rather than structural. In other words, the large fluctuations in the reported structural balance reflect

Table 1. Structural deficit
Methods of the EU, the IMF, the OECD

<table>
<thead>
<tr>
<th>Year</th>
<th>Method of the EU</th>
<th>Method of the IMF</th>
<th>Method of the OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>–5 189</td>
<td>–5 043</td>
<td>–4 881</td>
</tr>
<tr>
<td>1996</td>
<td>–5 593</td>
<td>–5 251</td>
<td>–5 227</td>
</tr>
<tr>
<td>1997</td>
<td>–3 784</td>
<td>–3 388</td>
<td>–3 565</td>
</tr>
<tr>
<td>1998</td>
<td>–67</td>
<td>380</td>
<td>–52</td>
</tr>
<tr>
<td>1999</td>
<td>–2 781</td>
<td>–2 151</td>
<td>–2 405</td>
</tr>
<tr>
<td>2000</td>
<td>2 259</td>
<td>3 042</td>
<td>2 997</td>
</tr>
<tr>
<td>2001</td>
<td>–2 313</td>
<td>–1 723</td>
<td>–1 582</td>
</tr>
<tr>
<td>2002</td>
<td>–3 700</td>
<td>–3 062</td>
<td>–2 817</td>
</tr>
<tr>
<td>2003</td>
<td>–3 216</td>
<td>–2 534</td>
<td>–2 611</td>
</tr>
<tr>
<td>2004</td>
<td>–4 200</td>
<td>–3 527</td>
<td>–3 694</td>
</tr>
<tr>
<td>2005</td>
<td>–4 945</td>
<td>–4 579</td>
<td>–4 459</td>
</tr>
<tr>
<td>2006</td>
<td>–5 988</td>
<td>–5 776</td>
<td>–5 559</td>
</tr>
</tbody>
</table>

Source: Bodmer and Geier, based on data from the Federal Finance Administration and the Federal Office of Statistics, using the published methodology as described in European Commission (1995), Giorno et al. (1995) and Hagemann (1999). The average elasticity is assumed to be 1. Underlying economic fundamentals are the same as in the base scenario in Table 3.
the fact that irregular revenues fluctuate strongly. As already argued, the irregular revenues are implicitly added to structural revenues in the methods of the international organisations, which leads to corresponding fluctuations in structural revenue.

The method we will propose in the remainder of the paper avoids this problem. It starts out by calculating structural revenue directly, without trying to determine the cyclical component. It is based on the basic idea that structural revenue should be fairly smooth once tax changes have been taken into account. In addition to the statistical methods already discussed in Section 2, there is, to our knowledge, no other mechanical procedure which accomplishes this task. We therefore use a non-mechanical procedure which is based on extra or “expert insight” regarding the behaviour of the different taxes. We start by looking at tax ratios which we try to interpret in the light of past experience and the knowledge of tax rate changes. Therefore, although the EU does, for example, use tax ratios, our approach is very different from theirs.

4. A method based on revenue ratios

Our method is based on the idea that it is possible to give a plausible range of what normal or structural revenue ratios are for different taxes. Using a simple formalisation, our method can be described as follows. First, structural revenue is determined on the basis of tax ratios:

\[ T_{it}^* = \sum_{i} T_{iit}^* = \sum_{i} t_{iit}^* \cdot Y_t \]

\( T_{iit}^* \) is the structural component of every revenue category \( i \), \( t_{iit}^* \) is the normal or structural ratio of the revenue category \( i \) with respect to nominal GDP and \( Y^T \) is the trend of nominal GDP. This corresponds to equations 3a, 5 and 9 in the methods of the three organisations just discussed. There are three basic differences. First, a disaggregation of taxes is used. Second, the structural ratio is taken directly instead of using the adjustment through cyclical effects. Third, and related to this, an elasticity of 1 is implicitly used. The reasoning is that the structural elasticity of revenue to trend GDP should be about 1. This might not be exactly correct in practice, but should give a good approximation. Reasons for deviations are twofold. First, the income tax revenues benefit from bracket-creep, i.e. the shift of people into higher marginal tax brackets. Second, some taxes might see an erosion of the base. This might affect taxes on capital income as well as transfer taxes. For this elasticity of 1 to be approximately correct, it is further necessary to account for changes in the tax rates since these affect the relation between tax revenue and output.

In a second step, structural expenditure has to be determined. Here, it might in principle be necessary to adjust for cyclical effects. However, as already discussed, important cyclical expenditure items are not (no longer)
part of the federal accounts. The unemployment insurance fund has been made independent of federal accounts. Other expenditure which possibly has a cyclical pattern, like support to the poor, is a local matter. Therefore, only the transfers of certain taxes to other entities remain. Our method allows an easy adjustment for these, since we have already determined structural tax revenues through equation 12. If we define \( G_C \) as current (non tax-related transfers) expenditure, \( G_I \) as capital expenditure and \( \alpha_i \) as the share of other entities in federal tax revenues, we get the following equation for structural expenditure:

\[
G^*_i = G_i^C + G_i^I + \sum \alpha_i . T_{ij}^*
\]  

In other words, we basically calculate the structural part of the transfers of federal taxes to other entities. Last, the structural balance is again calculated as the difference of structural revenue and structural expenditure:

\[
B^*_i = T^*_i - G^*_i
\]  

The most important difference of our method is that in addition to a disaggregation of revenues, normal or structural revenue ratios have to be determined. The claim is that the disaggregation provides additional information in comparison to just looking at aggregate revenue figures. And by using structural revenue ratios, we provide a solution to the problem of irregular revenues which is in our view the main problem of the methods of the international organisations. Also, our method allows an easy way of calculating the structural component on the expenditure side as well, by taking account of the direct link between certain taxes and the ensuing transfers to the cantons, the social security system and the transport system. But of course for our method to work, we have to be able to determine what the structural revenue ratios are. We turn to this point next.

4.1. Revenue ratios of the most important federal taxes

To apply our method: in a first step, the normal or structural revenue ratios have to be determined. To do this, we look at the series of different revenue components expressed as a share of GDP. We distinguish the following groups: the federal income tax; the corporate income tax; the sales tax (until 1994) and the value-added tax (from 1995); the withholding tax; the stamp duty; other fiscal revenues including customs duties, fuel taxes, cigarette taxes, etc.; and non-fiscal revenues including payments from the Swiss National Bank, interest income, etc. Here we have subtracted some extraordinary revenue positions such as the privatisation of the telecom firm Swisscom. These are one-time revenues which therefore cannot be called structural. Further, under the regime of the debt brake, this type of expenditure would not appear in the regular financial accounts. Figure 1 gives the series for 1985 to 2002.
A number of points are worth emphasising. First, the value-added tax saw a large increase. This was first due to the non-neutral change from the sales tax to the value-added tax which added about CHF 2.5 billion in tax revenue, though the rise took a while to materialise. Second, there was a tax increase in 1999, when the normal rate was increased from 6.5% to 7.5%. This increase went mostly to the social insurance system. The VAT rate was increased once more to 7.6% in 2001, the additional revenue going to the traffic fund. Since the VAT has an average collection lag of three months, one-fourth of each increase takes place in the following year. The stagnation and fall in the VAT in 2001 and 2002 are probably due to the fall in investments. Consumption has held up during these years, but business investments fell sharply in 2002. While the VAT is theoretically a tax on consumption, part of the tax falls on investments and intermediate inputs, due to the exceptions.13

Second, another tax shows a strong increase: the corporate income tax. However, there were no rate increases in this case. Rather, it seems that the behaviour of the corporate sector has changed. Until the mid-1990s, it was common for Swiss corporate firms to accumulate reserves which were not taxed at the time. In the late 1990s, there was a change towards international bookkeeping standards (GAAP, generally accepted accounting principles) which led to a dissolution of these reserves. The corporate tax was then levied on the gains when they were realised in the books. Second, corporate firms have the possibility to subtract past losses from present gains. This makes the
corporate tax react slowly to profits and leads to a significant lag of tax income in an upturn.

Third, the withholding tax shows very large fluctuations. These are partly due to the functioning of this tax: withholding taxes are levied on interest and dividend income in year $t$, then a large part of this is returned to the taxpayer, most of it in year $t+1$ and some of it in year $t+2$. However, this seems to be only part of the story since the fluctuations have grown much larger in recent years. A number of other factors have played a role. First, with the change in accounting practices, the share of dividend payments in total profits should have increased. The reason is that with less undeclared reserves there will most probably be higher dividend payments. Second, the revenue from the withholding tax might also have profited from the stock market boom of the late 1990s. Third, in a more long-term perspective, the tax base of the withholding tax is eroding, due to an increasing number of international agreements regarding double taxation. Residents of those countries that have such an agreement with Switzerland get the withholding tax back as long as they declare their income correctly in their country of residence.

Fourth, the stamp duty increased strongly between 1996 and 2000. This was related to the booming stock market which led to a large number of new stock emissions as well as to buoyant trading volumes on stock markets. Both are taxed by the stamp duty. With the end of the stock market boom, these revenues have reverted back to previous levels, and might fall even more as increasing numbers of market participants get exempted from stamp duty (as was recently the case for investment funds).

Fifth, the other fiscal revenues also show an increase. In this group of taxes, there have been a couple of increases. The tobacco tax has been increased several times. Also, new fuel taxes have been introduced as well as a number of road taxes. On the other hand, the alcohol tax has been abolished.

The capital income taxes can also be represented as a share of capital income. While their specific tax base might differ, ultimately they all tax capital income created in Switzerland. For this later, operating surplus is taken. Figure 2 gives the resulting series. The overall picture is the same as when GDP is taken. However, the changes are smaller since the share of capital income to GDP itself fluctuates, rising in boom periods and falling in recessions.

5. Structural revenue in 2002: different scenarios

The next step is to determine what the normal revenue ratios are. Based on the series in the previous section, a number of scenarios are specified and the corresponding structural revenue is calculated. As will be seen, this gives a range of estimates which will be discussed in terms of their plausibility.
Scenario 1 (low ratios) is rather pessimistic. Here, it is assumed that the revenue ratios for the stamp duty and the withholding tax are now at their normal or structural level. This is fairly realistic since they have fluctuated around this level for most of the period from 1985 to 2002. For the corporate income tax, it is assumed that it is still significantly above its normal level. We have assumed a normal ratio of 0.9% which still seems rather high. However, it would probably take a while to fall any further. For the income tax, we assume a slight fall, reverting back to the level of 2001. The income tax has a lag of about one year. This means that the taxes collected in 2002 reflect the incomes of 2001 which still was a good year. The VAT is assumed to revert back to its level of 2001. For the other revenue sources, the 2002 figures are assumed to represent normal levels.

Scenario 2 (2002 ratios) corresponds to the revenue ratios of 2002. We will argue that this is, by coincidence, a fairly plausible scenario. While the ratios will probably not stay at this level, offsetting changes can be imagined. The VAT will most certainly recover again once investments recover. On the other hand, a further fall in the corporate income tax is probable.

Scenario 3 (high ratios) is rather optimistic. It is assumed that the corporate income tax is now at a normal level, as are the other fiscal revenues. Income tax, withholding tax and stamp duty are assumed to increase slightly, as are VAT and non-fiscal revenues.

Scenarios 4 and 5 use Hodrick-Prescott filters to determine the trend revenue ratio. Scenario 4 uses the traditional HP filter with a value of 100 for the

Figure 2. **Capital taxes as percentage of capital income**

Source: Bodmer and Geier. Data for revenue components are from Federal Finance Administration sources; for details on calculation of capital income, see text.
smoothing parameter. Scenario 5 uses a modified HP filter developed by Bruchez (2003). This second filter puts less emphasis on the last observation and thereby reduces the end-point problem. The modification leads to bigger amplitudes, but also a bigger phase shift than the regular HP filter. It has been designed to match the requirements for the determination of the output gap in the context of the debt brake. The smoothing parameter employed is 100 as well.

Table 2 contains the corresponding estimates for the structural revenue ratios and the resulting revenues for the different categories. The last are obtained by multiplying the revenue ratios with an estimate for nominal trend GDP (CHF 418 082 million). We will come back in the next section to how this series was constructed. For the moment, it suffices to say that the estimate by the State Secretariat for Economic Affairs (SECO) in February 2003 put the nominal GDP of 2002 at CHF 416 840 million.

