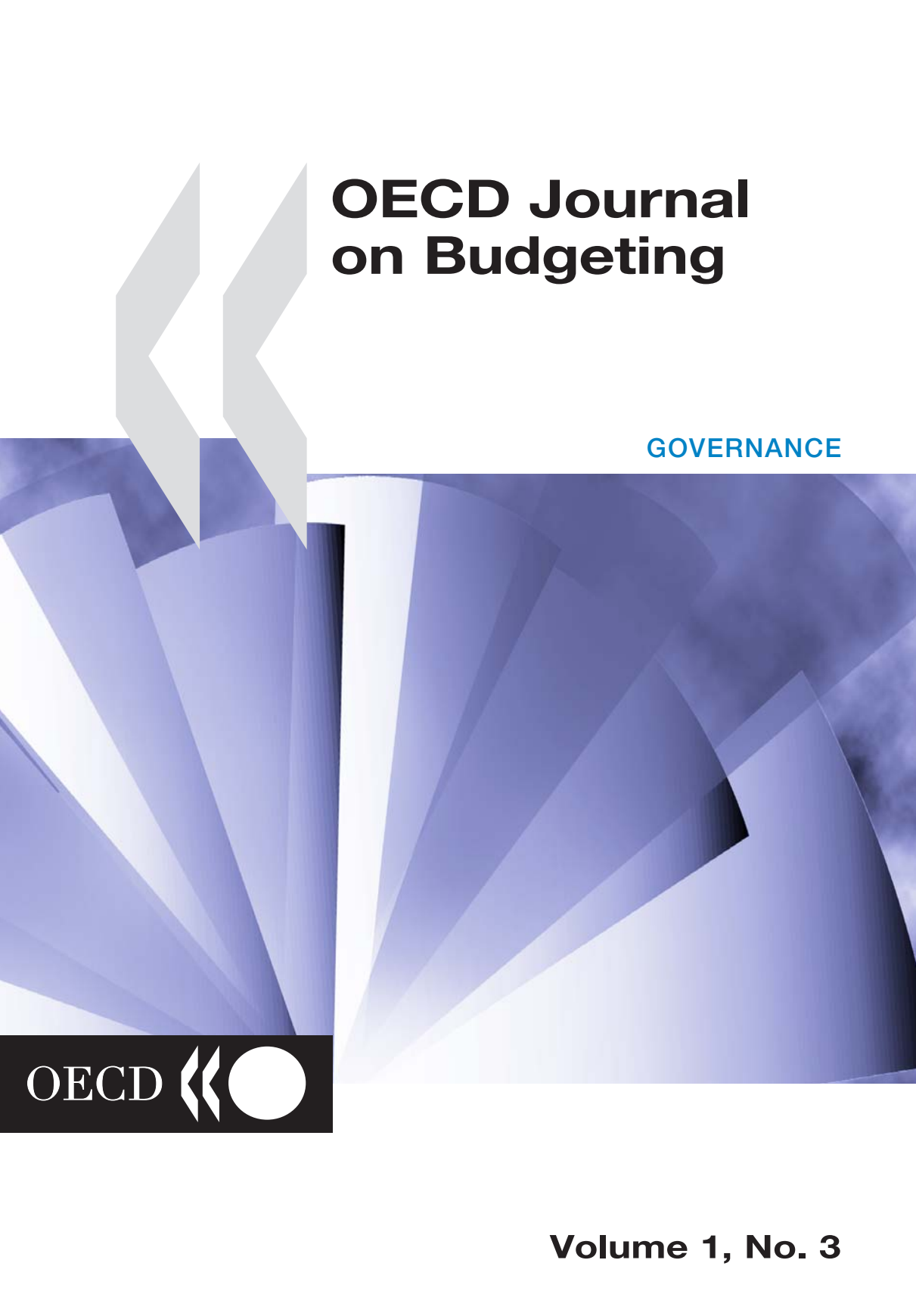




OECD Journal on Budgeting

GOVERNANCE

OECD 

Volume 1, No. 3

© OECD, 2002.

© Software: 1987-1996, Acrobat is a trademark of ADOBE.

All rights reserved. OECD grants you the right to use one copy of this Program for your personal use only. Unauthorised reproduction, lending, hiring, transmission or distribution of any data or software is prohibited. You must treat the Program and associated materials and any elements thereof like any other copyrighted material.

All requests should be made to:

Head of Publications Service,
OECD Publications Service,
2, rue André-Pascal,
75775 Paris Cedex 16, France.

OECD Journal on Budgeting

Volume 1 – No. 3



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Pursuant to Article I of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Publié en français sous le titre :

REVUE DE L'OCDE SUR LA GESTION BUDGÉTAIRE
Volume I – N° 3

© OECD 2002

Permission to reproduce a portion of this work for non-commercial purposes or classroom use should be obtained through the Centre français d'exploitation du droit de copie (CFC), 20, rue des Grands-Augustins, 75006 Paris, France, tel. (33-1) 44 07 47 70, fax (33-1) 46 34 67 19, for every country except the United States. In the United States permission should be obtained through the Copyright Clearance Center, Customer Service, (508)750-8400, 222 Rosewood Drive, Danvers, MA 01923 USA, or CCC Online: www.copyright.com. All other applications for permission to reproduce or translate all or part of this book should be made to OECD Publications, 2, rue André-Pascal, 75775 Paris Cedex 16, France

Foreword

The OECD *Journal on Budgeting* is a new and 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 regret we are unable to take unsolicited contributions to the *Journal*. We are, however, 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, 75775 Paris Cedex 16, France. Fax (33 1) 45 24 17 06; email: pum.contact@oecd.org

The views expressed are those of the authors and do not commit or necessarily reflect those of governments of OECD Member countries.

The Editors.

OECD PUBLIC MANAGEMENT SERVICE

Odile Sallard

Director

Alex Matheson

Head of Budgeting and Management Division

Andrea Uhrhammer

Communications and Information Manager

OECD JOURNAL ON BUDGETING

Jón R. Blöndal

Editor-in-Chief

Jennifer Gardner

Managing Editor

Marie Murphy

Administrative Co-ordinator

Board of Advisers

Geert van Maanen (Chairman)

Secretary-General, Ministry of Finance, The Netherlands

Peter Boxall

Secretary, Department of Finance and Administration, Australia

Gerd Ehlers

Director of the Budget, Ministry of Finance, Germany

Richard Emery

Assistant Director, Office of Management and Budget, United States

Eva Lindstrom

Director of the Budget, Ministry of Finance, Sweden

Sophie Mahieux

Director of the Budget, Ministry of Economy, Finance and Industry, France

Peter Saurer

Deputy Director, Federal Finance Administration, Switzerland

Table of Contents

OECD Best Practices for Budget Transparency	7
Can National Legislatures Regain an Effective Voice in Budget Policy? <i>By Allen Schick</i>	15
Budgeting in the Netherlands <i>By Jón R. Blöndal and Jens Kromann Kristensen</i>	43
The Implementation of the Stability and Growth Pact <i>Preface by Ludger Schuknecht</i>	81
A Framework for Public Sector Performance Contracting <i>By Murray Petrie</i>	117
The OECD Budgeting Database	155

OECD Best Practices for Budget Transparency

Note from the Editors

The relationship between good governance and better economic and social outcomes is increasingly acknowledged. Transparency – openness about policy intentions, formulation and implementation – is a key element of good governance. The budget is the single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner.

OECD Member countries are at the forefront of budget transparency practices. At its 1999 annual meeting, the OECD Working Party of Senior Budget Officials asked the Secretariat to draw together a set of Best Practices in this area based on Member countries' experiences.

The Best Practices are in three parts. Part 1 lists the principal budget reports that governments should produce and their general content. Part 2 describes specific disclosures to be contained in the reports. This includes both financial and non-financial performance information. Part 3 highlights practices for ensuring the quality and integrity of the reports.

The Best Practices are designed as a reference tool for Member and non-member countries to use in order to increase the degree of budget transparency in their respective countries. The Best Practices are organised around specific reports for presentational reasons only. It is recognised that different countries will have different reporting regimes and may have different areas of emphasis for transparency. The Best Practices are based on different Member countries' experiences in each area. It should be stressed that the Best Practices are not meant to constitute a formal "standard" for budget transparency.

1. Budget reports

1.1. *The budget*

- The budget is the government's* key policy document. It should be comprehensive, encompassing all government revenue and expenditure, so that the necessary trade-offs between different policy options can be assessed.
- The government's draft budget should be submitted to Parliament far enough in advance to allow Parliament to review it properly. In no case should this be less than three months prior to the start of the fiscal year. The budget should be approved by Parliament prior to the start of the fiscal year.
- The budget, or related documents, should include a detailed commentary on each revenue and expenditure programme.
- Non-financial performance data, including performance targets, should be presented for expenditure programmes where practicable.
- The budget should include a medium-term perspective illustrating how revenue and expenditure will develop during, at least, the two years beyond the next fiscal year. Similarly, the current budget proposal should be reconciled with forecasts contained in earlier fiscal reports for the same period; all significant deviations should be explained.
- Comparative information on actual revenue and expenditure during the past year and an updated forecast for the current year should be provided for each programme. Similar comparative information should be shown for any non-financial performance data.
- If revenue and expenditures are authorised in permanent legislation, the amounts of such revenue and expenditures should nonetheless be shown in the budget for information purposes along with other revenue and expenditure.
- Expenditures should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately. This should be done regardless of whether particular incentive and control systems provide for the retention of some or all of the receipts by the collecting agency.

* The Best Practices define "government" in line with the System of National Accounts (SNA). This definition encompasses the non-commercial activities of government. Specifically, the activities of state-owned enterprises are excluded from this definition. Although the SNA definition focuses on general government, *i.e.* consolidating all levels of government, these Best Practices should be seen to apply to the national government.

- Expenditures should be classified by administrative unit (*e.g.* ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (below).
- The budget should include a discussion of tax expenditures in accordance with Best Practice 2.2 (below).
- The budget should contain a comprehensive discussion of the government's financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3-2.6 (below).

1.2. *Pre-budget report*

- A pre-budget report serves to encourage debate on the budget aggregates and how they interact with the economy. As such, it also serves to create appropriate expectations for the budget itself. It should be released no later than one month prior to the introduction of the budget proposal.
- The report should state explicitly the government's long-term economic and fiscal policy objectives and the government's economic and fiscal policy intentions for the forthcoming budget and, at least, the following two fiscal years. It should highlight the total level of revenue, expenditure, deficit or surplus, and debt.
- The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (see below).

1.3. *Monthly reports*

- Monthly reports show progress in implementing the budget. They should be released within four weeks of the end of each month.
- They should contain the amount of revenue and expenditure in each month and year-to-date. A comparison should be made with the forecast amounts of monthly revenue and expenditure for the same period. Any in-year adjustments to the original forecast should be shown separately.
- A brief commentary should accompany the numerical data. If a significant divergence between actual and forecast amounts occurs, an explanation should be made.
- Expenditures should be classified by major administrative units (*e.g.*, ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.

- The reports, or related documents, should also contain information on the government's borrowing activity (see Best Practice 2.3 below).

1.4. *Mid-year report*

- The mid-year report provides a comprehensive update on the implementation of the budget, including an updated forecast of the budget outcome for the current fiscal year and, at least, the following two fiscal years. The report should be released within six weeks of the end of the mid-year period.
- The economic assumptions underlying the budget should be reviewed and the impact of any changes on the budget disclosed (see Best Practice 2.1 below).
- The mid-year should contain a comprehensive discussion of the government's financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3-2.6 (below).
- The impact of any other government decisions, or other circumstances, that may have a material effect on the budget should be disclosed.

1.5. *Year-end report*

- The year-end report is the government's key accountability document. It should be audited by the Supreme Audit Institution, in accordance with Best Practice 3.3 (below) and be released within six months of the end of the fiscal year.
- The year-end report shows compliance with the level of revenue and expenditures authorised by Parliament in the budget. Any in-year adjustments to the original budget should be shown separately. The presentation format of the year-end report should mirror the presentation format of the budget.
- The year-end report, or related documents, should include non-financial performance information, including a comparison of performance targets and actual results achieved where practicable.
- Comparative information on the level of revenue and expenditure during the preceding year should also be provided. Similar comparative information should be shown for any non-financial performance data.
- Expenditure should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately.

- Expenditure should be classified by administrative unit (*e.g.* ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- The year-end report should contain a comprehensive discussion of the government's financial assets and financial liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3-2.6 (below).

1.6. Pre-election report

- A pre-election report serves to illuminate the general state of government finances immediately before an election. This fosters a more informed electorate and serves to stimulate public debate.
- The feasibility of producing this report may depend on constitutional provisions and electoral practices. Optimally, it should be released no later than two weeks prior to elections.
- The report should contain the same information as the mid-year report.
- Special care needs to be taken to assure the integrity of such reports, in accordance with Best Practice 3.2 (below).

1.7. Long-term report

- The long-term report assesses the long-term sustainability of current government policies. It should be released at least every five years, or when major changes are made in substantive revenue or expenditure programmes.
- The report should assess the budgetary implications of demographic change, such as population ageing and other potential developments over the long-term (10-40 years).
- All key assumptions underlying the projections contained in the report should be made explicit and a range of plausible scenarios presented.

2. Specific disclosures

2.1. Economic assumptions

- Deviations from the forecast of the key economic assumptions underlying the budget are the government's key fiscal risk.
- All key economic assumptions should be disclosed explicitly. This includes the forecast for GDP growth, the composition of GDP growth, the rate of employment and unemployment, the current account, inflation and interest rates (monetary policy).

- A sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget.

2.2. Tax expenditures

- Tax expenditures are the estimated costs to the tax revenue of preferential treatment for specific activities.
- The estimated cost of key tax expenditures should be disclosed as supplementary information in the budget. To the extent practicable, a discussion of tax expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budgetary choices.

2.3. Financial liabilities and financial assets

- All financial liabilities and financial assets should be disclosed in the budget, the mid-year report, and the year-end report. Monthly borrowing activity should be disclosed in the monthly reports, or related documents.
- Borrowings should be classified by the currency denomination of the debt, the maturity profile of the debt, whether the debt carries a fixed or variable rate of interest, and whether it is callable.
- Financial assets should be classified by major type, including cash, marketable securities, investments in enterprises and loans advanced to other entities. Investments in enterprises should be listed individually. Loans advanced to other entities should be listed by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. Financial assets should be valued at market value.
- Debt management instruments, such as forward contracts and swaps, should be disclosed.
- In the budget, a sensitivity analysis should be made showing what impact changes in interest rates and foreign exchange rates would have on financing costs.

2.4. Non-financial assets

- Non-financial assets, including real property and equipment, should be disclosed.
- Non-financial assets will be recognised under full accrual-based accounting and budgeting. This will require the valuation of such assets and the selec-

tion of appropriate depreciation schedules. The valuation and depreciation methods should be fully disclosed.

- Where full accrual basis is not adopted, a register of assets should be maintained and summary information from this register provided in the budget, the mid-year report and the year-end report.

2.5. Employee pension obligations

- Employee pension obligations should be disclosed in the budget, the mid-year report and the year-end report. Employee pension obligations are the difference between accrued benefits arising from past service and the contributions that the government has made towards those benefits.
- Key actuarial assumptions underlying the calculation of employee pension obligations should be disclosed. Any assets belonging to employee pension plans should be valued at market value.

2.6. Contingent liabilities

- Contingent liabilities are liabilities whose budgetary impact is dependent on future events which may or may not occur. Common examples include government loan guarantees, government insurance programmes, and legal claims against the government.
- All significant contingent liabilities should be disclosed in the budget, the mid-year report and the annual financial statements.
- Where feasible, the total amount of contingent liabilities should be disclosed and classified by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. In cases where contingent liabilities cannot be quantified, they should be listed and described.

3. Integrity, control and accountability

3.1. Accounting policies

- A summary of relevant accounting policies should accompany all reports. These should describe the basis of accounting applied (*e.g.* cash, accrual) in preparing the reports and disclose any deviations from generally accepted accounting practices.
- The same accounting policies should be used for all fiscal reports.
- If a change in accounting policies is required, then the nature of the change and the reasons for the change should be fully disclosed. Information for

previous reporting periods should be adjusted, as practicable, to allow comparisons to be made between reporting periods.

3.2. *Systems and responsibility*

- A dynamic system of internal financial controls, including internal audit, should be in place to assure the integrity of information provided in the reports.
- Each report should contain a statement of responsibility by the finance minister and the senior official responsible for producing the report. The minister certifies that all government decisions with a fiscal impact have been included in the report. The senior official certifies that the Finance Ministry has used its best professional judgement in producing the report.

3.3. *Audit*

- The year-end report should be audited by the Supreme Audit Institution in accordance with generally accepted auditing practices.
- Audit reports prepared by the Supreme Audit Institution should be scrutinised by Parliament.

3.4. *Public and parliamentary scrutiny*

- Parliament should have the opportunity and the resources to effectively examine any fiscal report that it deems necessary.
- All fiscal reports referred to in these Best Practices should be made publicly available. This includes the availability of all reports free of charge on the Internet.
- The Finance Ministry should actively promote an understanding of the budget process by individual citizens and non-governmental organisations.

Can National Legislatures Regain an Effective Voice in Budget Policy?

by

Allen Schick*

Two contemporary developments are buffeting legislative work on the budget. One is the drive to discipline public finance by constraining the fiscal aggregates; the other is the effort to enlarge the legislature's role in revenue and spending policy. Whether these trends turn out to be complementary or contradictory will shape the budgetary role of national legislatures in the years ahead. One scenario is for the legislature to reinforce fiscal discipline by taking responsibility for the budget's totals; another is for it to undermine discipline by bombarding the budget submitted by the government with legislative amendments that trim revenues or boost expenditures.

The early signs point to the former course, but the history of budgeting and some contemporary research assume the latter. In a number of countries, the national legislature now votes the budget totals, in addition to its traditional work on revenue and spending measures. While this role still is exceptional, there is good reason to believe that it will spread to many countries during the next decade. Maastricht-type rules and other efforts to stabilise public finance may spur national governments and their legislatures to frame budgetary decisions within pre-set totals. Where this occurs, legislative work on the budget will parallel the government's, and may result either in greater co-operation or greater rivalry between the two branches. In some countries, the legislature's new responsibility for the overall budget will buy it greater independence in fiscal policy; in others, the legislature will behave more as a partner than as an adversary. The probability is that adversarial relationships will predominate in presidential systems and co-operative relationships in parliamentary regimes. But other variables, such as voting rules or the party system, may intervene to induce co-operation in governments

* Allen Schick is Visiting Fellow, Governmental Studies, Brookings Institution, Washington DC and Professor, School of Public Affairs, University of Maryland, United States.

where power is formally divided and to generate friction in countries where power is formally shared.

Legislative activism may lead in an entirely different direction, however – not to greater fiscal discipline but to budgets in which pressure to spend more and to tax less generate chronic deficits and a progressive rise in the share of national income spent by the government. As unlikely as this may appear to contemporary promoters of legislative activism, it was the predominant view of legislatures throughout the 20th century. In many countries, the legislature voluntarily yielded budgetary power to the executive because it accepted the view that parliamentarians cannot constrain their political inclination to tax less and spend more. Legislatures entrusted budgetary authority to the government because they could not trust themselves to make responsible financial decisions. This attitude is endorsed by prominent scholars who correlate the legislature's capacity to amend the budget with fiscal outcomes. For example, in an influential paper published by the European Commission, Jörgen von Hagen found strong empirical support for the hypothesis that limits on the amendment power of Parliament and other rules strengthen fiscal discipline and result in relatively small deficits and public debt.¹ There is good reason to challenge this finding, but its validity is less important than its widespread acceptance.

Although there are some notable exceptions, national legislatures generally are now more active on budgetary matters than they were in the post-World War II era. A 1998 OECD study reported that legislatures in more than half the countries surveyed had a larger budgetary role than they had a decade earlier.² The evidence of legislative activism is plentiful: new committees charged with legislative or oversight responsibilities; enlarged budget staffs; a vast increase in the flow of budget-related from government to legislators; and increased vigilance by independent or legislative auditors in reviewing the propriety and efficiency of expenditures. But adding institutional capacity does not itself ensure that legislators will stake out an independent position on the budget. To do so, they also need the political capacity to reject salient elements of the government's budget.

In dealing with budgets and other matters, legislatures face tension between the self-interest of members to promote their careers or to do good for constituents and the collective interest of the institution to produce sound, coherent legislation. As individuals, members tend to favour increased spending on particular items; as institutionalists, they have an imperative to adopt prudent revenue and spending totals. Numerous variables influence the manner in which legislators resolve these cross pressures, including party discipline, the electoral system, budget rules, and relations between the government and the legislature. As these variables differ among countries, so too does legislative treatment of the budget. Westminster-style legislatures characteristically resolve tensions between the budget's parts and totals by severely restricting the power of legislators to amend

the government's budget; Congress-style legislatures typically allow members broad scope to revise the budget and make their own revenue and spending decisions. European parliaments generally fall between these extremes; they permit legislators to modify the budget, but restrict changes to the totals.

Although legislatures differ in their budget roles, we can discern three stages in their evolution: *i*) emergence of the legislature's power to tax and spend *ii*) development of government capacity and processes to formulate and implement the budget; and *iii*) introduction of a legislative budget process. The first two stages coincide in countries that embraced democracy only recently; they are separated by generations or centuries in countries that have a long history of democracy. In these countries, the first stage evolved in the course of efforts to build an independent national legislature; the second emerged in the course of developing administrative institutions. The third stage is underway in some countries, but has not yet started in many other. It may never emerge in countries which assign a passive role to the legislature on budget matters.

Each stage is described in the sections that follow. My aim is not to conduct an historical tour of budgeting, but to shed light on the contemporary fiscal role of democratic legislatures and to explain why taking a more active and independent posture may be beyond the reach of some. Parliaments are tradition-steeped institutions; getting them to change is not simply a matter of grafting new practices onto the old, but of rethinking their place. This certainly is the case with respect to legislative budgeting, for new responsibilities must be accommodated both to long-standing appropriations processes and to political relations with government.

The legislature's new role in budgeting cannot come from government's weakness. If the government is incapacitated in managing the nation's finances, the legislature also will be unable to do so. This interdependence distinguishes contemporary reform from past efforts to build legislative fiscal capacity. It means that the legislature's role must be defined more in terms of policy, accountability and performance and less in terms of control and restriction. It remains to be seen whether contemporary legislatures and their election-oriented members are willing and able to fulfil this very different role.