While actual revenue (corrected for extraordinary factors) was CHF 46 255 million, the estimates for structural revenue range from CHF 45 060 million to 49 213 million. However, the estimates using Hodrick-Prescott filters seem out of line when looking at the series. The filters put much emphasis on the last couple of observations which leads to high estimates for structural revenues. The problem is larger when the modified filter is applied since it gives less weight to 2002 which saw already a sizeable fall in revenues, but more weight to the preceding boom years. For what follows, the two scenarios using the HP filter are no longer used as they are overly optimistic in our view.

<table>
<thead>
<tr>
<th>Table 2. Structural revenues, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Federal income tax</strong></td>
</tr>
<tr>
<td>Revenue 2002</td>
</tr>
<tr>
<td>Scenario 1 (Low ratios)</td>
</tr>
<tr>
<td>Scenario 2 (2002 ratios)</td>
</tr>
<tr>
<td>Scenario 3 (High ratios)</td>
</tr>
<tr>
<td>Scenario 4 (HP filter)</td>
</tr>
<tr>
<td>Scenario 5 (Modified HP filter)</td>
</tr>
</tbody>
</table>

Source: Bodmer and Geier. For a description of the scenarios, see the text. All calculations use a nominal trend GDP of CHF 418 082 million. The non-fiscal revenues are corrected according to the requirements of the debt brake.

While actual revenue (corrected for extraordinary factors) was CHF 46 255 million, the estimates for structural revenue range from CHF 45 060 million to 49 213 million. However, the estimates using Hodrick-Prescott filters seem out of line when looking at the series. The filters put much emphasis on the last couple of observations which leads to high estimates for structural revenues. The problem is larger when the modified filter is applied since it gives less weight to 2002 which saw already a sizeable fall in revenues, but more weight to the preceding boom years. For what follows, the two scenarios using the HP filter are no longer used as they are overly optimistic in our view.
6. The structural deficit, 2002 to 2007

Based on estimates for structural revenue in the last section, we can now provide estimates for the structural deficit by adding expenditure data. As described in equation 13, there is one important source of non-structural elements entering the expenditure accounts: there is an automatic link from revenue to expenditure due to earmarked tax revenues. Therefore, changes in structural revenue will also lead to changes in structural expenditure. In what follows, we will also make calculations for the years of the budget (2003) and of the financial plan (2004-07). For this, we will use the official previsions for GDP growth and inflation, as well as the planned expenditures for this period. In Table 3, we have reported the corresponding figures, as well as the numbers for nominal trend GDP. This last was calculated as: \( \text{nominal trend GDP} = k \times \text{nominal GDP} \) (where \( k = \text{real trend GDP}/\text{real GDP} \)).\(^{15}\)

The expenditure figures correspond to the revised financial plan of February 2003, which assumes a lower expenditure growth than the figures published in the 2003 budget. This is due to a lower revenue growth which leads to less expenses on earmarked taxes. It also has to be noted that a planned increase in the VAT of 1% in 2005 is included in the data. This increase is to entirely benefit the old-age pension system, which means that the tax increase leads to an expenditure increase of equal size.\(^{16}\) Due, among other factors, to a collection lag of about three months, this increase is distributed between 2005 (three-fourths) and 2006 (one-fourth). For 2007, it has to be noted that the figures for the last year always assume an expenditure growth of 1.5%. This is rather low in comparison with the previous years.

Given the series for nominal GDP growth and expenditure, it is already possible to assess whether the structural deficit is bound to increase or

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage change in real GDP</th>
<th>Inflation (Financial Plan)</th>
<th>Real trend GDP</th>
<th>Percentage change in real trend GDP</th>
<th>Nominal trend GDP</th>
<th>Percentage change in nominal trend GDP</th>
<th>Expenditures</th>
<th>Percentage change in expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>350 180</td>
<td>418 082</td>
<td>50 033</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>0.80%</td>
<td>1.00%</td>
<td>355 053</td>
<td>1.39%</td>
<td>428 105</td>
<td>2.40%</td>
<td>50 382</td>
<td>3.34%</td>
</tr>
<tr>
<td>2004</td>
<td>1.90%</td>
<td>0.60%</td>
<td>360 059</td>
<td>1.41%</td>
<td>436 697</td>
<td>2.01%</td>
<td>52 932</td>
<td>2.38%</td>
</tr>
<tr>
<td>2005</td>
<td>1.80%</td>
<td>1.50%</td>
<td>365 173</td>
<td>1.42%</td>
<td>449 426</td>
<td>2.91%</td>
<td>56 629</td>
<td>6.98%</td>
</tr>
<tr>
<td>2006</td>
<td>1.80%</td>
<td>1.50%</td>
<td>370 355</td>
<td>1.42%</td>
<td>462 520</td>
<td>2.91%</td>
<td>59 429</td>
<td>4.94%</td>
</tr>
<tr>
<td>2007</td>
<td>1.80%</td>
<td>1.50%</td>
<td>375 566</td>
<td>1.41%</td>
<td>475 938</td>
<td>2.90%</td>
<td>60 320</td>
<td>1.50%</td>
</tr>
</tbody>
</table>

Source: Bodmer and Geier. Percentage change in real GDP, inflation and expenditures correspond to the data of the Financial Plan (version of February 2003). Data for 2002 are again corrected for extraordinary factors.
decrease until 2007. For this, one has to deduct the VAT increase, which is about CHF 2.6 billion, from expenditure. Then there remains an expenditure increase of 15.2% in comparison to an increase in nominal trend GDP of about 13.6%. Therefore, the structural deficit is bound to increase slightly until 2007.

To make the calculations for the structural deficit under the assumptions of our different scenarios, the link from revenue to expenditure has to be taken into account. This is done with the help of a small model which will also allow making calculations under different assumptions about growth and inflation. For these calculations, the following assumptions are made:

- The growth rate of GDP as well as the inflation rate are given exogenously, i.e. they are not influenced by the budget. The values of both can be varied. The next section will report calculations with lower growth rates.

- The revenue of the different categories is calculated according to equation 12, i.e. as the product of an exogenously given revenue ratio and nominal trend GDP. The nominal trend GDP is calculated as the product of factor k and nominal GDP, as described above.

- As already described, expenditure depends on the revenue (see equation 13). First, the cantons get part of the revenue of personal and corporate income tax (30.3%) and part of the withholding tax (9.8%), as well as part of the levy on road transport and of the military compensation fund. The old-age pension system gets 12% of the VAT revenue. The traffic fund gets another 0.6% of VAT revenue as well as a share of the levy on road transport. The combined share on other fiscal revenues is at 8.6%. All of these shares are based on the corresponding numbers for 2002. As already mentioned, the old-age pension system will get 100% of the planned VAT increase in 2005. It is assumed that this will increase the revenue of the VAT by about CHF 2.6 billion.

Table 4 contains the results for the different scenarios. It can be seen that for 2002 a structural deficit of between CHF 1.9 billion and 4.5 billion results. The structural deficit rises in all scenarios, due to an expenditure growth above the growth of nominal GDP. The fall in 2007 cannot be taken very seriously since the expenditure growth of 1.5% is a number routinely used, without any foundation in specific plans.

Scenario 2, which is on current revenue ratios of 2002, gives a structural deficit of about CHF 3.7 billion. This is fairly similar to the estimates of the international organisations, which is not surprising. The reason is that their methods disregard irregular revenues. By interpreting the revenue ratios of 2002 as structural revenue, we implicitly do the same. The evolution of the structural deficit is also very similar, for the same reason.
### Table 4. Structural revenue and deficit, 2002-07

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<tr>
<th>Financial Plan</th>
<th>Federal income tax</th>
<th>Corporate income tax</th>
<th>VAT</th>
<th>With-holding tax</th>
<th>Stamp duty</th>
<th>Other fiscal revenues</th>
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Source: Bodmer and Geier. The scenario “Financial Plan” corresponds to figures from the budget and the Financial Plan. The deficit figure for this scenario is the actual deficit, not the structural deficit. Scenario 1 is the “pessimistic” scenario. Scenario 2 is based on 2002 revenue ratios. Scenario 3 is the “optimistic” scenario.
7. The structural deficit with lower growth rates, 2002 to 2007

The calculations can be extended to determine the effect of lower growth rates which – given the current global macroeconomic outlook – seem to be more likely than higher growth rates. The most direct link from nominal growth rates to revenue goes through the amount of revenue (see equation 12) which then also influences expenditure through the already described effect of earmarked taxes. However, there are other effects too: wages depend on inflation and possibly on real wage growth in the rest of the economy. Interest rates depend on inflation, since the nominal interest rate will (partly) reflect inflation figures. Spending on the social security system depends on inflation and also on real wage growth since the old-age pensions are indexed to inflation (1/2) and to real wage growth (1/2). For the calculations, it is therefore assumed that wages and interest payments adjust fully to changes in inflation, while the spending on the social security system depends on inflation (50%) and on nominal GDP growth (50%), where the later proxies for nominal wage growth.

Since the base scenario (financial plan for the years 2004-06) also depends on inflation and growth forecasts, this base scenario also has to be newly calculated. This is done by adding/subtracting the difference of the new scenario from a hypothetical financial plan calculated under our own assumptions. We call this "scenario 0". The calculations for the other scenarios are then done in the same way as described in the previous section.

For the calculations, we assume a lower GDP growth rate and more or less the same inflation rates. Table 5 contains the values used. It has to be noted that the nominal trend GDP falls as well. This is inevitable if the Hodrick-Prescott filter is used to determine the trend GDP, as is done under the regime of the debt brake.

Table 5. Growth of trend GDP, price level and expenditures

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<tr>
<th>Year</th>
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<th>Real trend GDP</th>
<th>Percentage change in real trend GDP</th>
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Source: Bodmer and Geier. Hypothetical numbers for real GDP growth and inflation. The expenditure figures are calculated using the assumptions described in the text.
In Table 6, the corresponding numbers for revenues and the structural deficit follow. Even though there are a number of offsetting factors on the expenditure side, the structural position worsens. This development starts already in 2002, since the lower growth figures lead to a lower trend GDP. The rise in the structural deficit is in the order of CHF 1 billion.

8. Conclusion

In this paper, we have proposed a different methodology for calculating the structural deficit. It starts from the basic insight that total revenue is made up of the three components: structural, cyclical and irregular revenue. While there are established methods to deal with cyclical revenue, irregular revenue poses more of a problem. It is common to disregard it completely and therefore to implicitly count it as part of structural revenue. However, in the case of Switzerland, this seems particularly inappropriate since the fluctuations of federal tax revenues are very large and have only a weak relation to the business cycle. Especially taxes on capital, such as the corporate tax, the withholding tax and the stamp duty, fluctuate much more than can be explained by the business cycle alone.

We therefore propose a method to filter out these irregular components. It is based on revenue ratios for which we try to determine normal or structural levels. For this, we use a method based on “expert insight” since purely mechanical adjustments do not, in our view, lead to plausible results. Our method also allows determining the structural part of expenditure. Here, it is important to take account of the earmarked part of a number of federal taxes which goes to the cantons, the social security system and a traffic fund. While we think that our method has a number of advantages, we do not think that international organisations will find it appealing to use in practice. The problem is exactly that our method is partly based on expert insight rather than being purely mechanical. This will make our method unappealing whenever “impartial” estimates are required, as is especially the case for the EU.