Section 1 surveys the first two stages and explains why national legislatures which rose to power on the principle that they should control the purse ceded budget initiative to the government, thereby giving ministers and officials much of the financial prerogative that had once been wrested from the crown. Section 2 analyses the factors that have enfeebled many contemporary legislatures in tax legislation and appropriations. Section 3 discusses recent efforts in a number of countries to establish legislative budget processes. This development has not yet run its course, and its spread to countries which presently restrict legislative

budget initiative is problematic. The concluding section presents alternative scenarios of the future budget role of national legislatures.

1. Legislative appropriations and executive budgets

Some national legislatures which trace their lineage back hundreds of years had more effective financial powers centuries ago than they have today. This anomaly lies at the heart of debate over the budgetary role of contemporary legislatures. Explaining it is facilitated by distinguishing between appropriations and budgets. Before governments prepared budgets, democratic legislatures made appropriations. This historical sequence is important for two reasons: first, it indicates that legislatures had fiscal power before governments had budgets; second, it suggests that budgetary practices emerged because legislative action was deemed to be an inadequate means of fiscal control. The details may differ from one country to another, but the pattern is near-universal: legislatures appropriate, governments budget. This section outlines the story of appropriations and budgets as it unfolded in England and France, two of the earliest countries to impose legislative control of the purse. These countries faced similar struggles in reining in the Crowns appetite to tax and spend, but they resolved the issue differently. England proscribed legislative initiative, France did not. Each country has served as a role model for many others, even for countries which have never been ruled by monarchs.

England's struggle for legislative pre-eminence dates back to the Magna Carta in 1215 when King John covenanted with the barons not to levy any tax without their assent. But far from settling the issue, this great event set the stage for almost five centuries of conflict between the Crown and the people's representatives. The King had several advantages in this contest: his own income which was commingled with tax revenue, authority to decide when Parliament met, and the asserted right to spend as he wanted. But when his resources were depleted or inadequate, as in time of war, the King had to call upon Parliament to replenish his treasury. Over time, Parliament extracted concessions in exchange for supplying the needed money. One was to separate the Crown's own money from the public's, another was to insist that money be spent only on authorised purposes. To enforce its will, Commons devised the tactic of voting appropriations near the end of the session, after the Crown had already spent some of his own money. Inasmuch as he could not be certain that the appropriations would be forthcoming, he had an incentive to be prudent in managing expenditure and in complying with the dictates of Commons. However, this means of controlling public spending contributed to the decline of legislative power. With appropriations voted after the fiscal year was underway, Parliament came to merely endorse spending that had already been incurred. When government replaced the Crown as the spender,

ex post appropriations become mechanical exercises rather than means of financial control.

Commons curtailed its power – in yet another way by adopting a standing order in 1706 that, with some changes in language, persists to this day:

*This House shall not accept any petition for any sum of money relating to the public service, nor shall it pass upon a motion which would bring about a vote on a subsidy or on a charge against public revenues... unless upon recommendation of the Crown.*³

According to Erskine May, the pre-eminent parliamentary authority, this rule codified “constitutional practice which had become established long before the passing of that order ... it was the natural result of the constitutional relations between the Crown and Parliament at the time when the practice was established.”⁴ Inasmuch as the purpose of tax legislation and appropriations was to restrain the Crown, it made no sense for Commons to vote money that had not been requested. With the transfer of financial authority from the Crown to the government, Commons found itself barred by its standing orders from initiating expenditures and by political *realpolitik* from denying requested funds. Its vaunted power of the purse was reduced to hollow ritual.

The legislature’s acquisition of financial power followed approximately the same path in France as in England, but there were some notable differences between the two countries. The French monarch insisted on unfettered power to tax and spend, while legislative bodies, initially composed of the privileged classes but broadened over centuries to represent the people, asserted authority to control the purse. During long periods in the 15th-18th centuries, the King had the upper hand because he rarely convened the *États Généraux*, which was the legislative assembly. In fact, this body did not meet at all in the 175 years from 1614 to 1789. Another complicating problem was the practice of the King to commingle public funds with his own. He felt no compunction in doing this because the King claimed an absolute right to use all money as he wanted.⁵

In contrast to England, where legislative authority emerged in a gradual, largely peaceful manner, in France it required a revolution to establish the principle that no tax could be levied without the consent of the National Assembly. In contrast to the House of Commons, which limited its fiscal power, the National Assembly did not restrict its power to initiate taxes or appropriations. Moreover, it asserted a more direct role in receiving how appropriated funds were spent. A 1791 decree proclaimed that “The Assembly shall itself definitely examine and audit the accounts of the Nation”. An accounting bureau, under the direction of the Assembly, was charged with reviewing expenditures.

In the more than two centuries since its Revolution, France has experienced a number of political upheavals which have affected financial relations between the government and the legislature. A recurring issue has been the competence of the

National Assembly to take an independent position on appropriations. The country has gone through alternations in legislative-government relations, with periods of legislative dominance followed by changes which have constricted legislative independence. Thus, in response to the independent, some would say irresponsible, exercise of financial power by the National Assembly during the pre-war Third Republic, the Constitution of the Fifth Republic constrains legislative independence.

The Budget: Aiding and Constraining Legislative Action. Thus far, we have avoided using the word budget because during the formative period of legislative control of the purse, official budgets did not exist. It is generally agreed that this word was first used to describe government financial practices in England during the 18th century, more than 100 years after Parliament's authority in taxation and expenditure was finally secured. The word budget was first used in official French documents early in the 19th century; it then spread rapidly to other developed countries. One of the earliest formal definitions appeared in an 1862 French law which described the budget as "a document which forecasts and authorises the annual receipts and expenditures of the State..."⁶ This definition contains the seeds of two rival conceptions of budgetary practice. One views the budget as a plan for a future period, normally the upcoming fiscal year; the other regards it as an authoritative decision on future receipts and expenditures. As a plan, the budget is a set of proposals that carry no special weight other than the influence the government has to sway legislative actions; as an authoritative decision, the government may tax and spend, subject to routine legislative approval, on the basis of the revenues and expenditures set forth in the budget. As a proposal, the budget does not expressly infringe on the legislature's primacy in financial matters; as an authoritative decision, it dictates or overrides legislative preferences.

Governments budgeted their revenues and expenditures before they had formal budget systems. That is, they compiled revenue and spending in a single document that was transmitted to the legislature at regular intervals. But as governments expanded during the 19th century, it became increasingly desirable to co-ordinate the claims on their finances by preparing comprehensive budgets. Rather than propose or decide revenues and expenditures in bits and pieces, the budget enabled the government to present the legislature a complete picture of public finance. The formalisation of budgeting coincided with other major reforms in public administration, such as professionalisation of the civil service, standardisation of accounts, and the bureaucratisation of government operations.

The formalisation of budgeting did more than rationalise public administration; it also altered the balance of financial power between governments and legislatures. With government decisions on the budget preceding legislative action, tax legislation and appropriations were either constrained or strongly influenced by the government's preferences. Even those parliaments which retained legal authority to deviate from the government's budget were politically subordinated

to its dictates. It became common in developed countries to assess legislative revenue and spending decisions in the light of the executive's budget recommendations. The budget became the authoritative metric for measuring legislative action. The budget impelled a Copernican revolution in public finance. The legislative supremacy which had been hard earned in centuries of struggle was surrendered on the battlefield of executive budgets.

It was taken for granted in all countries that budgeting is an executive function carried out by the executive, not by the legislature. Only the executive had the organisation and capacity to co-ordinate the spending bids of its various departments and agencies; only it could implement actual spending by these entities. In fact, efforts by some legislatures to bolster their capacity to review the government's spending plans met with strong opposition in some countries on the ground that they were trespassing on executive responsibilities. Stourm reports that the eminent French economist Leon Say opposed efforts by the National Assembly to establish a permanent committee to review the government's budget:

The Committee on Budget wants to put itself in the place of the administration and to prepare the budget itself instead of being satisfied with receiving it for the purpose of control. The Chairman of the Committee on Budget has become to some extent the First Lord of the Treasury... The opponents of ministerial power see at once the benefits they could derive from this new institution.⁷

Say's view, which expressed the sentiments of the times, was that the legislature's job is, to control public finance, that is, to vote appropriations that limit the amount to be spent. Its job is not to plan and co-ordinate public finance.

In most developed countries, legislators welcomed the new budget practices, for they brought order and coherence to tax legislation and appropriations. Legislators now had a fairly comprehensive view of how the parts fitted together and of total revenue and expenditure. Moreover, standards of good budget practice were codified in a set of principles which gained acceptance in most countries. These principles included annuality in budget decisions, comprehensiveness of budget accounts, and specification of the objects of expenditure. Only a few national legislatures resisted the rapid spread of the budget idea. The strongest objections came from the United States Congress, which sensed that entrusting the executive with budgetary power would weaken its authority on taxes and appropriations. Congress acceded to an executive budget process in 1921, later than all major European countries, and only after the costs of world war had demonstrated the need to discipline public finance. When Congress acted, some political experts predicted that the President's new budget power would spell the end of legislative supremacy.⁸

Why did budgeting, which was seen as strengthening legislative fiscal control, turn into a means of subordinating the legislature? The answers lie less in the

realm of legal authority and more in politics. The budget submitted to the legislature is the end product of a lengthy process of organising, monitoring and controlling public finances. Putting together the budget and overseeing its implementation engages a vast enterprise of specialists centred in the Finance Ministry or a similar organisation at the top of government. This ministry's reach extends to all government departments and agencies, and entails sifting through vast amounts of financial and operational data. To do its job well, the Finance Ministry must also assess political demands and interests, as well as the efficiency of expenditure. When the budget is submitted, the Finance Ministry knows a great deal about public finance, and the legislature knows very little other than what the government wants of it. This information asymmetry places the legislature at an enormous disadvantage. Even with standing committees and modest staff resources of its own, the legislature is no match for the government. While they can compensate somewhat through the hard work of sifting through the estimates, legislators rarely acquire a deep understanding of how public money is spent or of the implications of appropriating more or less than was budgeted by the government.

The vast growth of government, beginning in the last decades of the 19th century and accelerating through most of the 20th century, further diminished the legislature's influence. With growth, the budget's line items were consolidated into broader categories. For example, rather than specifying each position in the public service, the budget estimates the amounts to be spent in each job classification or in a group of classifications. In some countries, consolidation was taken further, so that a single sum was entered for all personnel expenditures. Consolidation made the budget less unwieldy, but also reduced legislative control over individual line items. Another by-product of government expansion was that the budget came to be seen more as a statement of public programmes and objectives and less as an instrument of financial control. The budget also matured into a means of guiding and stabilising the economy, and its totals acquired a fiscal salience that transcended the individual items of expenditure. In some countries, the budget also gained status as the means by which government managed its administrative entities and operations and prodded them to improve efficiency. As laudable as these transformations were, they subordinated financial control to larger budget purposes. In a legal sense, little had changed, politically hardly anything was the same.

2. The decline of national legislatures

Contemporary scholars speak routinely of the decline of national legislatures, not only on budgetary matters but on the full range of legislative responsibilities. Decline has occurred, they agree, despite the fact the modern legislatures are better organised and resourced than before. In their view, the decline has little to do with internal legislative operations, but to three external developments that have

stripped parliaments of independence and control: i) the rise of disciplined political parties which set the legislative agenda and compel legislators to vote the party line; ii) the enormous escalation in public spending, and the concomitant shift away from spending on housekeeping and security functions to spending on entitlements and income support; and iii) the rise in interest groups and corporatist political arrangements. In combination, these trends reduced many parliaments to debating clubs which have ample freedom to deliberate but not to decide. Although it is a sweeping generalisation which brushes aside important differences in political culture and structure, the “decline of parliaments” hypothesis appears to fit most OECD Member countries.⁹

During the past 100-150 years, party lines have stabilised in many countries and solidaristic parties, organised to enforce political discipline, have become the norm. In quite a few parliaments, the only scope members have to express independence is on private bills which the government takes little interest in. Budget deals are made outside Parliament, within government or by party functionaries, and then ratified within it. Extra-parliamentary budgetary arrangements prevail in majoritarian regimes where the budget is imposed on Parliament by government *diktat*, and in coalition regimes where the parties to the coalition hammer out agreements that frame Parliament's work for the life of the government. In some countries, the budget is negotiated through formal party channels which parallel the government's budget process. In Japan, the dominant Liberal Democratic Party has standing committees which review the Ministry of Finance's budget and make final decisions which are then transmitted to the Diet. The role of parties is especially prominent when the government takes significant policy initiatives or prepares a budget package which is adopted in a single vote. One insightful observer of Nordic parliaments concludes that:

*... the penetration of the internal machinery of assemblies by solidaristic political parties has significantly limited the efficacy of parliamentary activity. Briefly stated, party control has tended to mean that the legislative function of assemblies i.e. the successful initiation of proposals, has been subordinated...*¹⁰

A second driver of parliamentary decline has been the vast expansion in the scale of government. In the OECD community, the growth in public spending during the 1960-1980 period averaged more than one-half of a percentage point relative to GDP a year. At the start of this period, government spending in OECD Member countries totalled 29% of GDP. Two decades later it was 40%.¹¹ Most of the rise was in spending on entitlements, which must be paid regardless of the government's financial condition or other demands on the budget. Social security transfers were 6.8% of GDP in 1960 and 16.2% in 1980. As government expanded beyond its watchman responsibility to maintain domestic order and protect citizens against external threats to one whose main financial effort is to sustain the economic well-being of its people, the traditional role of legislatures in restraining

the exercise of power no longer fitted well. Expansionary government needs empowerment, not restraint, and empowerment depends on a stable supply of money to government. An expanded state needs secure financing, which is not impeded by legislative whim or impasse. While expanded entitlements weaken executives, who also are beholden to commitments made by their predecessors, that do even more damage to legislative capacity, for parliaments typically finance income transfer schemes in permanent legislation which, unlike conventional budget expenditures, do not require periodic legislative approval.

Expansion of the state strains legislative capacity to oversee the executive, not only because there is so much more to review but also because effective power shifts from elected ministers to non-elected officials who work in massive bureaucracies that are shielded from public view and are difficult to penetrate. Despite innovations such as the Ombudsman and enlargement of legislative staffs, it is not an easy task for legislators to control a state that has grown so large and active. More importantly, enlargement of the state has stirred interest in performance and results rather than with legality and propriety in public expenditure. Citizens want government to do more for them, not to be held back by stingy legislators.

Growth of the state has affected legislative power in yet another way. Although it is conventionally assumed that legislators add to the budget, government executives have been the prime movers in stretching the programmatic boundaries. For decades, the budget tabled by governments regularly proposed programme initiatives and spending increases in excess of the rate of increase in prices or in economic activity. Governments also regularly proposed, and parliaments adopted, tax increases to finance incessant programme expansions. As noted earlier, the legislative contribution to spending increases was typically marginal. Thus expansion itself connoted a shift in the balance of power between Parliament and government.

The third blow to legislative capacity has been delivered by the multiplication and activism of interest groups. All democratic countries have many more politically active groups than they had a generation ago, but a vital distinction must be drawn between pluralist and corporatist versions of the relationship between groups and government. The pluralist model, which is most evident in the United States, narrows group interests; the corporatist model broadens these interests. In pluralist societies, the sheer number of groups impels them to take a narrow view of their interests; consequently, the demands they make on legislators (and other political actors) typically deal with marginal matters which can be satisfied with a little more or less taxing or spending. The budget impact of pluralism is to discourage legislators from focusing on the big picture. The marginalised legislature is busy with a large number of amendments that may attract much political notice but barely make a dent in the government's budget plans. In

corporatist societies, major government policies are made in consultation with conglomerations of groups which represent a broad swath of interests. There may be one such conglomeration speaking for industry, another for workers, another for municipalities, etc. In some cases, the government maintains formal, continuing relations with these “social partners” and acts only after it has discussed policy initiatives with them. But once government and corporatist interests have reached agreement, the legislature either has no role or must go along.

Decline in the legislature's budget role. The foregoing paragraphs deal with the overall place of modern legislatures and governing institutions; it does not single out their budget powers. But a legislature cannot be influential in financial policy if it has been marginalised as a policy institution. The 1998 OECD survey referred to earlier confirms that contemporary legislatures are perceived to have a weak budget role. Table 1 summarises country responses in that survey to the following set of questions:

Does the legislature typically enact the budget as proposed by the government? How many amendments to the budget (in number and amount) are typically proposed by the government and opposition members of the legislature respectively?

Most countries responded that they make no changes or only minor adjustments in the budget proposed by the government. Among the countries that have numerous legislative amendments, most reported that these do not significantly change the government's budget.

In some countries, the bulk of the adopted amendments come from the government itself or from legislators affiliated with it. This pattern indicates that working with the government rather than against it may be the most productive route to legislative influence. After it submits the budget, the government may accept or offer amendments, either to thwart opposition or to reward loyal members by embracing their proposals. In some countries, robust, behind-the-scenes negotiations between the government and legislative leaders give Parliament some opportunity to influence the budget at the margins.

The OECD survey indicates that constraints on legislative influence arise more out of political considerations than from formal restrictions on its power to amend the budget. Table 2 drawn from the survey compiles country self-assessments on the restrictions faced by their legislatures. In pointing to political rather than legal factors, the data suggest that even if budget rules were changed to accommodate a broader legislative role, underlying political conditions may preclude significant change in legislative behaviour. A corollary of this conclusion is that the impact of efforts to empower the legislature will vary among countries. Depending on political variables, changes that induce the legislature to take a more active role on the budget in some countries may induce continuing passivity in others.

The OECD survey invited each country to offer a brief response, without supporting analysis or explanation. Some of the details can be filled in by revisiting an insightful study published a quarter of a century ago on the budget role of six European parliaments. In *The Power of the Purse: A Symposium on the Role of European Parliaments in Budget Decisions*, David Coombes and his colleagues generally concluded that Parliament had become marginalised on budget policy. The following paragraphs, adopted from this study, assess the legislature's budget role in four of the countries.

In Germany, K.H. Friauf notes, the government and its parliamentary majority are not regarded as politically identical. There is some separation of power between the two which allows the *Bundestag* to express its own will. The *Bundestag* can amend the government's budget without raising a question of confidence. But Friauf concludes that although the government frequently accepts additions to the budget offered by the *Bundestag*, "the total amounts involved in additional expenditures voted by Parliament are usually insignificant when set against the total volume of the budget."¹² Inasmuch as Friauf's conclusions were drawn mostly from the Adenauer years, it may be appropriate to reconsider them in the light of more recent developments, especially those since unification of Germany, a period during which the *Bundestag* was called upon to vote tax increases and cuts in some social programmes. The distaste of these actions and the weakening of the government's ruling coalition may have enlarged legislative budgetary influence.

Alain Dupas begins his article on parliamentary control of the budget in France by noting that in "France, as in many other representative democracies, the decline of Parliament has become a favourite theme for political theorists... The belief that Parliament's examination of the budget must now be considered an unimportant ritual is one which many experts and politicians of all shades will support... Today, all real power has passed to the executive; the debate on the budget is no more than conversational and the parliamentary role is limited to the registration of governmental decisions."¹³ Later in his analysis, Dupas softens this harsh conclusion by arguing that the National Assembly can modify the budget. He describes the Assembly's distinction between *credits votes*, which are the expenditures authorised for the *current year*, *services votes*, which are the costs of carrying out approved activities in the next year, and *measures nouvelles*, which are proposed initiatives for the next year. This arrangement institutionalises a form of incrementalism, for it invites the legislature to concentrate on changes to the base of authorised expenditures. Incrementalism is a fact of budgetary life, whether or not it is formalised in procedural rules. The relevant question is whether in behaving incrementally, parliament rubber stamps or revises the proposed budget. One feature of the French system suggests a limited parliamentary influence: the *service votes* in the general budget are approved en bloc rather than by individual item or budget chapter. Despite this practice, Dupas concludes "it would be the opposite

of the truth to maintain that the French Parliament is no more than a register for budgetary decisions. Constructively or otherwise, voting on the budget gives Parliament an opportunity to make its mark."¹⁴

This surprising conclusion is openly challenged by P. Lalumiere, who notes that the 1958 Constitution of the Fifth Republic "reaffirms Parliament's power of decision in budgetary matters while multiplying the legal restrictions on exercising this power... In fact, the actual working of the budgetary institutions betrays an important decline in parliamentary influence."¹⁵ According to Lalumiere, "budgetary debates no longer provide the parliamentary assemblies with an opportunity to exercise real influence over the choices proposed and thereby over government activity. The majority of observers now admit that the institution of Parliament has been effaced in this way..."¹⁶

Nowhere is the budgetary decline of Parliament more noticeable than in Britain. J. Molinier sums up the process by which the House of Commons, the cradle of budgetary democracy, lost all formal influence over revenues and expenditures:

*The emergence of two large mass, coherent and disciplined parties with national support and alternating in power led in effect to a transfer to the Cabinet of what was essential in the financial and other powers exercised previously by the House of Commons. Having stripped the monarchy of its financial prerogatives, Parliament was in turn stripped of its financial competencies by the Cabinet... Today the House of Commons is hardly able to participate effectively in the determination of the budget.*¹⁷

The British Parliament is distinguished from other national legislatures in that both its budgetary success and decline occurred much earlier than in other countries, and its loss of budgetary role has been greater. As an outlier, it is a model that few legislatures have emulated but most have rejected. Nevertheless, there are elements of the British experience in the many countries which have sought to avoid the fate that has befallen the House of Commons.

In Italy, the frequent turnover in government and the constant bargaining and bickering among coalition partners gives the legislature abundant opportunity to shape budgetary outcomes. But in Italy the problem is not that Parliament is weak vis-à-vis government, but that both have been undermined by political instability and financial rigidity. Valerio Onida describes the reality of Italian budgeting in these words:

*The budgetary system is dominated by the concept of strict parliamentary control. It is designed to place tight restrictions on government expenditure and to ensure that these are respected. In reality, however, parliamentary control is emptied of all significance. The root of this apparent contradiction is most likely to be found in the fact that the type of parliamentary control for which this system is designed... is quite different from the control which the assemblies really want.*¹⁸

Onida points to a significant change in legislative practice that has been underway in many OECD Member countries; “the increasing tendency for the locus of decisions regarding both the overall amount and the particular use of expenditure to move out of the annual budget altogether into the procedure for passing ordinary laws which require and provide expenditure in particular sectors for a fixed number of years, often for many years.”¹⁹ This observation is endorsed by other participants in the symposium who find that a large part of the national budget, consolidated in fixed expenditures or flowing from laws passed many years earlier, for practical purposes evades all control. While not mentioned, most of these laws are entitlements which weaken not only legislative control of the purse but the government's capacity to regulate short-term fiscal outcomes. Arguably, legislatures cannot regain financial control if the budget itself is out of control.