We get a range of estimates for structural revenue. The baseline case starts from the assumption that the revenue ratios of 2002 are “normal” and therefore correspond to structural values. We argue why this might be plausible. Taking these 2002 ratios, the estimates for the structural deficit are around CHF 3.7 billion. This is somewhat higher than the estimates of the IMF and the OECD, which is due to the fact that these organisations use a production function based output gap while we use a Hodrick-Prescott filter to determine trend GDP. It is close to the number which would be obtained by using the method of the EU. However, the estimates do not differ too much, which can be attributed to the fact that we have interpreted the revenue ratios of 2002 as structural. As a consequence, in our view, irregular revenue happened to be close to zero in 2002.
### Table 6. Structural revenue and deficit, 2002-07, lower growth rates

<table>
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<tr>
<th>Scenario</th>
<th>Federal income tax</th>
<th>Corporate income tax</th>
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<th>With-holding tax</th>
<th>Stamp duty</th>
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<td>9 823</td>
<td>52 516</td>
<td>59 019</td>
<td>6 503</td>
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<tr>
<td>2007</td>
<td>6 887</td>
<td>5 394</td>
<td>21 813</td>
<td>2 851</td>
<td>3 059</td>
<td>10 006</td>
<td>53 713</td>
<td>59 706</td>
<td>5 993</td>
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</tr>
<tr>
<td>Scenario 3</td>
<td>1.60%</td>
<td>1.19%</td>
<td>4.11%</td>
<td>0.85%</td>
<td>0.70%</td>
<td>2.23%</td>
<td>48 037</td>
<td>50 225</td>
<td>2 188</td>
<td></td>
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<tr>
<td>2002</td>
<td>6 615</td>
<td>4 931</td>
<td>17 141</td>
<td>3 514</td>
<td>2 894</td>
<td>9 220</td>
<td>48 037</td>
<td>50 225</td>
<td>2 188</td>
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<tr>
<td>2003</td>
<td>6 744</td>
<td>5 027</td>
<td>17 552</td>
<td>3 583</td>
<td>2 951</td>
<td>9 400</td>
<td>49 051</td>
<td>50 676</td>
<td>1 625</td>
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<td>2004</td>
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<td>5 102</td>
<td>17 905</td>
<td>3 637</td>
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<td>9 542</td>
<td>49 877</td>
<td>53 116</td>
<td>3 238</td>
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<tr>
<td>2005</td>
<td>6 975</td>
<td>5 198</td>
<td>20 269</td>
<td>3 705</td>
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<td>9 721</td>
<td>52 843</td>
<td>56 696</td>
<td>3 853</td>
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<td>2006</td>
<td>7 105</td>
<td>5 295</td>
<td>21 492</td>
<td>3 774</td>
<td>3 108</td>
<td>9 903</td>
<td>54 674</td>
<td>59 327</td>
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<td>2007</td>
<td>7 237</td>
<td>5 394</td>
<td>22 115</td>
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<td>10 087</td>
<td>55 914</td>
<td>60 021</td>
<td>4 107</td>
<td></td>
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</tbody>
</table>

Source: Bodmer and Geier. Scenario 0 corresponds to figures from the budget and the Financial Plan, adjusted for changing inflation and GDP growth figures. The deficit figure for this scenario is the calculated actual deficit, not the structural deficit. Scenario 1 is the “pessimistic” scenario. Scenario 2 is based on 2002 revenue ratios. Scenario 3 is the “optimistic” scenario.
Notes

1. See Bodmer (2004b) or Danninger (2002) for a description of the “debt brake”.
3. For an overview of the Swiss tax system, see Carey et al. (1999) or Bodmer (2002).
5. Ibid.
8. The same is done in the case of the Swiss debt brake.
9. As it implies that \( \eta_t = \left( 1 - \frac{T_t^*}{T_t} \right) / \left( \frac{Y_t}{Y_t^*} - 1 \right) \)
10. This is based on a variant of Okun’s law.
11. This difference disappears in the case of Switzerland, since the unemployment insurance fund was separated from the federal budget.
12. For these calculations, we have further used a data adjustment which is also made for the debt brake: extraordinary revenues – such as those obtained from the sale of Swisscom shares – are excluded.
14. For the years until 1989, data are taken from the OECD National Accounts data. There, the operating surplus is reported directly. For 1990 to 2000, data are taken from the national accounts data from the Federal Office of Statistics (Bfs). There, the operating surplus has to be calculated as gross operating revenue (Bruttobetriebsüberschuss) minus depreciation. For the years 2001 and 2002, the corresponding data are not yet available. They were therefore calculated using preliminary data published by Basle Economics (BAK). The three sources are combined by chaining the other two to the Bfs series.
15. This last formula serves to determine the business-cycle component within the debt brake framework, where a Hodrick-Prescott filter with a smoothing parameter of 100 is used to calculate the real trend GDP.
16. There is an ongoing discussion on whether the central government can retain 15% of this increase to compensate it for increased spending for the social security system. The figures of February 2003 which we have used assume that there will be no such share. We have used this same assumption in what follows.

References


Managing the Public’s Money:  
From Outputs to Outcomes – and Beyond

by

David Webber*  

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1. Introduction

The search for better ways of budgeting and managing public finances is a continuous process. This may be because, like in many other areas of economics, there are always some who see a need or an opportunity to improve on existing approaches. It may also be because performance – that is, the results from public spending activities – is often disappointing or at least falls short of the political rhetoric that announced or accompanies it. Either way, the continuous pursuit of improvement is a good thing and one hopes that there are many successful innovations yet to be uncovered.

For a brief period in the late 1980s and early 1990s the New Zealand public sector was widely seen at the forefront of reforming public financial management. There were several dimensions to these reforms, all of which have been covered exhaustively in a range of publications.¹ “Output budgeting” was undoubtedly one of the more innovative components. It remains a core element of the New Zealand budget process 15 years on.

Nonetheless, despite the considerable international attention given to the New Zealand model of output budgeting, it remains an approach with few international disciples. Although some aspects of the output focus have been borrowed and adapted by other countries, the closest adherents of this approach have mostly been smaller or poor countries in the Asia-Pacific region receiving development assistance from New Zealand. In fact, a view has developed internationally that this and other New Zealand public sector reforms may often be inappropriate for less developed public sector environments, especially those that lack the level of institutional capability and developed legal environment that underpin their application in New Zealand.

Within New Zealand too, the efficacy of output budgeting has been openly questioned at times. A series of amendments to the Public Finance Act (PFA) of 1989, that provides much of the framework for budget appropriations by output class and the application of output budgeting methods, have been introduced in an attempt to refine and improve the overall model. Perhaps the most obvious indicator of a groundswell of support for modification of this approach, however, has been the gradual development over the last three years, including recent public sector-wide adoption, of the “managing for outcomes” initiative.² Proposed amendments to the PFA in 2004 effectively cement in these and other modifications to the output-based approach.
Throughout this period, international experience and experimentation with various new approaches and methods for budgeting and expenditure management have also progressed, both towards and away from the New Zealand model in different respects. “Performance budgeting” – an increasingly broad term that now describes almost any approach or methodology that embodies a significant focus on impacts (including output budgeting) – has gained increased acceptance. To a large degree, most recent refinements in budgeting practice have a common objective of improving the administrative performance, or service delivery, of budgetary institutions, rather than significantly altering the process of appropriation or financial control. In several of the more advanced economies, significant insights from the international managerial literature and private sector management practices – especially relating to strategic management – have also been increasingly overlaid on the task of managing public finances.

While each of these concepts and innovations may have added interest and richness to the subject, for most New Zealand government departments at least, they have also added greater expectations, complexity and compliance demands. Given the infusion of new ideas and methods over recent years, it is reasonable to ask whether we are still on track to achieving new and improved levels of effectiveness in public spending. Is there any risk that in our eagerness to sustain a continuous improvement approach – cycles of reform in effect – we may have inadvertently sidelined a core tenet of prudent public financial management: that before all else, changes or innovations should do no harm? Does the current approach still embrace all that is fundamental to good budget management?

2. What the public expects

A key theme of this paper is that a prolonged search for improvements and innovation in the theory and practice of public management may lead to a loss of coherence in the overall approach. It may also generate a tendency to move away, imperceptibly at times, from simply doing the basic things correctly. We have already seen some evidence of this in New Zealand in terms of excessive attention to “client focus” in the delivery of basic welfare services and in the undue weight given to “management solutions” in the delivery of hospital services. There are probably many such examples that managers and analysts in the New Zealand public sector, and in other developed public administrations, could cite as similar examples. In managing budget spending in New Zealand, there may also now be diminishing value added from a growing number – or in some cases just renaming – of “accountability documents”. It is not always the case that more is better.
Since budgeting is really all about managing the public's money, improving the ways departments prepare, disburse and report their budgets can be aided by simply retaining, and in some cases restoring, a focus on what is important to the public. It is, after all, the public's money that departments are managing. Focusing on what the public expects highlights three basic concerns:

- For what purpose, or need, is the money to be allocated?
- How and where is it being spent?
- What has it achieved?

There are no doubt teams of accountants and others who will add a fourth concern: how fully and accurately was the spending accounted for? Indeed, that is often very important. However, the public's concern with the accounting for public expenditure is invariably less if the above three concerns have been adequately addressed.

All budgetary and expenditure management systems – whether they are labelled (or have their origins in) “programme budgeting”, “performance budgeting” or “outcome budgeting” to name a few – respond to these three concerns to a greater or lesser degree. While economists may describe or assess them in terms of “aggregate, allocative, and technical efficiency”, most public sector employees simply see them in terms of “appropriation, spending operations and performance measurement”. However, what is less well recognised is that it is often the quality of the interactions, or managerial linkages, between these components that determine the efficacy of the system.

Different budgeting methodologies can and do give different emphasis to the various components or connections within this structure. The relative simplicity of the public's three basic concerns therefore understates the real difficulties in obtaining meaningful assurances of quality and integrity. In practice, the public relies heavily on various institutions, including parliament as well as private commentators and non-government agencies, to monitor and where possible ensure on their behalf the quality and effectiveness of the spending decisions and actions of the government. However, many of these institutions and observers have a tendency to focus on specific stages or components of the financial management process. The ultimate value and quality of their analysis and reporting therefore depends on a management process that is not only clearly defined, but also effectively linked.

As Figure 1 indicates, there is nothing particularly complicated in the way the principal elements of the public expenditure system reflect the public's expectations regarding appropriation, programme (or service) delivery and impact assessment. The difficulty lies in linking these components effectively. A major challenge for departments in their uptake of the “managing for outcomes” initiative over the last three years has therefore been the requirement for them to design and articulate both their intervention logic and a meaningful performance measurement framework.
3. The pressures for change

The shift from an output to an outcomes focus for public expenditure management in New Zealand has occurred progressively since about 2001. It arose largely as a result of two factors: a developing view, from about 1997 onwards, that the output budgeting approach had failed to ensure that government departments were giving sufficient attention to the results of their policy interventions and, secondly, a change in government in 1999 which set about attempting to roll back a number of the policy reforms of the previous 15 years, including selected aspects of the “new public management” model. Although the shift to an outcomes focus was arguably more of a bureaucratic initiative than a political one, it was an integral part of a wider response by central agencies to the demands of a new government for different and more effective approaches in managing the public sector.

At the same time, an essentially political argument that government should be taking a more proactive role in the economy was not entirely separated from a growing technocratic perception that the linkage in the output budgeting model between the public sector’s accountability for outputs and ministerial responsibility for determining outcomes was inadequate or flawed. A third and related nuance in these assessments was reflected in the “consensus” in the domestic public management research literature at this time that “a key weakness in the current regime is the lack of information on the effectiveness of the public sector” (Petrie and Webber, 2001, para. 119).

Lack of attention to, and information on, the impacts of public policies was not the only perceived shortcoming of the output-based approach. Problems were also apparent in the fact that departmental appropriations, once broken up into “output classes” (defined theoretically as groups of “similar outputs”), often failed to provide a meaningful basis for parliamentary scrutiny or debate. Increasingly, output classes had become (and still are) determined by individual departments on the basis of quite different criteria, even within departments, few of which provide a consistent or meaningful indication of purpose or intended impact. Given also that the size of output classes varies substantially in monetary terms, they have provided parliament and ministers with little additional information about, or meaningful control over, the purpose of appropriations. There is...
some evidence that ministerial understanding of and interest in the detailed spending activities of their departments may well have waned further, partly as a result (Economics and Strategy Group, 2003).

Another clear shortcoming of the model, of which central agencies had been aware for some time, concerned the lack of information about – and therefore, quite possibly, a lack of attention given to – the connection between departmental outputs and the intended impacts of spending programmes. One initiative to address this problem – key result areas (KRAs) – had been largely abandoned by the late 1990s, despite the fact that it had succeeded in some respects in drawing departments’ attention to the importance of the relationship between the design of their interventions and their expected or intended policy impacts.