3. Restoring legislative budget capacity

In the distant past, legislatures leveraged their power of the purse to gain independence as governing institutions. The competence of legislatures to decide taxes and spending and to enforce their dictates on monarchs and executives opened the door to an active role in establishing government programmes and policies. Can the budget once again be the wedge that enables resurgent legislatures to reclaim the budget powers yielded in the past century? An expectation exists that parliamentary bodies are tooling up to once again take centre stage in budgeting. But recapturing legislative hegemony in public finance cannot be achieved by reverting to the control posture that served legislatures so well in the past. While citizens may welcome more control of government, they also want more programmes and benefits from government. They want the schools to be well staffed and the social security checks and other payments to arrive on time. If fiscal control gets in the way of these widely shared objectives, it will be brushed aside by legislators and executives alike bent on giving citizens what they want.

The problem for contemporary legislatures is that in the past they fought for a foothold in budgeting in order to represent the people. Today, the people do not want them to serve as controllers, for doing so would limit the flow of money and programmes. Accordingly, legislators have to define a new role, that of promoting fiscal discipline, improving allocation of public money, and stimulating administrative entities to manage their operations more efficiently. Fulfilling these new roles requires: *a*) enhancement of legislative capacity and resources to deal with budget issues; *b*) changes in both executive and legislative budgeting to promote fiscal discipline, allocative efficiency and operational efficiency; *c*) new tools for reconciling long-term commitments such as entitlements and other “sticky” expenditures with short- and medium-term budget objectives; and *d*) redefinition of relationships with the government that recognises the strong influence of political parties and interest groups on legislative behaviour.

Resourcing the legislature for a renewed budget role is the easiest of the required changes, though it may stir up conflict both within Parliament and between it and the government. One move has been to expand the role of standing committees to deal with the budget. These committees are authorised to review the estimates, take evidence, demand information on the budget, and recommend legislative action. In countries where the legislature may amend the budget, its committees also recommend changes in the fiscal plans submitted by the government. There are, however, significant differences in the way committees are structured to deal with the budget. One pattern is to assign full responsibility to a finance or budget committee; another is to disperse jurisdiction among sectoral committees. The first eases the task of co-ordination and promotes consistency in legislative budget action; the second allows wider scope for sectoral interests to influence the budget. The first encourages examining the budget in fiscal terms, the second encourages a programme orientation. The centralised model facilitates fiscal discipline, the dispersed model may complicate the task of maintaining discipline.

A well-balanced legislature needs both a programme and fiscal outlook; both considerations must be welded together in producing a legislative position on the budget. Accordingly, a third version has gained popularity in recent years: it empowers sectoral committees to review relevant portions of the budget and recommend legislature action within an overall fiscal framework maintained by the finance committee. As will be discussed below, some countries have formalised this arrangement in a two-step process, in which the legislature first votes budget totals, and sectoral committees then make recommendations consistent with the agreed totals.

Responsible and effective legislative action on the budget depends on adequate information concerning the activities financed with public funds and the results ensuing from government programmes. It also requires information on how changes to the budget submitted by the government may affect activities and programme results. Getting these types of information has not always been easy because budgeting in many countries is still wedded to inputs, with detailed estimates of the amounts allocated for personnel, equipment, supplies, travel, and other items. In the past, efforts to shift budgeting to a more programmatic orientation have not been successful. The well-known failures include planning-programming budgeting systems (United States), public expenditure management (Canada), programme budgeting (Sweden) *rationalisation des choix budgétaires* (France), and programme analysis and review (Britain). It is highly unlikely that the legislature will take a programmatic orientation if the government does not.

The failed reforms all involved efforts to rationalise budget practices within government. The legislature was not directly affected, though advocates of the reforms typically argued that it too would benefit from an enriched supply of budget information. Contemporary reforms concentrate explicitly on the information

given to legislatures, and even more importantly on the form and content of estimates and appropriations. Led by New Zealand, which has shifted both estimates and appropriations from inputs to outputs, a number of countries have drawn the conclusion that successful implementation of budget reform within government is contingent on changing the way the legislature makes fiscal decisions. While this thesis appears sound, it opens up a critical question: will the legislature be better able to influence the budget and maintain accountability for expenditures and results if it is supplied programme and output information, along with a flow of analytic and evaluative reports? On the surface, the answer appears obvious: the legislature is always better off with this type of information than with line item data. But the verdict is not in yet, for legislators inured by generations of practice to review input detail may be disadvantaged by the complexities of programme-oriented budget and overwhelmed by the volume of information given them. In this regard, it bears mentioning that most developed countries have not joined the performance budgeting bandwagon. Most have settled for injecting more data on performance into their budgets, but have stopped short of removing the input data and fundamentally restructuring the estimates and appropriations.

One of the frontiers of changes in budgetary information and structure entails a shift from cash-based accounting and budgeting to an accrual basis. More than half a dozen countries are in the vanguard of this movement including Australia, the United Kingdom, the Netherlands, New Zealand, Iceland and Sweden. The shift to an accrual basis has been given momentum by the Maastricht accords whose enforcement depends on application of internationally accepted accounting standards, and IMF's conversion of its government financial statistics to an accrual basis. In terms of prospective impact on legislative behaviour, a distinction must be drawn between accrual accounting and accrual budgeting. If only the accounting basis were changed, the effect on legislative action would be modest. The legislature would have cost-based information to supplement the conventional cash-based estimates. But if government were to budget on an accrual basis, the impact might be truly significant, for the form and content of the estimates and appropriations would also be changed.

The supply of information has also been enriched in some countries by building the capacity of audit offices to assist the legislature. While the relationship of the audit office to the legislature varies among countries, in some the audit office is directly responsible to the legislature, in others it is an entirely independent entity, and in a few it is responsible to government – these organisations have become more active over the past decade in reviewing the financial and programme performance of government departments and agencies. The list of countries requiring audited financial statements is growing from year to year, and though lagging behind, so too, is the list of countries expanding the audit function to cover substantive results.

To make effective use of the avalanche of information, modern legislatures have added staff, invested in information technology (IT), and professionalised their operations. There is a marked trend to expand the staffs of standing committees, so that they can sift through the voluminous information and assist legislators in reviewing executive proposals, devise alternatives and amendments, and review performance. The up-staffing of legislatures is not limited to budget work, but it is in this area that some of the most dramatic changes are likely to occur. While still few in number, a growing number of legislatures are inching to the view that they cannot truly exercise independent judgement on the budget if they do not have expert staff to help them do the job. The question for these legislatures is not whether to add a position here or there, but to establish a separate legislative budget organisation. Although it rarely is a model for other legislatures, the US Congress may be so in this area. The Congressional Budget Office established 25 years ago has garnered considerable acclaim for its objective analysis and forthright budget projections. Staffed by more than 200 professionals selected on a non-partisan basis, this office has exerted considerable influence on US budget policy. Other national legislatures may follow its lead, but their budget organisations are likely to be more modestly sized.

Resourcing the legislature does not itself ensure that it will assume a larger or more effective role. The legislature must also define how it fits into overall governance. The three trends identified in the previous section that account for the decline of legislatures are not going to be reversed. Public spending is not likely to decline as a proportion of GDP, nor will the fraction of the budget allocated to entitlements shrink. Political parties will not disappear, though their ability to enforce discipline may be weakened, and the number of interest groups is likely to climb in the years ahead, though corporatist arrangements may give way to more pluralistic patterns. How, then, can a legislature stake out a truly independent position when it is, beholden to entitlements, whipped into line by party leaders, and pressured by groups bent on protecting their interests? The answer is, not easily. But perhaps the best way to address this question is by considering the specific budget tasks that legislatures may participate in. Three of these tasks – fiscal discipline, allocative improvement, and operational efficiency – were briefly mentioned earlier. Discussing each in turn sheds light on the niche contemporary legislatures may carve for themselves.

Before doing so, it would be appropriate to discuss the traditional role of the legislature as a restraint on the exercise of government power. Clearly, this role survives in most countries, though not as robustly as before. In a legal sense, the doctrine of control has not been impaired. Stripped to its essentials, it means that government may not spend more than authorised in law or for other than authorised purposes. *De facto* however, control does not mean the same today as it once did. Nowadays, appropriations tend to be lump sum, and are intended as much to

authorise as to limit spending. Moreover, entitlements generally are established in permanent legislation which does not specify or limit the amount to be spent.

Currently, legislative budget work has as much to do with making policy as with controlling executive action. This entails a more integrated examination of the budget than many legislatures are prepared to undertake, as well as capacity to specify in law or by other means the performance required of those who spend public funds. Some legislatures have sought to hold on to a control orientation by shifting from *ex ante* control of expenditure to *ex post* accountability for expenditures and results. But in view of the fact that reporting and auditing of performance are still underdeveloped in most countries, one cannot be certain that legislatures are prepared for this new assignment.

To maintain fiscal discipline a responsible legislature must give precedence in its decisions to budget totals before it takes up the various parts. Sweden, the Czech Republic, and a few other countries have introduced a two-stage budget process involving both governmental and legislative decisions. In the first stage, decisions are taken on the aggregates as well as on the amounts allocated to major sectors. The aggregates are prepared by the government and transmitted to the legislature for review and, in a few countries, approval. Some months after the first stage has been completed, the government tables estimates and these are voted under the rule that the sum of all the voted amounts may not exceed the aggregates agreed in the first stage. Enforcing the totals is dependent on adequate information concerning the cost of programmes and the prospective impact of policy changes. It also requires controllers in both the executive and legislature to maintain discipline in the face of spending pressures. In legislatures which parcel the budget among sectoral committees, this watchman role falls to the budget committee which monitors what each of the other committees is doing. The price of enforcing discipline in this matter is to generate friction among legislative committees as they fight for budget shares.

Contributing to improved allocation of public money requires that the legislature take a programme perspective, and that it be prepared to shift money from lower priority and less effective activities to higher priorities and more productive uses. Realistically, however, this is a momentous task, especially for legislators schooled in the politics of distribution. Redistribution does not come easily to legislatures, if at all. But in light of the determination of many countries to reduce or stabilise public expenditure, the only way to find resources for new priorities will be to take them from older ones. Redistribution may be most difficult in the case of entitlements, where citizens have been programmed to expect benefits from government as a legal right. Nevertheless, quite a few OECD Member countries have been compelled by budgetary *force majeure* to trim these payments, though typically only at the margins. As ageing populations add to budget pressures one may see even more vigorous efforts to curtail entitlements in the future.

Efforts to reduce the budgetary burdens imposed by permanent law may be difficult for yet another reason. Quite a few countries draw a distinction between legislation and the budget or appropriations. The former establish law and policy, the latter provide money. Changing the amounts spent on entitlements means that in addition to budgeting fewer resources for these programmes, underlying laws must be modified. There is a need to link legislative action on the budget with actions affecting such laws. Some governments have taken to produce budget packages which combine revenues, spending, and changes in standing law. The United States has had a reconciliation process since 1980 which enables Congress to use its budget to initiate changes in revenue and entitlement legislation. Reconciliation is not used every year, only in those where major changes in budget policy are undertaken.

Finally, legislatures may participate in the contemporary movement to improve the quality and efficiency of public services by appropriating funds on the basis of expected or actual performance. A legislature which rewards or ignores poor results will get poor results. Legislatures should be in the vanguard of demanding better information on performance, relying on performance measures in appropriating money, and specifying in advance the performance expected of government agencies.

4. Legislative budget futures: alternative scenarios

Future legislatures will have more resources to carry out budget responsibilities. They will have staff, committees, and information. But will they have an effective role? The answer will differ in each country which tools up for budget work. But for ease of analysis, let us draw four different scenarios and the implications of each. The four scenarios are arrayed from the least to the most effective budget role.

The first scenario leaves the legislature better informed but with no real power to alter the budget, either because they are barred by law or their own rules or because political realities foreclose significant alteration to the budget. Such legislatures may persist with the habits of the past and tinker with minor adjustments, while taking credit for helping constituents and promoting their political careers. This role is similar to that played by many legislatures in the recent past. Perhaps having staff and budget responsibility will broaden legislative perspective and ambition and thereby generate bigger changes to the budget. But the more likely outcome all dressed up with additional capacity, but little opportunity to shape budget policy.

The second scenario has the legislature transforming itself to challenge the government's policies and priorities by preparing a full-fledged budget. Rather than adjusting revenue and spending plans at the margins, the newly-empowered legislature deploys added resources to act independently of the government. This scenario leaves one with several important questions: Will an independent legislature have the requisite political support to sustain its ambitions? Will the politi-

cal system be able to bear the elevated conflict and tension that would certainly arise when the legislature charts its own course on the budget? Which will give way first, party discipline or the legislature's drive to forge ahead?

The third scenario has elements of the first two. The legislature has more resources and is more active, but rather than using its resources to act independently, it holds the government to account for its financial and substantive results. In playing this role, the legislature may target performance *ex ante* and review results *ex post*. To succeed in this role, the legislature's attentiveness to performance cannot be sporadic: it must be sustained and it must be informed. The best model for this role is the Public Accounts Committee in the House of Commons. But there is one important difference: rather than focusing only on how public money was spent, a modern legislature would have to expand accountability to what was accomplished with the money.

The final scenario has the legislature participating with the government in developing budget policy. It would still vote estimates, but its larger role would be to work with government in setting out a medium-term framework, along with sectoral policies, and statements of policy. Partnering with government can proceed through the party system, through coalition agreements, and other instruments of budget policy. It is hard to quite define this emerging role because no contemporary legislature fulfils it, though a few, such as Sweden, come close. The task in budgetary partnership, as in other co-operative relationships, is for each party to have its own say, but for both to work together toward a resolution of differences. This may be a difficult undertaking, both in governmental systems where separation of powers pulls the executive and the legislature apart and in parliamentary regimes where party discipline welds them together.

Throughout this paper we have considered how modern legislatures can change budgeting. It may be appropriate to conclude by reversing the question and considering how modern budgeting may change parliaments. One undertone of the paper has been that budgeting would empower parliaments. But perhaps the opposite is closer to reality: under the pretext of empowering legislatures, might it be that budget responsibility would weaken them? This possibility arises out of three characteristics of legislative budgeting: i) budgets limit what the legislature may do with public money; ii) budgets intrude on other legislative functions, such as law-making; and iii) budgets have the potential to turn legislative work into a technocratic exercise. Each of these possibilities warrants reflection.

Budgeting introduces limits into legislative work: some of these may be externally-imposed, others are market-driven, and still others are self-imposed. External constraints come from many sources: convergence criteria, such as those introduced via Maastricht, accounting standards, and transparency codes. The market also constrains by exacting penalties (such as lower growth or higher interest rates) from countries which manage their finances imprudently. But the constraints

which provoke the most concern are those imposed on itself by a legislature when it shift from just making appropriations to also adopting budgets. Some of these limitations are procedural: they govern when and how the budget is to be considered or amended, how the budgetary effects of policy changes are to be measured, whether or how multi-year decisions taken one year may be reconsidered in a future year, and so on. There also are formidable substantive rules, the most important of which is that legislative actions must be consistent with the budget framework.

In promoting an enlarged role for legislatures in budget policy, it must be recognised that budgeting is inherently a confining process. To budget is to routinise financial choice in accord with – set of rules and procedures, to bar action outside the boundaries of the budget, to rule out certain actions and to rule in others. Budgets bring discipline to legislatures, just as they do to governments. In the absence of budget rules and procedures, decisions can be taken whenever there is the will to do so; with budgets, decisions must be orderly and consistent, and framed in both time and amount within pre-set boundaries. A legislature behaves in a more disciplined manner when it budgets than when it doesn't.

The second concern about enlarging the scope of budgeting is that decisions on revenues and spending may sprawl to other legislative work as well. Rather than legislation being walled off from the budget, it is defined in budgetary terms and the fate of substantive law often depends on budgetary decisions. In countries where the legislature has been most active on the budget front, much of the session is devoted to financial matters. This has happened both in the US Congress and in Italian Chamber of Deputies. In some congressional sessions, two-thirds or more of the recorded votes have been budget related. In Italy, efforts to have separate budget and legislative sessions have broken down under pressure to consider substantive laws under the expedited rules provided for budget actions.

To some parliamentarians, the greatest risk of expanded responsibility for the budget is that their work will become more technocratic and therefore will be based less on political judgement and more on technical expertise. Where legislative budgeting flourishes, legislative budgets staffs grow, as does the business of measuring fiscal impacts, use of accrual rather than cash methods, and reliance on assumptions rather than actual numbers. In some countries, one can detect the emergence of “yes, legislator” behaviour, in which elected parliamentarians do the bidding of permanent staff.

How should one respond to these legitimate concerns? Not by denying them but by suggesting that the spreading influence of budgeting occurs even if legislatures are beholden to their old ways and unprepared for enlarged responsibilities. A capacity to budget does not transform politicians into managers; it enables them to exercise political power in a disciplined manner. In this writer's view, only legislative luddites will oppose this new role.

Table 1. **Legislature's authority to amend the government's budget**

	Response
Australia	- The House of Representatives may modify the budget, but it rarely does so because the government holds a majority in the House. - The Senate may not initiate taxation or appropriations bills, nor may it amend such measures. It can, however, refuse to pass revenue or appropriations bills until they are amended to its liking by the House.
Austria	The National Council may amend the draft budget submitted by the government, but it usually only makes slight corrections.
Belgium	The ability of the Chamber of Deputies to modify the budget is not limited by law, but the legislature faces at least two constraints in practice. First, Belgium has committed to some unrestricted and recurring expenses that are not subject to debate. Second, a major modification to a budget proposal by the Chamber of Deputies would be the equivalent of calling for a "vote of confidence" regarding the government.
Brazil	The National Congress may amend the budget, but it cannot increase total spending or modify payroll expenditure, debt service, or constitutional transfers. Amendments must be within the parameters of the annual Budget Guidelines Law and quadrennial Multi-Year Plan.
Canada	- Although there are no formal restrictions, it is difficult to adopt changes once the budget has been introduced in Parliament. Legislators often consult with the government before the budget is formally submitted. - Defeat of the budget in the House of Commons implies a defeat of the government and leads to new elections.
Chile	- The Constitution severely curtails the budget role of the National Congress; Congress discusses the budget, but it may not revise revenue estimates or increase expenditures. It may cut variable expenditure. - Adopted amendments have only a marginal impact and usually are presented by the government pursuant to negotiations with Congress.
Czech Republic	Parliament may modify the budget, but must not contravene the various laws that circumscribe its ability to do so.
Denmark	- In principle, legislators may present budget proposals; in practice, they lack the administrative capacity to prepare such proposals. - Parliament may make changes to any part of the government's budget proposal before adopting it.
Finland	Parliament's right to make changes to the budget is not restricted, but it is constrained by certain procedural rules.
France	Current law dictates that Parliament may not raise spending above a pre-established ceiling, or lower revenues below a pre-established floor. If some legislators wish to change either or both of these numbers, Parliament must first vote to approve their proposal.
Germany	In theory, various budget regulations provide the only constraint on Parliament's ability to change the budget. In practice, however, legislators face additional constraints, since about 80 to 85% of budget expenditures are required by various laws and treaties.
Hungary	The Constitution does not restrict the National Assembly's ability to modify the budget. The Public Finance Act dictates that the legislature must decide the amount of the budget deficit, as well as budget expenditures and revenues for each chapter. After those amounts have been voted, legislators may only reallocate amounts within the chapters.

Table 1. **Legislature's authority to amend the government's budget** (*cont.*)

	Response
Iceland	• Parliament is not formally constrained in its ability to change the budget. • The government almost always has a majority in the legislature, and that majority usually consults with the government prior to modifying the budget.
Ireland	• The <i>Dáil</i> may only vote appropriations requested by the government. • The legislature may not amend expenditures, but it may, and does, make changes to revenues.
Italy	• Parliament may modify the budget. It is restricted by the financial covering principle that applies to proposed increases in spending or decreases in revenue.
Japan	• The administration develops and proposes the budget; the Diet may modify the budget as long as the modifications are consistent with the Constitution.
Korea	• The National Assembly may reduce the budget as it sees fit, but the government must approve proposed budget increases.
New Zealand	• The Standing Orders of the House of Representatives dictate that it will not pass a measure that will have a significant impact on the government's fiscal aggregates. • The government may veto a spending proposal if it will affect the Crown's overall financial position. This veto cannot be overturned by the House. • Members of the House may propose changes that would affect votes, and the government may veto such proposed changes.
Norway	• Parliamentary parties may introduce any budget measures they wish, but the legislature is constrained by financial obligations to the beneficiaries of the National Insurance Scheme and state employees, and by the statutory rights of Norwegians to health care, education, and law and order.
Portugal	• The Assembly of the Republic has no restrictions on its ability to make changes.
Spain	• The Constitution specifies that the government must approve proposed increases in expenditure or decreases in revenue before these may be discussed in Parliament.
Sweden	• Parliament has no restrictions on its ability to make changes.
Switzerland	• Around 80% of expenditures cannot be reduced, because they are the product of legal prescriptions or contractual commitments. • The Constitution specifies the maximum tax rates that may be imposed.
Turkey	• The budget is reviewed first by the Plan and Budget Committee and then by Parliament. During the first step, members of the Plan and Budget Committee may propose whatever changes they wish; during the second step, legislators may not propose changes that would increase expenditures or decrease revenues.
United Kingdom	• The House of Commons may amend tax proposals. • The Commons cannot increase the government's spending proposals, and in practice its ability to do other than accept them is very limited. • The House of Lords is not significantly involved in the budget process.
United States	• Congress faces no specific restrictions on its power to change the President's budget. However, revenue and spending legislation are controlled by budget enforcement rules that have been in effect since 1990.

Source: OECD.