At a more operational level, there were also what might be termed “technical weaknesses” in the output model that had contributed to a gradual devaluing of its status as a budgeting innovation, both in New Zealand and internationally. Examples of these weaknesses included the difficulty in defining and measuring outputs meaningfully in significant areas of departmental administration, such as policy advice or ministerial servicing. Secondly, there was increasing frustration among some departments with the resource demands and perceived inconsistencies in the conduct of “output pricing” reviews.

Notwithstanding these concerns, there was (and still remains) broad agreement that the overall efficiency of government had improved substantially as a result of the public management reforms and that the strong focus on departmental outputs had been a significant contributing factor in those gains. However, there were formidable effects from a greater international focus on performance issues combined with the concerns expressed by a range of well-qualified commentators and advisers, including Schick (1996), Boston (1999), and the Auditor-General (1999) – arguing principally for greater attention to outcomes. The State Services Commission (SSC) too was pressing for the adoption by departments of a more “strategic management” approach.3 By 2001, it was clear that some modifications to the output focus were both desirable and, given the change of government, inevitable.

4. “Managing for outcomes”

Practical implementation of the concept of outcome-focussed public management, or “managing for outcomes” as the initiative is officially labelled, has been a combined undertaking on the part of the central agencies, principally the Treasury and the SSC. The concept, however, is by no means unique to New Zealand. Outcome-focussed management (or at least a more performance- or results-oriented approach to budgeting) could be found widely in the international public finance literature during the 1990s and had
featured in the management of public finances in Australia for at least several years prior to 2001.4

What has perhaps defined the New Zealand approach over the last three years has been the degree to which an outcomes focus has been formally integrated with insights and tools from the managerial literature. These have included an emphasis on strategic development within organisations combined with the description, integration and reporting of a strategic/outcomes management framework in a range of budget-related and accountability documents. Much work has been done by central agencies to guide and support departments in the uptake of these tools,5 and recent evaluation work suggests that good progress has been made in some areas.6

This should not imply that all is well. Arguably, there have been considerable weaknesses in the approach taken by central agencies to modification of the public management framework that are now clearly evident in the design, management and reporting of public expenditure activities. Understanding how these weaknesses occurred helps to throw light on the difficulties now encountered by some departments at least in implementing the managing for outcomes approach and indicates where additional work is required in both conceptual development and practical application. Notwithstanding the experimental or institutional learning objectives that have underpinned implementation of these outcome-focused reforms, it is far from clear that these are helping departments to achieve a higher level of effectiveness. Furthermore, in the context of the “do no harm” principle, there would seem to be strong arguments for much firmer limits on the extent to which departments should be encouraged to adapt these concepts through a trial and error process.

Much of the public management reform process of these last 3-4 years is based, in particular, around the analysis and recommendations work of the “Review of the Centre” (RoC) – in essence an officials committee review process involving representatives from the central agencies, with input from a small number of external advisers. The RoC reported its initial findings to ministers in 2001. These were expanded on by the review team and officials through a number of reports and presentations over many months, through until about December 2002.7 Considerable further work has followed, though much of it is at the level of central agency interaction with individual departments and other public sector entities.

The approach taken in the Review, quite legitimately perhaps, was to focus specifically on the more obvious shortcomings that had been identified in the public management model established by the reforms of the late 1980s. The RoC grouped these perceived problems into three main categories: a lack of integration in service delivery; fragmentation and lack of alignment within
and between sector departments and agencies; and weaknesses in building
and sustaining institutional capabilities and organisational culture. It is
beyond the scope of this paper to assess the accuracy or validity of the Review's
overall analysis of these problems, or the linkages between them. However, on
the whole, there was a broad consensus within the public sector that these
were indeed the principal areas in need of attention. Particular concern with
insufficient attention to the outcomes from public expenditures was identified in
the context of the policy fragmentation and alignment problem.

The main thrust of the RoC's recommendations for modifying the budgeting
and expenditure management process involved adding on a much stronger
results (outcomes) focus to the existing output-based model. As the review
committee had stated, the public management reforms of the late 1980s had
"hard-wired in an output-based management system" (SSC, 2001). The aim,
therefore, was to soften this output-based model rather than to replace it with
a new or different approach. Subsequent guidance under the "managing for
outcomes" initiative has therefore encouraged departments to build into their
annual planning activities a requirement for more formal inclusion and
development of internal strategic planning methods, aligned to their chosen
outcomes.

A major initial component of this re-focusing has been the requirement
for departments to produce annual statements of intent that emphasise a
"strategic outcomes framework". An explicit consequence of this focus has
been less reliance on the previous, narrower, output-based planning. This
more explicit focus on outcomes in the planning process is required to be
reflected and reinforced by parallel adjustments in official departmental
documents relating to ex post performance reporting.

Thus the prior balance of accountability between departments (for
outputs) and ministers (for outcomes) has been subtly but incontrovertibly
discarded. A practical reflection of these changes has been that departments
now have a considerably greater role in both defining relevant outcomes and
in ensuring that their policies and operations are strategically aligned to them.
Although one might argue that the formerly clear line between ministerial
and departmental accountability for outputs and outcomes has become more
than somewhat blurred as a result of these changes, one cannot deny that
they have modified the expenditure management framework more or less
exactly in the manner intended by the RoC.

Modification of the expenditure management process has therefore
occurred through a series of further planning and reporting requirements
being added to the original output-based model. At no stage did the RoC
provide a formal analysis of the strengths and weaknesses of the output
model itself, nor describe how the changes it proposed would fit within a
coherent new expenditure framework. Indeed, the minister of finance confirmed in 2003 that the legislation underpinning the output-based model did not require major amendment: “Experience shows that the fundamentals of the two Acts (the State Sector Act 1988 and the Public Finance Act 1989) are sound.”

Decisions on which parts of the public management model should be modified, and how, thus occurred largely as a process of central agency discussion, learning, negotiation and, to some degree it would seem, compromise. There is nothing inherently wrong with that. Moreover, the way in which the New Zealand public management process has gravitated towards an outcomes focus has been entirely consistent with international trends in favour of performance (i.e. results-oriented) budgeting. For example, Brumby and Robinson state:

> A strong argument can be advanced for outcome-focused performance budgeting. Outcomes are the intended effects of government programmes, whereas outputs – the goods or services delivered by government – are the means of achieving those outcomes. It can therefore be argued that outcomes are what really matters, and that to focus too much upon outputs in a performance budgeting system is to run the risk of focusing too little upon the effectiveness and quality of services. …Nevertheless, it can be argued that outputs must have a central role in a workable form of performance budgeting.

(Brumby and Robinson, 2004, p. 7)

A lot of hard work has been done by both the Treasury and the SSC to achieve this unspecified balance and, in New Zealand’s case, to reconcile the methodological uncertainty and institutional ambivalence that accompanies it.

While many of the former requirements on departments relating to output planning, specification and reporting remain, the roles of both outputs and output classes are much less clear and fit less comfortably within this new expenditure management framework. Proposed amendments to the PFA aimed at reconciling the two models may forge a compromise, but fail to provide either conceptual or practical clarity on many issues. Whether the difficulties that have arisen for departments in adopting this new hybrid are just teething problems or reflect deeper incompatibilities in design is yet to become clear. Nevertheless, it can be argued that practical application of the new structure is not only difficult to describe, but certainly more difficult, and onerous, for departments to implement.

This lack of a clear and fully articulated model in which output and outcome concepts are effectively integrated in the budgeting and expenditure management process has generated two particular difficulties for senior managers in the public sector. First, in terms of Figure 1, it has presented departments with considerable challenges in linking the rationale for their spending operations with both appropriations (i.e. relevance) and impact
assessment. Not surprisingly, the requirements to develop a meaningful intervention logic and an effective structure for performance measurement have clearly emerged for all departments as the most difficult aspects of implementing the “managing for outcomes” initiative. The newly modified model of expenditure management provides no inherent process and little clear guidance for how these critical linkages should be made, only that they should be made. Current practice therefore largely involves a range of department-specific responses and practices that vary significantly in both content and merit (Economics and Strategy Group, 2003).

The lack of a formal and coherent framework for expenditure management may have also increased the difficulty in integrating other critical facets of improved public management. For example, the conclusions and recommendations of a subsequent committee on the role and conduct of formal evaluation processes in public sector management were disappointingly non-specific (SSC, 2003). A relatively simple but clear budgeting and expenditure management framework may have provided the review process with a much better starting point for determining where and in what form evaluation activities might contribute, given various policy objectives and performance measurement needs. Supporting the general utility of evaluation capabilities while leaving the role, structures and methods largely to individual departments to determine was an arguably weak conclusion that reflected, in part, the uncertainty surrounding the integration of output and outcome methodologies, including where evaluation could therefore best contribute to policy development.

Finally, reports that some departments may also be considering organisational restructuring involving, apparently, greater alignment to outcomes is a cause for even greater concern. At no stage yet have any departments demonstrated a clear, consistent and direct relationship between their functions and the achievement of outcomes.

5. International experience with outcomes-based budgeting

The New Zealand public sector has not been alone in recent years in struggling to achieve an effective integration of output and outcome concepts. Brumby and Robinson cite the British Public Service Agreement (PSA) system in this context:

When the system started off in 1998, most of the PSA targets were output targets. In the two subsequent rounds of PSA target setting, there has been a progressive and deliberate re-orientation towards outcomes, so that today most PSA targets are outcome rather than output targets. Nevertheless, outputs have not been forgotten. Service Delivery Agreements have been introduced at a more operational level, and these set targets for outputs which are intended to mesh together with the top-level PSA outcome targets.

(Brumby and Robinson, 2004, p. 8)
The fact that the United Kingdom started this process two or three years ahead of New Zealand may be encouraging. Although the authors do not comment on the success of the “meshing” process so far, anecdotal reports suggest that a slightly messy, but perhaps more structured relationship has developed in some areas between the two sets of concepts and measures – albeit through a mostly ad hoc, experiential process.

In 2001, the Finance Committee of the Scottish Parliament commissioned a study of outcome budgeting to help guide it on the possible introduction of these concepts (Flynn, 2001). The study included a survey of experience in other countries that is summarised in Table 1.11

Table 1. **Survey on outcomes budgeting for the Finance Committee of the Scottish Parliament: “Lessons from Other Countries”**

<table>
<thead>
<tr>
<th>Surveyed country/jurisdiction</th>
<th>Summarised conclusions</th>
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<tr>
<td>Australian states</td>
<td>“In no case does the budget process dispense with specifying outputs as part of the process. The budget documents and process link overall aims and outcome aspirations to the outputs but the link is not firm as to be able to directly connect the expenditure of money on outputs to the achievement of outcomes. It is possible however to see clearly which outputs are purchased for what purposes. This implies a disciplined thought process to inform the outcome aspirations with what the government can do to achieve its goals, and to inform the people running the services about what the ultimate purposes of their activities are.”</td>
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<tr>
<td>United States</td>
<td>“The main lesson from the USA is the time that it takes to develop outcome based budgeting systems, even where there is legislation in place to make it happen. It also shows that the solution is not to generate huge amounts of data and numbers of targets that only swamp the process of outcome assessment. On the other hand it is now difficult to imagine governments at any level in the USA retreating from performance based budgeting.”</td>
</tr>
<tr>
<td>New Zealand</td>
<td>“The main lesson is that while it has been possible for the New Zealand government to specify outcomes and its aspirations for the effects of public services, the planning process is still concerned with outputs and it has discovered that it is not possible to make a watertight connection between a stream of outputs and the flow of outcomes that results from them.”</td>
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<tr>
<td>Singapore</td>
<td>“(The) Singapore … government is recognised as a modern and progressive manager of the civil service and the economy. It adopted a system of performance-based budgeting and then decided not to try to integrate its outcome definition, quality programmes and special initiatives into the budget process, leaving the budget purely for resource allocation.”</td>
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<tr>
<td>Sweden</td>
<td>“(The Swedish Government concluded that) … the generation of information does not in itself constitute a capacity to use that information in resource allocation or scrutiny. Giving managerial freedom to agencies in exchange for a definition of outcomes may simply replace one set of detailed bureaucratic controls for another, the bureaucracy of outcome measurement replacing the bureaucracy of input controls. The third lesson is that creating a relationship between departments and agencies that focuses on outcomes does not automatically produce a better process from parliament’s point of view.”</td>
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Source: Flynn, 2001, p.5.
The Scottish study recommended that: “all decisions made about resource allocation should be illuminated by explicit statements about the outcomes that are expected to result from those allocations. This implies that MPs should keep pressing departments for better objectives and targets, including expected outcomes” (Flynn, 2001). It further concluded that: “outcome measures should form the main basis for the parliamentary scrutiny of government” (ibid., p. 6). However, the report cautioned the Finance Committee against having high expectations of what outcome setting could reliably add to the quality of resource allocation decisions.