Table 2. **Legislative modification of the government's budget**

	Response
Australia	• The legislature typically enacts the government's budget. • The House of Representatives does not usually offer amendments, as the government always holds a majority. Most amendments are proposed by opposition Senators, and most of these amendments fail.
Austria	• Although the National Council can in principle amend the budget during the time allotted for that purpose, it usually only makes slight changes.
Belgium	• The Chamber of Deputies typically adopts the proposed budget, with the majority coalition voting in favour of the budget and the opposition voting against it. • During the first trimester of the budget year, departments have the opportunity to propose changes in their budgets. In general, the legislature rarely makes significant mid-year adjustments.
Brazil	• The National Congress made a large number of amendments to the budgets proposed during a recent three-year period.
Canada	• Parliament typically enacts the government's budget; the legislature offered few, if any, significant budget amendments during a recent three-year period. • The opposition may make minor amendments to the budget if the government assents.
Chile	• Most of the budget is not significantly modified by the National Congress. When changes occur, they are usually the result of negotiations between the legislature and the government.
Czech Republic	• Parliament enacts the government's budgets with minor changes only.
Denmark	• Parliament typically enacts the government's budget, including the numerous amendments the government proposes. • Amendments proposed by the opposition usually fail.
Finland	• Parliament usually approves the government's budget bill. • The most important approved amendments come from the government. • Few amendments proposed by individual legislators pass.
France	• The government's budget is always adopted by Parliament, but the legislature might make changes prior to approving it. These do not significantly affect the balance of the budget, and do not modify the bulk of the budget's revenues and expenditures.
Germany	• Parliament reviews the budget before passing it. The review process includes consultations between legislators and ministry officials.
Hungary	• The National Assembly has made numerous amendments to each of the government's budget proposals. • A large portion of proposed amendments aim to secure funds for minor development projects or other purposes; these do not significantly influence the financial commitments or internal structure of the budget.
Iceland	• Parliament usually passes the government's budget. • During a recent two-year period, the legislature made numerous amendments to the budget. All of the amendments were offered by the government or by its supporters.

Table 2. **Legislative modification of the government's budget** (*cont.*)

	Response
Ireland	• The <i>Dáil</i> usually offers a significant number of amendments to the budget. Typically, only government amendments are approved. • Legislators cannot propose amendments to the expenditure side of the budget.
Italy	• Many minor amendments are proposed each year, and Parliament typically passes a number of them.
Japan	• When the ruling party dominates the legislative majority (as usually has been the case), the government's proposed budget is normally approved without alteration.
Korea	• The National Assembly typically modifies the government's budget. Government and opposition parties conduct talks to determine the changes to be made. They usually only make small modifications.
New Zealand	• The House of Representatives usually enacts the budget proposed by the government. Few, if any, amendments are proposed, and usually no amendments are enacted.
Norway	• Typically, Parliament enacts the government's budget after making a number of small changes, but its behaviour depends on the political situation. During the 1990s, minority governments negotiated with opposition parties.
Portugal	• The Assembly of the Republic typically makes relatively minor changes to the government's budget. • The government does not propose amendments; the number of amendments proposed by parliamentary groups varies.
Spain	• All political groups represented in Parliament submit amendments to the budget.
Sweden	• Parliament typically enacts the budget proposed by the government. • Opposition parties can propose changes to the budget during a two-week period.
Switzerland	• The Federal Assembly adopts the budget after making changes to the government's draft. • Most changes proposed by members of the governing coalition are approved, while most proposed by opposition members are rejected.
Turkey	• Parliament does offer amendments to the government's budget. During a recent three-year period, these amendments only had a small impact on the budget as a whole.
United Kingdom	• The House of Commons enacts the government's proposals. A number of amendments are usually made to the budget bill, but the government is almost always the proposer of these changes.
United States	• Congress does not vote on the President's budget, but in acting on revenue and spending measures it often deviates from the president's proposals.

Source: OECD.

Table 3. **Changes in the legislature's budget role during the 1988-98 period**

	Response
Australia	The role of the legislature has not changed substantively in recent years, although Senate committees now have access to more information when considering the estimates.
Austria	The role of the National Council has not changed over the past 10 years.
Brazil	There have been no substantial changes in the role of the National Congress over the past 10 years.
Canada	- Parliament's role in the budget preparation process has expanded. The government now produces an economic and fiscal statement each fall; his statement has enhanced the legislature's pre-budget consultations. - The budget has emerged as a major policy statement.
Chile	In recent years, the National Congress has debated budget ceilings and limits on budgetary flexibility within those ceilings.
Czech Republic	The legislature's role has changed dramatically since the transition from socialism.
Finland	The role of Parliament has become smaller because the budget bill has become less itemised, and there has been an increase in extra-budgetary funds and organisations.
Germany	The role of Parliament has not changed much over the past 10 years, although legislators must now offset any proposed spending increase with a cut in spending elsewhere in the budget.
Hungary	Since the transition from socialism, the legislature has been much more involved in the creation of budget laws and in the process of making budget decisions.
Italy	In 1997, Parliament changed the budget process in ways that have allowed it to evaluate available resources and their utilisation more easily.
Ireland	The number and scope of <i>Dáil</i> committees has increased significantly in recent years. This development has meant that the annual estimates receive greater scrutiny by the <i>Dáil</i>.
Japan	The institutional framework for the role of the Diet has not changed since World War II. Lately, though, some individuals have argued that the legislature should deliberate the contents of the budget more fully.
Korea	There have been no significant changes in the role played by the National Assembly in the budget process.
New Zealand	The Fiscal Responsibility Act of 1992 has increased the amount of information put before Parliament during the budgeting process. The government must now provide Parliament with a statement indicating its broad strategic priorities for the upcoming budget, its fiscal intentions for the next three years, and its long-term fiscal policy objectives.
Norway	The role of Parliament varies with the political situation. The proportion of seats held by the government in the legislature has an impact. In 1998, the government held only 42 of the 165 seats in the legislature; this situation probably increased the role of the legislature.

Table 3. **Changes in the legislature's budget role during the 1988-98 period** (*cont.*)

	Response
Portugal	The Assembly of the Republic has become more active over the past 10 years. Possible reasons for this change include the recent expansion of its budgetary responsibilities, and the fact that the present government is not represented by a majority in the legislature.
Spain	Parliament currently has the same pre-eminent role in the budgetary process that it had 10 years ago.
Sweden	Sweden recently instituted a new budget process. It has yet to be determined if Parliament's role has changed as a result.
Switzerland	In response to the sharp deterioration of the Swiss Government's finances in recent years, the Federal Assembly has come to play a more active role in budget discussions.
United Kingdom	In recent years, legislators have added a greater number of pages to the Finance Bill between its publication and Royal Assent. This change suggests that either the number or length of amendments, or both, has increased.

Source: OECD.

Notes

1. Jörgen von Hagen, *Budgeting Institutions and Fiscal Performance*, Brussels: European Committee, 1992.
2. OECD, *Role of the Legislature*, PUMA/SBO(98)4, Paris, 1998.
3. This was initially passed as a resolution in 1706 and made a standing order in 1713. For the current text of this order, see Erskine May's, *Treatise on The Law, Privileges, Proceedings, and Usage of Parliament*, Nineteenth Edition (edited by Sir David Lidderdale, London: Buttersworths, 1976, p. 707.
4. *Ibid.* p. 706.
5. The historical evolution of the legislature's financial power is chronicled in Rene Stourm, *The Budget* (New York: D. Appleton and Company, 1917). See pp. 24-29.
6. *Ibid.*, p. 2.
7. Quoted in Stourm, p. 289.
8. See Edward Fitzpatrick, *Budget Making in a Democracy* (1918) which characterised the executive budget concept as a fatal step toward autocracy.
9. The decline of parliaments is discussed in David Arter, *The Nordic Parliaments: A Comparative Analysis* (New York: St. Martin's Press, 1984), especially pp. 31-41.
10. *Ibid.*, p. 32.
11. OECD, *Historical Statistics: 1960-1983* (Paris, 1985), Table 6.5.
12. Karl Heinrich Friauf, "Parliamentary Control of the Budget in the Federal Republic of Germany", in David Coombes, ed. *The Power of the Purse: A Symposium on the Role of European Parliaments in Budgetary Decisions* (New York: Praeger Publishers, 1975). p. 81.
13. Alain Dupas, "Parliamentary Control of the Budget in France: A View From Inside the National Assembly", In Coombes, *op. cit.*, p. 104.
14. *Ibid.*, p. 129.
15. Pierre Lalumiere, "Parliamentary Control of the Budget in France", In Coombes, *op. cit.*, p. 125.
16. *Ibid.*, p. 129.
17. Joel Molinier, "Parliament's Financial Powers: A Comparison of France and Britain", in Coombes, *op. cit.*, p. 168.
18. Valerio Onida, "The Historical and Constitutional Foundations of the Budgetary Systems in Italy", in Coombes, *op. cit.*, p. 220.
19. *Ibid.*, p. 228.

Budgeting in the Netherlands

by

Jón R. Blöndal and Jens Kromann Kristensen*

1. Budget formulation process

1.1. Introduction

The budget formulation process in the Netherlands operates in two very distinct phases. The first phase occurs when a new government takes power and it establishes its overall budgetary policy for its term of office. This is done in explicit terms, rather than being a general statement of intent. The second phase then occurs annually, as the government's overall budgetary policy is translated into operational terms for all of the government's various activities.

Budget deficits increased dramatically in the early 1980s. In 1983, the government embarked on a new course with the aim of major reductions in the budget deficit. Initially, this policy was successful in bringing down the deficit: it fell from more than 8.9% of GDP in 1983 to 5.7% in 1986. In the period 1986-90, however, at a time when the cyclical economic situation improved considerably, budget overruns and additional expenditure were easily financed by cyclically high tax revenue without violating the actual deficit targets. As a result, the positive change in the cyclical component of the budget balance was, for a large part, offset by a negative change in the structural component. In the subsequent downturn, the opposite happened. The high structural deficit limited the scope for allowing the automatic stabilisers to work and required the government to take discretionary measures to respect the actual targets. From 1989-1994, budget projections were overtaken four times by downward revisions in economic activity, forcing the government to introduce fiscal packages additional to the initial budget. In terms of

* Jón R. Blöndal is Principal Administrator and Jens Kromann Kristensen is Administrator, Budgeting and Management Division, Public Management Service, OECD.

budget savings measures, these additional packages were of greater importance than the original budget.¹

This system of “continuous budgeting” had its costs. From a political point of view, previous multi-party agreements on budget policy had to be frequently re-opened, which created a fragile environment for governing. From a budget management point of view, the system became very tumultuous with major decisions made on an *ad hoc* basis and at the last possible minute. As a result, it was increasingly recognised that the framework for budgeting had to be reformed.

In 1993, the Minister of Finance appointed a *Study Group on the Budget Margin* to recommend a new budget formulation system.² The Study Group was composed almost exclusively of senior government officials from the key ministries within the field of economic policy. Based on the recommendations of the Study Group, fundamental changes were made to the budgeting process in the Netherlands. They impacted both phases of the budgeting process in the Netherlands, the first directly and the second indirectly. They are discussed in the following two sections respectively. The chapter concludes with commentary on various aspects of the Dutch budget formulation process. It should be noted that the new results-based budgeting initiative is discussed in Chapter 5.

1.2. Phase 1: Setting overall budget policy – The coalition agreement

No political party enjoys a majority in the Dutch Parliament. As a result, it is necessary to form coalitions between two or more political parties in order to form a majority government. When a new government is created, it announces its major policy objectives in a document known as the *Coalition Agreement*. Budgetary policy is a key focus of the multi-party Coalition Agreements, with very explicit objectives agreed upon for the conduct of budgetary policy for its four-year term of office.