This conservative assessment also seems well supported on the basis of wider evidence. Other countries engaged in outcome specification have experienced significant challenges in maintaining consistency in the definition of outcomes (in terms of the level at which outcome objectives are set), in maintaining the feasibility and practicality of outcome targets (in the face of political pressure to aim higher) and in maintaining specific outcome targets long enough and sufficiently clearly enough to enable meaningful performance measurement and policy assessment to occur.

New Zealand departments are also encountering these problems. The definition of an outcome – as opposed to other potential policy impacts – has been wide and variable within and across departments and in some cases set at levels well outside the feasible reach or direct policy influence of the department. The identification of an “outcomes focus” has already been coined as a trendy (but invariably insubstantial) indicator of the relevance of policy or research. There is also slow but increasing realisation in some parts of the public sector at least – for example with regard to the targeting of welfare payments – that this year’s policy problems are not infrequently last year’s policy outcomes. Policies often do not achieve what politicians or bureaucrats may have hoped or expected of them, and the expenditure management framework needs to ensure that policy design can respond quickly and appropriately when needed. This may be more difficult if it involves a government “giving up” on particular outcome statements.

6. Connecting management decisions

The eventual success of the New Zealand model as it has now evolved relies explicitly on departments acquiring, or developing over time, the skills and capability required to achieve an effective integration of output and outcomes concepts. Whether this confidence is justified remains uncertain. A key constraint, already apparent during the piloting stage, is that the technical expertise necessary to develop a sophisticated and effective strategic and performance framework for guiding management decisions requires skills that are not only in short supply across the wider public sector, but are often limited to even one or two individuals within the larger departments.
What is already clear is that no amount of guidance material can seem to make the outcomes structure a readily applicable tool at the general operational level. Much of the work required for outcomes specification and the associated documentation is thus being assigned to relatively small groups of strategic managers or policy analysts whose task it is to make the framework “fit” with departmental policies and operations. There is a risk that by ceding responsibility to a very small number of these specialists, or worse to out-sourced consulting expertise as has also occurred, will simply distance the process further from the day-to-day managerial and operational teams. Put another way, the expenditure management framework of the public sector should be a valuable tool in the hands of budget managers in spending agencies as well as for economists and governance professionals in the central agencies; but it should put the needs of budget managers first.

This concern is further reflected in the fact that an outcomes focus does not easily fit with the way many public sector organisations “think” – that is, how they are internally structured and managed. Many larger departments in particular must be constantly focused on the management and delivery of core programmes and services that need to meet relatively simple but invariably high public expectations. While they can “see” in an institutional sense (that is, identify, assess and report back on) the consequences of their activities, it is much more difficult for them to develop effective policies back from the longer-term outcomes of those activities – even assuming that accurate and timely performance data are available. This problem is closely linked to the Swedish conclusion reported in Table 1 that producing outcome information does not by itself imply (or engender) a capacity to use that information to design more effective interventions.

An outcomes focus therefore makes substantial demands on departments to “think backwards” (in terms of Figure 1) from the impacts of their activities to the design of policies and operations and to appropriation and sub-appropriation needs and groupings. The difficulty of this task is made more acute by the fact that a great majority of the activities of most departments are ongoing (baseline) policies and activities. New policies that provide an opportunity to focus first on outcomes – i.e. before detailed operations and organisational structures are determined – mostly occur only occasionally, or at the margin of ongoing departmental expenditures. This is a difficult point at which to inject an outcomes orientation. Even then, the broad purpose or objectives of the policy may have been determined at the political level, probably involving a very non-analytical approach to outcome relevance, much less outcome achievement.

It is therefore no surprise that the organisations which appear to have implemented the outcomes model most readily – for example, the Department of Corrections – are those whose mandate implies a relatively tightly-constrained “outcomes set”. Similarly, departments such as the Ministry of Fisheries
appear able to apply an “outcomes” focus more readily, provided that this is constrained to quite specific resource monitoring and management functions.

In practice, these “more successful” departments are actually focusing on quite narrowly defined policy results. Take away this narrow results focus – for example, by introducing broader industry development goals and/or by consolidating ministries – and the task of specifying an outcomes-focussed intervention logic, with relevant performance measures, becomes much more difficult.

7. Beyond outputs and outcomes

The “managing for outcomes” initiative has undoubtedly succeeded in moving departments to a more performance-oriented view of their activities. It has not, however, prompted this development in a way that guarantees an improvement in the quality and impact of government interventions. On the contrary, the “do no harm” principle is at risk as departments experiment with intervention logic and performance measurement frameworks in the outcomes model and as some of the sharper accountability features of the previous public management regime are eroded. The absence of a clear conceptual understanding of the linkages between the main elements of budgeting and expenditure management with a more results-oriented system has left many departments, especially those with a wider and more complex mandate, with insufficient skills or tools for this transition. There is a need to keep the best aspects of what has been developed so far, but to complement these with a methodology that is aligned with their institutional capacities, operational priorities and organisational behaviour and that enables them to integrate much more effectively policy design, operations, service delivery and impact assessment.

To help achieve this, Figure 2 attempts a more detailed exposition of the nature and composition of the budgeting and expenditure management process, including a more integrated expression of the core relationships. Moreover, it links the contribution and performance of each of these functions to the diversity of public management objectives that are invariably relevant in most well developed public administrations. It demonstrates that operational activities are at the heart of departmental management priorities and resource allocation decisions and that the impacts of these decisions may be measured and assessed at varying distances from the delivery function.

Outcomes are shown as clearly at the end of this process. For this reason, they may often be the most difficult point from which to work back to improved policy and operational decisions, much less to an expression of the department’s intervention logic and its funding (i.e. appropriation) criteria. Furthermore, Figure 2 indicates the linkages between the essential components of the
expenditure management process in a way that meets parallel and specific demands for “relevance”, “efficiency”, “effectiveness” and “sustainability”.

7.1. Programme design and delivery: the essence of intervention

The difficult task of determining intervention logic is best undertaken in the course of designing and developing the department's operational programmes and activities. This is the point at which the government's broad policy objectives implied by their appropriation decisions are converted into practical functions and operations. Thus, it is at this point that a department must make its policy objectives explicit and link them to specific spending decisions that will generate quantifiable outputs. Determining the department’s intervention logic cannot and should not be separated from the process of determining what operational activities those interventions will involve.

The logic in this approach of starting with the integration of policy objectives and the design of programmes should be readily apparent to most departmental managers. It is consistent with internal structures, including clearly assigned managerial responsibilities. It should avoid the problems now being encountered with the current outcomes-based approach that staff may become isolated from the planning process and therefore unable to closely or usefully relate their activities to specific outcome targets. On the other hand, it also avoids the problems that were experienced with an almost exclusive focus on outputs where managers and operational staff expressed dissatisfaction with a comparatively sterile description of purpose and incomplete or unchallenging measures of performance and accountability.
Once the core rationale for the department’s intervention has been established through this linkage of policy objectives and programme operations, it is a relatively simple process to work outwards (in both directions) towards appropriation and performance measurement without losing any of the benefits of either the outputs or outcomes-based concepts. Departmental programmes may well be further broken down into sub-programmes that align best with organisational structures and responsibilities, each with their corresponding performance frameworks.

7.2. Appropriations

The organising principle for budget appropriation in New Zealand has traditionally been institutional. It is only by assigning public monies clearly to specific organisations, within which managerial and financial accountabilities are clearly identified, that full accountability can be maintained. Attempts elsewhere to appropriate by outcome or other organising principle have almost always given way in a short space of time to a need for improved transparency and accountability through at least de facto assignment to specific institutions. New Zealand should resist any tendency to appropriate budget funds on the basis of “joint” or “cross-sectoral” outcomes. Where such outcomes or broad objectives may exist, they can be pursued much more effectively, and with greater transparency and accountability, through co-ordinated departmental management and operational or service delivery mechanisms.

Effective parliamentary scrutiny and control of expenditures requires that aggregate appropriations (Votes) in most cases need to be broken down into smaller categories of expenditure. As noted earlier, the current sub-appropriations, or output classes, are now effectively redundant within the current expenditure management framework. In fact, they were probably never a satisfactory sub-appropriation mechanism. These should be replaced in favour of classes of sub-appropriation that are organised or grouped on a functional, programmatic basis – i.e. programmes with broadly related expenditure objectives or common goals. However, it may be quite possible, in addition, for each of these sub-appropriation classes to be aligned to a common specific outcome or sub-set of outcomes within the sector.

Outcomes may, of course, be common to more than one appropriation or sub-appropriation. However, which outcomes may be relevant to each sub-appropriation can only be established after the performance measurement framework has been defined at the programme (or sub-programme) level.
7.3. Outputs

Figure 2 shows that there is a clear and logical hierarchy of performance measures that flow upwards from outputs to results and on to outcomes. Outputs are thus a key starting point within the performance measurement framework that enable departments to express their policy decisions and programme design in terms of practical and transparent purchases of goods and services. Outputs ought therefore to remain an integral part of the expenditure management framework as a key accountability device and as the principal and most effective basis for establishing and measuring efficiency issues.

7.4. Results

Policy and programme interventions are, or should be, designed to achieve a clear and measurable set of results that sit between outputs and outcomes. Results should be directly linked to programme objectives as the direct consequences or impacts of the expenditure. They differ markedly from outcomes in two main respects: their achievement is totally or very substantially the result of the policy or programme and this impact or improvement is evident and measurable within a policy-relevant period. As Figure 2 indicates, this is the only level at which it is feasible and meaningful to assess the effectiveness of interventions. If relevant and measurable results cannot be articulated, then the policy or programme design needs to be revisited. As with outputs, the measurement of results should for most programmes be limited to a small number of critical indicators (2-5).

7.5. Outcomes

The budgeting and expenditure management framework proposed in this paper includes a continuing, albeit adjusted, role for outcomes. Their most important function is to indicate the sustainability of the range of government expenditure policies embodied in current appropriations. The sustainability objective is best measured by the degree to which government policies collectively – i.e. taking into account the interventions of all public agencies within the sector plus the incentives or controls applied to private behaviour, through regulation for example – have a positive or negative longer-term impact on societal outcomes. Monitoring of these outcomes, most likely at the sectoral level for most departments, should therefore enable departments to advise the government on the degree to which the total sum of their policies and operations may be contributing to positive change. Measurement of outcomes cannot, however, provide a particularly useful indicator of either the efficiency or effectiveness of individual agencies or expenditure programmes and ought not to be used for this purpose. They should most certainly not be used as a basis for determining organisational structures.15
This proposed configuration of the outcomes focus implies a different but no lesser role for outcomes from that currently assigned to them in the “managing for outcomes” initiative. Indeed, some departments with comparatively limited operational functions – such as policy ministries in health and research, science and technology – are now (after some initial missteps) recognising the need to assign outcomes to this broader (i.e. sectoral) performance measurement role. Other ministries ought to follow this example, ensuring in the process that outcomes are expressed as sectoral, not departmental, goals. This implies that outcomes – and outcomes measurement – should play only a background role in assessing the effectiveness of policies and therefore in the accountability framework of the department.

7.6. Evaluation

Finally, it should be evident that this framework makes it easier to assign clear objectives and an explicit focus for the evaluation of public expenditures. The performance measurement hierarchy in Figure 2 not only identifies the various types of evaluation – any one or more of which may be appropriate for different purposes – but links these concerns to the corresponding form and level of objectives. From here, it should be possible in most cases to establish clearly and unequivocally the principal, or appropriate, locus of institutional accountability. This improved expenditure management framework, including the roles of the various components described above, is summarised in Table 2.

8. Conclusions

An output-based budgeting framework brought much-needed specificity and accountability to the spending operations of the New Zealand public sector. However, it was perceived as failing to generate sufficient attention to or improvement in the impacts of government policies. Recent requirements for an increased focus on outcomes have been directed at these problems, but have created many difficult challenges for most departments. The “managing for outcomes” approach also risks eroding clear understanding of the determinants of policy effectiveness and may have already removed some of the sharp edges from organisational accountability. These developments raise serious concerns for the quality of public spending. Sound management of public finances should be pursued by moving beyond outputs and outcomes to a clearly articulated and effectively integrated expenditure management framework. This will be one that puts policy design and programme delivery back at the core of the expenditure management process and binds them to clear, modest and achievable policy objectives and results.
Table 2. **Beyond outputs and outcomes: improving the expenditure management framework**

<table>
<thead>
<tr>
<th>Appropriation</th>
<th>Sub-appropriation</th>
<th>Programme design</th>
<th>Output specification</th>
<th>Performance measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriations, or Votes, are allocations determined by the executive and approved by parliament (as at present). They are based on the operational funding requirements of a department and/or sector institutions.</td>
<td>Sub-appropriation categories (&quot;programme classes&quot;) are aggregations of similar or related departmental functions/programmes. They are approved by parliament in the context of the budget legislation. (They replace the current output classes.)</td>
<td>Departmental programmes are determined and designed on the basis of core management functions, operations and activities. They both reflect and determine the coherent assembly of inputs, organisational structures and capabilities.</td>
<td>Outputs (as at present) are the specification of deliverables – <em>i.e.</em> the quantity and quality of goods and services that each programme or activity generates.</td>
<td>Results are the principal expression of programme impacts and the key indicator of performance. They sit below outcomes and within the feasible short-medium term influence of the department’s policies and operations.</td>
</tr>
<tr>
<td>The purpose of the appropriation is expressed in terms of the government’s desired sector-level socio-economic goals.</td>
<td>Sub-appropriations provide an increased level of information and financial control to parliament. They enable parliament to ensure that the design and implementation of departmental functions have relevance and alignment with the overall appropriation.</td>
<td>Programmes are the key mechanism for translating appropriation purpose into specific interventions. For this reason, they are the basis on which departments are structured, managed and resourced.</td>
<td>Outputs remain a key accountability mechanism for the expenditure of public money. In addition, they provide a means for departments to improve programme impact through variable output configurations.</td>
<td>Results are directly related to programme objectives. Their purpose is to focus programme managers on specific and achievable impacts that will enable the department, and outside agencies and monitors, to measure the effectiveness of public expenditures.</td>
</tr>
<tr>
<td>The overall impact of appropriations are measured and reported in the form of high-level, medium-term sectoral outcomes.</td>
<td>Sub-appropriations may be limited in total number and maximum financial size for each appropriation. They do not require measurable impact criteria, but may be aligned with specific outcomes within the broader outcomes set.</td>
<td>All programmes require explicit objectives that describe the results they are expected to achieve. These results are the principal measures of programme effectiveness.</td>
<td>Outputs are measured through quantity, quality and price. They are the principal mechanism for assessing both departmental and programme efficiency.</td>
<td>Results are likely to be expressed and measured in terms of the direct impacts that policies, operations and the delivery of services have on their respective targets. This may include service recipients (<em>e.g.</em> waiting lists), resource levels, business efficiency, environmental quality, prison security, etc.</td>
</tr>
</tbody>
</table>

Source: Webber.

**Notes**

1. See for example, Scott (1996), Boston et al. (1996) and Schick (1996).
2. A number of papers describing the managing for outcomes initiative are available at www.ssc.govt.nz/managing_for_outcomes.
3. For a discussion of this, see Tahi (1998).
4. Strictly speaking, “outcome budgeting” involves the appropriation of public funds on the basis of defined outcomes. Outcomes-focused management does not...
necessarily imply that budgets are appropriated on this basis, though the increased orientation of policy towards measurable results is certainly common to both.

5. Much of this guidance material can also be found at www.ssc.govt.nz/managing_for_outcomes.


7. Many of the more significant documents and recommendations resulting from this process are consolidated at www.ssc.govt.nz/roc.


9. Some evidence for this can be found in the volume and relative complexity of the guidance materials on “managing for outcomes”.

10. An attempt was made early in the “managing for outcomes” development process to provide departments with a business planning model that could perhaps have generated a more effective planning process. However, this initial model failed to gain acceptance among the pilot agencies, and no further formal attempts were made in this direction.

11. Note that the survey of, and reference to, New Zealand’s experience is based on the (previous) public management model that was operating at that time.


13. For example, re-offending rates among former prison inmates.

14. It is worth noting in this respect that one or two departments which have made considerable efforts to involve line managers and operational staff in the initial outcomes planning process have commented that they hope it will not be necessary to undertake such extensive consultation in future years.

15. The Treasury’s initiative to assign specific staff to co-ordinate the pursuit and achievement of outcomes across branches of the organisation may have merit, though the sustainability of this approach has yet to be fully tested.

**Bibliography**


Public Sector Modernisation: Modernising Accountability and Control

by

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1. Introduction

How governments keep control over large and complex operations and how they are held to account has changed over the past 15 years because of technological innovations, changes in the size of government, and the introduction of performance budgeting and management. This paper looks at the challenges and changes under way to control systems in OECD member countries. It is an interim report. More comprehensive information on the topic will be gathered in a survey to be completed in 2005.

What is control? While the term seemingly translates easily among languages, there are wide variations in what is meant by the word control. For the purposes of this paper, control means ensuring that an organisation is operating as intended. Systems of control provide internal and/or external assurance that the management systems are operating well. Traditionally, they focus on ensuring that funds are properly accounted for and regulations complied with. In modern management, control systems can extend to the quality of performance information, and internal control can cover the processes for strategic and performance management.

What are the main trends in control? The main story of control in OECD member countries is the move from ex ante to ex post control, and the development of stronger processes of internal control. Simplistically, the ex ante to ex post trend is from a system where transactions (payments) were approved prior to commitment from a controller outside the spending ministry, to one where internal management makes many financial and non-financial resource allocation decisions, which are externally checked after the event. This move puts a new burden on managers to implement processes to achieve effectiveness, reliability and compliance. In practice it means trading the inefficient but relative certainty of checking the regularity and legality of individual transactions to the more efficient and relative uncertainty of verifying the proper operation of systems.

The trends to ex post controls and managerial flexibility do not mean there is less control – in fact there are more and more varied controls. Up to 50% of the work of external auditors is now performance audits. Many more financial and non-financial reports are produced. Ex ante internal controls are being replaced with ex post internal audits. New and more complicated auditing and accounting regimes (e.g. accruals) are being put in place.
What has prompted these trends? There is no one event that prompted this move, nor one reform that brought countries to this stage. Rather it was the steady accumulation of many influences and the gradual evolution of systems. The changes include: the growth in size and complexity of government; technological advances; a focus on performance; and increased delegation of decision making and the use of service delivery entities outside direct government influence.

What are the current challenges for control systems? Despite the many changes in control systems, there are challenges ahead. For example, the move to formalise performance in budget and management systems has unresolved difficulties. Performance information is more often than not unaudited and unused. Governments are delegating more service delivery functions to entities outside direct ministerial control. With third party providers, the responsibility for the programme is further from those who are held to account for the funds. Many countries are trying to give managers more flexibility to achieve performance goals, but political systems deal poorly with mismanagement of funds and have lower tolerance for risk.

What are implications of control changes for accountability? As control becomes ex post, accountability becomes more important. If decisions are audited after the fact but the audit is not made available to the public and/or if there is no body obliged to ensure corrective action is taken for non-compliance or malfeasance, then the control purpose is not being served. If there are more controls, it means there is more information generated. The formalisation of performance, and of controls of information generated, runs the risk of creating too much information and obscuring the most important controls of public service behaviour, which are those values that public servants have internalised.

Many reformers expected that with new public management approaches, formal controls would be reduced and managers would be more free. This has not happened as envisaged. What has resulted is both more managerial freedom and more formal control – but the nature of control is changing because of the complexity and ambition of the contemporary public management agenda. There is in fact a gap between those ambitions and what control has so far been found feasible. Consequently, control systems are in transition. Gaps between management ambitions and control eventually have to be closed if governments are not to be at risk. How much this will be by improving control, or by limiting management ambitions, remains to be seen.

The OECD Public Sector Modernisation Series reviews the impact of modernising influences on public governance in OECD member countries over the past two decades. This paper, which is part of the series, looks at control systems in transition. In the past two decades, new technologies, privatisation and new forms of management have changed the way governments operate, but
have also created a need for new ways of making governments accountable for what they do. Who takes control of ensuring that the public service is spending its money on the tasks assigned to it and carrying out the job efficiently? And how do governments exercise that control over large and complex operations?

This paper covers the key elements of control systems in OECD member countries, the broad changes under way and the challenges resulting from those changes. It is part of a broader study looking at how control systems have changed and what the effects are on wider systems of accountability. In modern societies governments are accountable for the use they make of public resources. This accountability in OECD member countries is based on a democratic mandate, spanning government’s promises to the public, its management behaviour and the expected outcomes. While there are suggestions of what helps promote accountability, the paper focuses principally on control systems.

2. What is accountability and control?

The terms accountability and control at first glance seem straightforward. Linguistically, they are words and concepts that seemingly are easy to translate. For example, the word control in English translates easily to contrôle in French and kontrol in German and is used universally as a term in budget execution systems. However, the English meaning evokes an active authority to manage, whereas the French meaning implies a more passive oversight and other terms in French like direction and responsable fill out the meaning of the English word control. As a concept, given the country, control can run the gamut from an ex ante to an ex post system from one that focuses purely on financial transaction or to a wider set of procedures that is often described as management control. Accountability, too, is a difficult term across languages. For many languages, the translated equivalent of accountability is limited to a strict meaning of the accounting system or is thought of as a reporting obligation. Other cultures use accountability to mean broader concepts like how those entrusted with the powers of state are held responsible for their actions. These differences in meaning, concept and practice must be acknowledged for an international dialogue to occur.

For the purposes of the work undertaken by the OECD, the terms accountability and control will be wider, more encompassing terms. Accountability is the obligation to present an account of and answer for the execution of responsibilities to those who have entrusted those responsibilities. Control is broadly defined as a process designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of reporting and compliance with applicable laws and regulations. For the purposes of this paper, we distinguish between external control and internal control, and between ex ante and ex post control. External control means the audit process performed by a central and often independent audit agency. Internal controls
are the management processes, regulations and structures that provide senior management assurance of the legality, regularity, efficiency, effectiveness and economy of actions. *Ex ante* controls refer to those requirements which must be approved or pre-specified by a supervisory body before implementation. *Ex post* controls refer to checks after implementation. Internal or – more broadly – management controls refer to systems of control within an organisation, and they can be of an *ex ante* or *ex post* nature.

3. **What are the trends in control?**

The main story of control in OECD member countries is the move from *ex ante* to *ex post* control, and the development of stronger processes of internal control. Simplistically, the *ex ante* to *ex post* trend is from a system where transactions (payments) were approved prior to commitment from a controller outside the spending ministry, to one where internal management makes many financial and non-financial resource allocation decisions, which are externally checked after the event. This move puts a new burden on managers to implement processes to achieve effectiveness, reliability and compliance. In practice it means trading the inefficient but relative certainty of checking the regularity and legality of individual transactions to the more efficient and relative uncertainty of verifying the proper operation of systems. The rise of internal control has freed up external auditors and controllers to adapt their processes to focus on governmental performance. The tendency is that there is more work for both, rather than internal control influence coming at the expense of external control. *Ex ante* controls have been generally reduced but they remain important because of the move to performance goal setting and for sensitive spending and large spending projects (*e.g.* large IT systems).

The tendency to more internally controlled management applies to all OECD member countries, but countries are at different points on a spectrum. At one end are the heavily *ex ante*, externally controlled systems in classic continental European systems like in France, Italy and Spain where delegated treasury controllers and quasi legal “courts” of auditors approve and oversee spending. At the other end are the Westminster and Nordic countries that are externally controlled but on an *ex post* basis. Each country seems to have moved relative to its starting position. Some countries have abandoned external delegated financial controllers in favour of internal auditors but have been slower to relax input controls, while others have delegated and decentralised more decision-making authority and are confronting challenges in employing risk management and more complex management controls.

There is no one event that prompted this move, nor one reform that brought countries to this stage. Rather it was the steady accumulation of
many influences and the gradual evolution of systems. These influences and changes include:

- the growth in the size of government, including the sheer magnitude of transactions;
- the growth in the complexity of government (e.g. government trying to correct social problems);
- the emergence of technology to improve the efficiency and oversight of the transactions;
- the growing focus on the performance of government rather than simple conformance with law;
- the increasing delegation of decision-making power to governmental units closer to clients;
- the use of entities outside of direct government control to deliver services, including agencies, lower levels of government and other third parties (e.g. banks).

These changes have been set against a backdrop of maturing economies and the need to limit aggregate government spending. One notices that many of the changes in budget rules have been accompanied by or resulted in changes to accounting regimes, structural changes, managerial freedom and the like. Each change has posed challenges to accountability and control systems.

4. How have countries confronted the changes?

Generally, there have been more and more varied changes to the internal control process than to external controls. For example, internal audit and other internal management processes have replaced ex ante control while management information has changed to line up organisational objectives.

External control units have seen relatively fewer reforms and are more homogenous because of the deep constitutional and statutory basis of their work and the existence of international norms for auditing. As most OECD member countries have incorporated performance in their budget and management systems, value-for-money and performance audits by external auditors have become virtually universal. This move to value-for-money auditing has been partly in response to strengthened internal control. As internal control has dealt more with financial reliability and compliance, audit offices have played a much larger role in promoting government accountability – notably by strengthening their links with legislatures.

Table 1 shows some reforms made in a selection of countries in the last 10 years. The paper continues with a closer look at changes in internal and external control systems.
### Table 1. **Control reforms over the last decade**

<table>
<thead>
<tr>
<th>Country</th>
<th>Reforms in internal control</th>
<th>Reforms in external control</th>
<th>Reforms in reporting</th>
<th>Other reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Replacement of pre-audit offices by internal control.</td>
<td>Budget pilot project (output-oriented).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>Accounting officer’s statement on internal financial controls.</td>
<td>Management information framework.</td>
<td>Risk management to be introduced. Expenditure review initiative.</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>The traditional financial control by the Ministry of Finance is moving from a sanction type to a &quot;collaborative&quot; kind of <em>ex ante</em> control. Efficiency and effectiveness controls have been introduced since 1993 (management and strategic control). Management controls are performed at the departmental level of each ministry, while strategic control is at the ministerial level. <em>Ex ante</em> external control by the SAI has been reduced to a few issues (regulatory acts, contracts above EU levels, budget reallocations). <em>Ex post</em> performance-based control has been introduced. Performance reporting (efficiency, effectiveness and economy) is made by internal control bodies to the ministers. The SAI is experimenting with an <em>ex post</em> aggregation of financial data based on broad policy goals. The Ministry of Finance reaggregates traditional financial information by centres of responsibility.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Adoption of the Act on Financial Control and Internal Audit.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>Results-based control in central government. Internal audit function in main government agencies.</td>
<td>New supreme audit institution merging the parliamentary auditors and the audit office that previously belonged to the executive branch. Objectives and results dialogue between the responsible minister and the agency's director general.</td>
<td>Creation of a commission to assess improving internal audit by creating a central body.</td>
<td></td>
</tr>
</tbody>
</table>
4.1. Changes in internal control systems

Wide international acceptance of the goals for internal control are articulated in the COSO model which states that “internal control is a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1) effectiveness and efficiency of operations; 2) reliability of financial reporting; and 3) compliance with applicable laws and regulations.”

While the goals of internal control are broad, most countries focus on the latter two goals of regularity and legality of spending. Indeed internal control is mostly a financial process while only a few countries are now branching out into management control, performance audits and risk management techniques.

4.2. Internal control is primarily financial control

As shown in Table 2, control on transactions – commitment and payment procedures, accounting procedures and financial statements – continues to constitute the core of the executive’s activity. All OECD member countries have internal control units but most have moved away from ex ante transaction controls to ex post audit. For the most part internal audit exists and is mandatory. The OECD/World Bank budgeting survey shows that of 28 countries queried, only three OECD member countries – Iceland, Sweden and Turkey – currently do not use internal auditors, and in three other countries – the Czech Republic, Germany and Greece – the use of internal audit is not widespread.
Table 2. A snapshot of internal control systems

<table>
<thead>
<tr>
<th></th>
<th>Unit responsible for execution</th>
<th>Level of control co-ordination</th>
<th>Reporting destination</th>
<th>Typology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>Spending ministry</td>
<td>No</td>
<td>Managers; external controls</td>
<td>Financial audit</td>
</tr>
<tr>
<td>Germany</td>
<td>Spending ministry</td>
<td>Department</td>
<td>Head of department</td>
<td>Ex ante budget; financial audit</td>
</tr>
<tr>
<td>Ireland</td>
<td>Spending ministry</td>
<td>Department</td>
<td>Management; accounting officer; audit committee</td>
<td>Ex ante control; financial audit; risk management to be applied</td>
</tr>
<tr>
<td>Italy</td>
<td>Ministry of Finance; spending ministry</td>
<td>Ministry of Finance; spending ministry</td>
<td>Ministry of Finance; ministers and managers; technical committee at the Presidency of the Council of Ministers</td>
<td>Ex ante control; financial and compliance audit; management and strategic control</td>
</tr>
<tr>
<td>Japan</td>
<td>Spending ministry</td>
<td>Ministry</td>
<td>Head of department; rarely minister</td>
<td>Financial audit</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Ministry of Finance; spending ministry</td>
<td>Ministry of Finance</td>
<td>Ministers; cabinet</td>
<td>Ex ante control; financial audit</td>
</tr>
<tr>
<td>Spain</td>
<td>Ministry of Finance</td>
<td>Central unit in Ministry of Finance</td>
<td>Managers; ministers; Ministry of Finance; cabinet</td>
<td>Ex ante control; financial audit; evaluation of programmes (a few)</td>
</tr>
<tr>
<td>Sweden</td>
<td>Agencies</td>
<td>Management unit</td>
<td>Agencies’ management</td>
<td>Value for money; compliance</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Spending ministry</td>
<td>Department</td>
<td>Accounting officer</td>
<td>Management control; internal audit; risk management</td>
</tr>
<tr>
<td>United States</td>
<td>Spending ministry</td>
<td>Department/ agency</td>
<td>Head of department/ agency; chief accounting officer</td>
<td>Management control; financial audit</td>
</tr>
</tbody>
</table>

Source: Case studies and expert meeting discussion, November 2003.

4.3. Moving beyond financial control

For those countries that have moved beyond financial control, more sophisticated management controls are used as complementary add-ons rather than substitutes for the financial processes. There are meaningful differences, though, in the extent to which countries use effectiveness and efficiency audits as well as risk management techniques. Moreover, to whom the control bodies report and the degree of decentralisation of the internal control units varies markedly from country to country.

There is a steady increase in the volume of performance information. However, the quality and use of performance information is not necessarily monitored by the internal control entities. While in most countries, performance information is incorporated in the formal budget formulation process, it is not always taken into account when making decisions about budget allocations. When internal control incorporates non-financial aspects, one finds a
performance-oriented audit closer to financial performance or value for money (economy, effectiveness and efficiency) than results auditing. Thus countries moving away from financial control to wider management control regimes tend to focus on programme effectiveness rather than whether the performance data is accurate.

Recently, a few countries (Australia and the United Kingdom) have formalised risk management techniques into their management control structures and other countries have become actively interested in this development (Ireland and Japan). These countries had more elaborate internal controls as a starting point and have gone the furthest in relaxing input controls and managing by performance and contract. However, most countries follow a more classical approach of external audit risk assessment, since individual managers lack a global view of risks, both financial and non-financial.

4.4. Co-ordination of internal control

One issue encountered by countries is how to relate internal and external control. Because internal control is responsible to management, its independence, impartiality or objectivity can be called into question. According to Figure 1, half of OECD member countries have created central coordination, policy and/or monitoring units to oversee the departmental internal control systems. Half of these units are located in the finance ministry. These range from units that actively audit internal auditors, to small units which set standards and co-ordinate specific overlapping issues. Some countries have explicit links

Figure 1. **Is there a Central Office for controlling and monitoring audits?**

<table>
<thead>
<tr>
<th>Response</th>
<th>% of OECD countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, an independent government organisation</td>
<td>14.8</td>
</tr>
<tr>
<td>Yes, in another government organisation headed by a Minister</td>
<td>7.4</td>
</tr>
<tr>
<td>Yes, in the ministry of finance (or similar organisation)</td>
<td>25.9</td>
</tr>
<tr>
<td>Yes, located elsewhere</td>
<td>3.7</td>
</tr>
<tr>
<td>No</td>
<td>51.8</td>
</tr>
</tbody>
</table>

between the external audit institutions and internal control units. The supreme audit institutions (SAIs, see section 4.7.) evaluate internal control systems in deciding on the extent and depth of their own auditing work.

4.5. Ex ante remains important

While there has been a trend to ex post control, ex ante control still exists in important ways. Top-down budgeting requires stronger ex ante control, with input rationing, rules, control systems and incentives to ensure that departments, and government as a whole, receive and spend no more than they were allocated. And performance-oriented budgeting and management requires a limited return to centralised planning of performance (ex ante specification of intended outputs and impacts,) but also more ex post performance reporting, audit and evaluation.

4.6. Internal control reporting

In OECD member countries, most internal control reports are issued and used at levels below the ministerial level. Only a few countries, including Italy and the Slovak Republic, report beyond the senior management level. Internal control units are generally independent of line management. Senior management, ministers and the cabinet tend to receive summary reports on financial and management activity on an annual or semi-annual basis.

For example, in the United Kingdom the head of internal audit of any department reports to the accounting officer with the necessary information to issue the annual statement on internal control, providing the accounting officer with an opinion on the body’s arrangements for risk management, control and governance. In the case of Spain, internal auditors report to top managers and to the central unit in the Ministry of Finance. Special reports can be addressed to ministers and the cabinet. The central unit provides the cabinet with an annual report with the most relevant features, findings and recommendations on the financial activity.

4.7. The external control system audit

While there has not been the variety of changes as in internal control, external control bodies have almost universally added performance and/or value-for-money audits to their workload. External audit ensures that planning, budgeting and use of public resources conform to a country’s laws, pursue the objectives defined by parliament and government, and are linked to the real world of programme operation. In most countries, the main body responsible for this is the national audit office often known as the supreme audit institution (SAI). The role of the SAI has evolved from the traditional task of verifying legality and regularity of financial management and of accounting. The
## Table 3. **A snapshot of external control systems**

<table>
<thead>
<tr>
<th>Country</th>
<th>Scope of audit</th>
<th>SAI’s status*</th>
<th>Audit typology</th>
<th>Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>Government; Institutions funded by government; local government areas funded with national funds.</td>
<td>Parliamentary office.</td>
<td>Financial (including regularity) audit; performance audit (VFM).</td>
<td>Parliament (Public Accounts Committee).</td>
</tr>
<tr>
<td>Germany</td>
<td>Federation; federal public corporations; social security; federation shareholders’ interests.</td>
<td>Independent office; provides assistance to parliament and the executive.</td>
<td>Regularity; VFM; effectiveness for large-scale programmes.</td>
<td>Annual (both houses); special reports; impact report on recommendations’ remedial actions.</td>
</tr>
<tr>
<td>Ireland</td>
<td>Whole government (but not the State debt policy); agencies; universities; etc.</td>
<td>Independent office.</td>
<td>Financial audit; certification of accounts; VFM.</td>
<td>Committee of Public Accounts (parliament).</td>
</tr>
<tr>
<td>Italy</td>
<td>Whole government; State enterprises; autonomous bodies; main local authorities.</td>
<td>Independent office (president and magistrates appointed by the President of the Republic).</td>
<td>Regularity; financial audit; performance audit (objectives).</td>
<td>Two Chambers and Treasury.</td>
</tr>
<tr>
<td>Japan</td>
<td>Whole national government; bodies receiving government financing or grants (agencies, prefectures, municipalities).</td>
<td>Independent office.</td>
<td>Regularity; financial audit; certification of government accounts; VFM.</td>
<td>Annual (Diet).</td>
</tr>
<tr>
<td>Spain</td>
<td>Whole public sector; (co-ordination with regional courts of accounts).</td>
<td>Dependent on parliament (not hierarchical subordination).</td>
<td>Regularity; financial audit; economy and efficiency audit</td>
<td>Mixed Congress-Senate commission; government.</td>
</tr>
<tr>
<td>Sweden</td>
<td>State; agencies and government-owned companies; government grants and benefits conceded by government; Bank of Sweden; social insurance fund.</td>
<td>Parliamentary office (as of 2003).</td>
<td>Financial audit; performance (effectiveness) audit.</td>
<td>Annual financial audit report to government; annual agency reports to parliament.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>National government (local and health authorities controlled by the Audit Commission).</td>
<td>Office of the House of Commons (through the Comptroller and Auditor General).</td>
<td>Financial (including regularity) audit; certification of accounts; VFM audit.</td>
<td>Parliament (Committee of Public Accounts).</td>
</tr>
</tbody>
</table>

* Refers to the legal relationship with the legislature.

Source: Case studies and expert meeting discussion, November 2003.
modern SAI audit objectives cover both the traditional focus of legality, regularity and economy, and reviews of efficiency and effectiveness of financial and programme management. The United States Government Accountability Office, given the constitutional framework of the United States, stands alone in pushing beyond these objectives to provide policy advice and making management recommendations. (Budget offices and finance ministries in general also perform what some people term external controls – both ex ante and ex post reviews of spending, processes, performance and value-for-money evaluations. However for the purposes of this paper, the finance ministry reviews are considered as internal control mechanisms.)

4.8. Independent, but how independent?

The most significant changes in external control have been to secure the independence of auditors as well as to reinforce the links between the audit office and the legislature. Either at the constitutional or the statutory level, most SAIs are now independent of the executive. In Nordic countries particularly, the audit offices have been made independent offices of parliament.

In most countries, the audit office determines its own workload with some countries allowing audit subjects to come from parliament (40% of OECD member countries) or even the executive itself (25% of OECD member countries – see Figure 2). This means that despite moves to make the office more independent, there are still some countries with audit offices that cannot fully determine their workload.

Figure 2. How are audit subjects determined?

![Bar Chart](image-url)

4.9. Differences in the scope of audit

Some differences appear in the scope of institutions overseen by the SAIs, including, for example, control over regional or local governments and state enterprises in Italy and Japan. Also, in many continental countries SAIs continue to have a jurisdictional role for enquiries and for sanctions of an individual’s use of public resources. The most important reasons for changes in scope have been decentralisation, and changes resulting from privatisation.

4.10. SAIs universally do performance audits

As internal control and the rise of automation has made financial auditing easier and less burdensome, external auditors have addressed programme effectiveness or value-for-money audits (Table 3). However, financial audits still comprise the majority of the SAI workload. Because internal control focuses on financial audits as well, most SAIs either co-ordinate or use the reports from the internal auditors if they are confident of their credibility.

![Figure 3. Does the supreme audit body coordinate with or use the reports of internal auditors?](image)


Only in a few countries like the United Kingdom and the United States do VFM and effectiveness audits account for more than half of the work performed by the SAI. As the United States moves beyond traditional financial, performance and risk audits, the linkages between the executive branch must necessarily be stronger, and the Government Accountability Office is attempting to maintain its objectivity while being intimately involved in management operations.
5. What are the modernisation challenges resulting from the reforms?

5.1. The complexity of government

Governments of OECD member countries grew throughout the last 30 years by taking on larger, more complex and ambitious tasks. The last two decades have been a period of financial constraint which requires government managers to be more purposeful with the resources available to them. The complexity of government requires more varied and performance-related internal controls. As government diversifies its services, external auditors must also adapt and expand their oversight in equally diversified ways.

5.2. The formalisation of performance

Reforms to accountability and control systems have paralleled efforts to introduce performance budget and management reforms aimed at giving service delivery organisations more managerial freedom to comply with programme objectives. Tight ex ante control is inefficient and incompatible with the needs of a performance-oriented system.

The limitations of setting performance goals and then measuring and auditing them are well documented. In current practice in member country governments, for the most part, performance data is accepted at face value. Parliaments have been interested in the programme evaluations conducted by the auditors, but they have so far lacked significant interest in performance measures. Since the linkages between available resources and performance are weak, internal control systems still focus primarily on financial measures. While international bodies are working on creating standards for auditors and to a limited degree internal control for performance audits and performance information, countries have been slow to adopt them in their systems.

5.3. Decentralisation and delegation

As countries fund service delivery and even policy making at lower levels of government, overseeing and accounting for those funds is difficult. Other levels of government sometimes have their own control and audit procedures that can be at odds with national systems. Other more difficult problems can occur. For example, local politicians can prevail on national politicians to waive financial audit penalties, thus weakening accountability for central government funds. Monitoring and holding officials of other levels of government to account is more difficult than in direct line ministries. As systems become decentralised or deconcentrated, there is a need for better co-ordination of internal controls and more robust external oversight.
5.4. Partnering and third party delivery

In the drive to make government more efficient and responsive, governments have turned to agencies and other arm’s-length bodies to deliver services. Moreover, governments are partnering with private companies and non-governmental organisations as well that are subject to private sector audit standards, can withhold non-public portions of their records from governments, and are subject to contractual arrangements. Programme managers must rely on external, ex post control which means they have few tools at their disposal to correct problems mid-stream. Most countries still place ultimate accountability on ministers and senior civil servants. With third party providers, the responsibility for the programme is placed further from those who are held to account for the funds.

5.5. Automation and technology

The introduction of automation and other technology, combined with conceptual advances in accounting and auditing, has been the true success story in control. In general terms, the information provided is better and more reliable, as a consequence of improvements in terms of performance information, the introduction in the accounting systems of some accruals information and the use of information and communication technology, both for reporting and for controlling. Also, the use of the Internet allows more possibilities for open government, with feedback from citizens. Through technology, internal and external controllers have been able to enlarge their scope and types of audit without abandoning their traditional functions of preventing mistakes and fraud, and conducting financial analyses. Of course, there are risks from technology. The design of computerised control systems can be difficult and expensive.

5.6. Innovation, flexibility and risk

The fundamental challenge to control is the move from expecting conformance with tightly defined rules to a flexible system where managers are given flexibility to achieve wider goals. This means that the model for control is moving from a fundamental distrust of management to a model that values management taking calculated risks and making decisions based on performance rather than rules. Political systems deal poorly with mismanagement of funds and have lower tolerance for risk. Private sector organisations have the discipline of the market place, but there is no public bankruptcy process. A handful of countries have attempted to incorporate risk management into their accountability and control systems, but at this point experience is limited and lessons are few.
### Table 4. The modern control framework

<table>
<thead>
<tr>
<th>External control</th>
<th>Central control</th>
<th>Internal and management control</th>
<th>Organisational control</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Direct</td>
<td>Ex ante</td>
</tr>
<tr>
<td>Ex ante</td>
<td></td>
<td>Ex post</td>
<td></td>
</tr>
<tr>
<td>Indirect</td>
<td></td>
<td>Direct</td>
<td>Ex ante</td>
</tr>
<tr>
<td>Indirect</td>
<td></td>
<td>Indirect</td>
<td>Ex post</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Spending reports</td>
<td>Spending reports</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial management controls, such as signing authorities</td>
<td>Entity financial management policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ex ante</td>
<td></td>
</tr>
<tr>
<td>Financial</td>
<td>SAI observations and recommendations</td>
<td>Budget controls, such as spending controls</td>
<td>Accounting and financial management policies and guidelines</td>
</tr>
<tr>
<td></td>
<td>SAI attest audits</td>
<td>Accounting and financial management policies and guidelines</td>
<td>Spending reports</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ex ante</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Direct</td>
<td>Ex ante</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Indirect</td>
<td>Ex post</td>
</tr>
<tr>
<td>Trend</td>
<td></td>
<td>Expansion for some SAI’s of coverage to individual entities</td>
<td>Modernising of policies occurring</td>
</tr>
<tr>
<td>Financial</td>
<td></td>
<td>Budget controls now at entity or large programme level</td>
<td>More flexibility given to managers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Modernising of policies occurring</td>
<td>Modernising of policies occurring</td>
</tr>
<tr>
<td>Performance</td>
<td>SAI recommendations, guides and best practices</td>
<td>Dialogue on setting objectives and results</td>
<td>Performance-related policies and guidelines</td>
</tr>
<tr>
<td></td>
<td>SAI performance audits; audits and reports from other legislative officers</td>
<td>Performance-related policies and guidelines</td>
<td>Central evaluations and audits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ex ante</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Direct</td>
<td>Ex ante</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Indirect</td>
<td>Ex post</td>
</tr>
<tr>
<td>Trend</td>
<td></td>
<td>Increasing issuance of guidelines etc. by some SAI’s</td>
<td>Increasing coverage of performance audits and audits/studies by other independent agents</td>
</tr>
<tr>
<td>Financial</td>
<td></td>
<td>Increasing at least in some countries, such as Sweden, United Kingdom and United States</td>
<td>Now occurring in most countries</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increasing coverage of performance audits and audits/studies by other independent agents</td>
<td>Some increase here, especially audits; others have backed off</td>
</tr>
<tr>
<td>Performance</td>
<td></td>
<td>Occurring as a result of the results focus (?)</td>
<td>Occurring as a result of the results focus (?)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increasing internal audit in most places with some increase in evaluations (?)</td>
<td></td>
</tr>
</tbody>
</table>

6. Conclusions

Most OECD member countries claim to be interested in the performance of government. This performance focus has led to or followed differentiated organisational structures, new reporting regimes and data, new service delivery arrangements and new management techniques. This complexity of government intervention requires a generally ex post orientation with new internal and management control regimes, and more external attention to value-for-money and performance audits. However, performance-oriented budgeting and management also requires a limited return to centralised planning of performance (i.e. ex ante specification of intended outputs and impacts); and to be effective it also requires increased attention to ensuring that public employees have values which internalise both compliance and the desire to pursue public interest goals.

In the early stages of the period under review, there was an expectation that formal controls would be reduced – and managers would be more free. This has not happened as envisaged. What has resulted is both more managerial freedom and more formal control – but the nature of control is changing because of the complexity and ambition of the contemporary public management agenda. There is in fact a gap between those ambitions and what control has so far been found feasible. Consequently, control systems are in transition. Whereas traditional public management featured purely financial ex ante external controls, modern systems rely on internal controls backed up by strong ex post audits by SAIs. In OECD member countries, control is still generally financial in nature – although less and less exclusively so. There is much more financial reporting because of improvements in technology, freedom of information laws, parliamentary needs and new accounting regimes (e.g. the introduction of accruals). Ex ante control still exists, since reforms like top-down budgeting require stronger ex ante control, with input rationing, rules, control systems and incentives to ensure that departments, and government as a whole, receive and spend no more than they were allocated.

Gaps between management ambitions and control eventually have to be closed if governments are not to be at risk. Whether this will be by improving control, or by limiting management ambitions, remains to be seen.

Notes

1. There are two primary sources for this paper. The first is a set of case studies developed by OECD member countries participating in an expert meeting held in November 2003. These countries appear in the series of tables on changes in control systems. The other source is the OECD/World Bank Survey on Budget Practices and Procedures that was completed in 2003 and includes 28 OECD
member countries as well as a number of non-member countries. The data from this survey are the basis of the graphs. See http://ocde.dyndns.org.

2. This definition is generally taken from the COSO model, www.coso.org. COSO is an international, voluntary professional organisation dedicated to the improvement of financial reporting through ethics, effective internal control and corporate governance. While originally a private sector group, the COSO definitions and procedures are generally relevant to public sector organisations.

3. Classically, external control included central executive branch entities which provided, for example, ex ante transaction level spending authority. This is no longer an accepted concept, and typically not employed in OECD member countries.


7. Ibid., Section 4.3.