The framework for the budgetary policy aspects of the Coalition Agreements was fundamentally altered following the recommendations of the Study Group. The major conclusion of the Study Group was that the government needed a more solid budget policy anchor. In practical terms, this meant that the focus should be on the *level of expenditures*, rather than the *level of the deficit*.³ They should also be based on cautious economic assumptions. This created more stability as extra revenue would not automatically translate into extra expenditures and the cautious economic assumptions would reduce the inherent risks. The following box summarises the key elements of the Study Group's recommendations.

For historical reasons, the Dutch budget is divided into three separate sectors. These are: *i*) the “core” budget sector; *ii*) the health care sector; and *iii*) the social security and labour market sector. The separation of the latter two sectors from the “core” budget sector is in part due to the fact that they have their own

Box 1. Key elements of the coalition agreements on budget policy

- Valid for the government's entire term of office – four years.
- Fixed maximum caps for expenditures in each sector.
- The maximum caps are established in real terms.
- Transfers are permitted between different sectors.
- Maximums are based on cautious economic assumptions.
- “Firewalls” exist between revenues and expenditures.
- Explicit rules apply for dealing with windfalls and shortfalls.

dedicated financing sources. The latter two sectors are each the responsibility of a single minister respectively. The “core” budget sector, however, is the responsibility of a number of ministers. Each minister is politically responsible for his own budget and presents it to Parliament himself. All in all, 23 separate budget bills are presented to Parliament. Officials emphasised, however, that for budget formulation purposes, all of these are considered one and that their separation causes no problems. In the Coalition Agreements, separate caps on expenditures are established for each of the three sectors. The Coalition Agreements also incorporate the multi-year expenditure projections of each ministry as the basis for sub-caps for each minister within the “core” budget sector. As the Coalition Agreements encompass all the government's major policy initiatives, this will mean more expenditure in certain areas, and less in others. All of these are integrated into the multi-year estimates for the respective area and their respective caps.

The expenditure caps are established in real terms, and adjusted annually for inflation. This serves to preserve the key decisions made irrespective of price fluctuations. This is primarily to prevent the Coalition Agreements from having to be re-opened during the course of the government's term of office, which previous experience has shown to create a fragile environment for governing.

Transfers are permitted between the sectors, and between sub-caps established within the “core” budget sector. For example, the social security and labour market sector is currently in strong surplus due to a more favourable economic situation than assumed. This surplus is being used to finance additional expenditures in other sectors, principally the health care sector. Surpluses in one area can, however, only be used to fund *existing* policies that are experiencing higher costs than projected. The consent of the entire Cabinet is required to finance *new* proposals. This is often a grey area as the next section on the annual budget process discusses.

If a budget over-run occurs in any area, it is the primary responsibility of that respective minister to prevent or deal with it. This is in line with the principle that each minister is responsible for his own budget. In practice, this means that a minister will have to reduce another part of his budget in order to finance the over-run. In exceptional cases, the cabinet may decide that more than one ministry, or all ministries, should contribute to financing the overrun in one ministry. In essence, this is the equivalent of a transfer between spending caps as described above.

Box 2. The economic structure enhancing fund

The Netherlands enjoys sizeable deposits of natural gas resources and the government receives significant revenues from them. At their peak, these revenues had a great expansionary influence on government expenditure in the Netherlands. In due course, when these revenues dropped, the government had to increase taxes very markedly in order to sustain the added expenditures. This was at the core of what became known as “Dutch Disease”.

Today, gas revenues and the *ongoing* effect of the sale of government property* go in their entirety into a special *Economic Structure Enhancing Fund*. This Fund is used exclusively to improve the economic infrastructure of the Netherlands; high-speed rail links and highways being prime examples. Expenditure financed by the Fund is excluded from the maximum expenditure caps in the Coalition Agreements, as the Fund's ability to spend is dependent on the amount of money it receives from gas revenue and other revenue from the sale of government property.

The objective of the Fund is two-fold: first, to remove these revenues from the general budget debate and thus their expansionary impact. Second, to guarantee that significant money would be spent on improving the country's economic infrastructure, an area that had borne the brunt of many budget cuts in the 1980s and early 1990s. Economic infrastructure projects generally do not involve added operating costs in future years and they enhance the efficiency of the economy.

* The proceeds of the sale of property are applied to retire outstanding government debt; the resulting lower levels of annual interest payments are applied to the Fund.

The expenditure caps are based on cautious economic assumptions for the economy. The *Study Group* viewed this as an “insurance policy” for shifting the focus from the deficit to expenditures, *i.e.* the risk of the budget out-turn being worse than expected is mitigated. Any “surprises” are likely to be positive. During the Coalition Agreement negotiations, the Central Planning Bureau (see Box 3) will

Box 3. Central Planning Bureau

The Central Planning Bureau (CPB) plays a key role in the development of the budget policy contained in the Coalition Agreements. The CPB is a very unique institution. It is a government institution but is completely independent; it commands the trust of all political parties and the public at large.

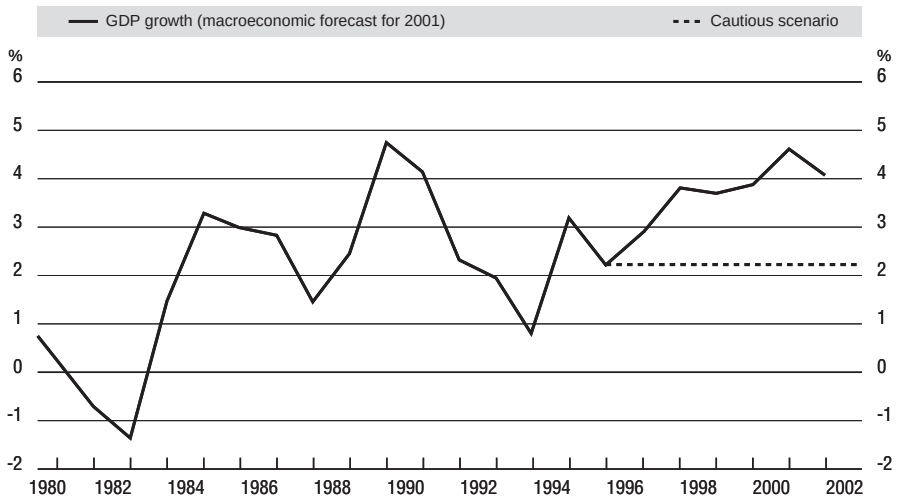
Prior to elections, the CPB will issue its economic forecast for the coming four years. All political parties use the CPB economic assumptions as the basis for their policy platforms. The larger political parties submit their policy platforms to the CPB ahead of elections for costing and to assess their economic impact. These policy platforms are generally very detailed. Although there is no legal obligation for political parties to do so, it is part of the Dutch political culture. In fact, the analysis by the CPB has often clarified the political platforms of political parties as the CPB has pointed out inconsistencies or errors in the proposed programmes.

As the CPB economic forecasts are taken as a “given” and the fact that the CPB has already costed and assessed the economic impact of the policy platforms of different political parties, the Coalition Agreement negotiations go much smoother than would otherwise be the case. When new policies, or policy compromises, are being negotiated, the CPB will assess their impacts as well.

present to the political parties two economic scenarios. The first one is what it considers to be the most likely level of economic growth for the new government's term of office. The second one is what it considers to be a cautious level of economic growth that should be used for budget policy purposes. The political parties will then decide to use the cautious scenario. The differences between the two are shown in Figure 1. In political terms, the parties would rather be faced with “good surprises” during their term of office rather than with “bad surprises”. Also, the Netherlands has a previous history of relying on overly optimistic economic assumptions as the basis for budget policy.

It is important to reiterate that there are strong “fire-walls” between revenue and expenditures. This means that should the economy perform better than expected, this does not automatically lead to increased expenditures. There are specific rules in place for how to deal with such “windfalls” in the Coalition Agreement. If the budgetary situation is turning out to be more favourable than the government anticipated, *i.e.* higher economic growth, then the following applies: If the deficit is greater than 0.75% of GDP, 75% of windfall goes to reducing the deficit and 25% on tax cuts. If the deficit is less than 0.75% of GDP, then 50% of windfall goes on reducing the deficit and 50% on tax cuts. The Netherlands is currently enjoying a budget surplus, so the 50-50 split applies.

Figure 1. Economic growth between 1980 and 2001



Although this new framework for the Coalition Agreements only dates to 1994, it appears to have become a very entrenched part of the budget formulation process in the Netherlands. There is no serious questioning of the new framework *per se*, only how it is applied. This is especially the case for the rules for how any windfalls are used, *i.e.* paying down debt, lowering taxes, or increasing expenditure as some are now advocating. The specific rules for how the windfalls are dealt with are more recent (1999) and are not as entrenched or as tested.

1.3. Phase 2: The annual budget process

As can be seen above, the key features of the government's budget policy are set at the time it takes office. This relieves a lot of tension from the annual budget process. As one official remarked: "The key role of the Minister of Finance and the Ministry of Finance each year is to ensure that the Coalition Agreement's budget rules are adhered to." This is especially important today with budget surpluses.

The annual budget process starts at the beginning of the preceding year. The Ministry of Finance begins updating its multi-year expenditure projections based on the latest data. The Ministry of Finance maintains comprehensive projections for four years beyond the next budget at the level of each vote. These are published and any changes from year to year are reconciled and fully explained.

Box 4. Annual budget formulation timetable

January-March	Finance Ministry updates multi-year expenditure projections. Spending ministries compile policy (expenditure) proposals. Finance Ministry and spending ministries in frequent contact.
March	Spending ministries send Policy Letters to the Finance Ministry outlining new policy (expenditure) proposals.
April	Cabinet meets to decide budget framework. Finance Ministry sends Letters of Totals to spending ministries stating their maximum level of spending for the coming year.
May-June	Negotiations between Finance Ministry and spending ministries on detailed composition of their budgets.
August	Cabinet meets to make decisions on revenue and make any final adjustments to the expenditure side of the budget.
3rd Tuesday in September	Minister of Finance presents budget to Parliament.

At the same time, spending ministries assemble their policy (expenditure) proposals for the coming year. The Ministry of Finance will have sent a letter outlining the format to be used for these proposals the previous November. Although the *Policy Letters* from ministries, where they formally request new expenditures, arrive in early March, there will have been frequent contacts between the Ministry of Finance and the spending ministries. The Policy Letters focus only on any changes from previous multi-year forecasts for existing policy and on any new policy initiatives. These letters are generally about 10-12 pages in length for each ministry.

The major decision moment in the budget process is the Cabinet meeting in late April. As stated earlier, the key decisions regarding budget policy will have been made in the Coalition Agreement at the beginning of the government's term of office. The issue at the Cabinet meeting is how to apply under-spending in any category for other activities, how to distribute windfalls in concrete terms, and whether the Coalition Agreement should be revised. The discussion at the Cabinet meeting is based on a note from the Minister of Finance. The Finance Minister will have had bilateral discussions with Cabinet members to settle issues prior to the Cabinet meeting, but the Cabinet meeting can take on great urgency if there are large issues outstanding. The Finance Minister will propose a maximum level of expenditure for each ministry in his note and this note can be quite detailed if, for example, the Finance Minister's expenditure assumptions are based on changes in specific programmes.

Shortly following the Cabinet meeting, the Minister of Finance will send to all ministers a formal *Letter of Totals*, which is the maximum level of expenditure that each ministry is permitted for the coming year. This Letter of Totals is generally not as detailed as the note presented to the Cabinet meeting as the minister will already have explained the key assumptions underlying it.

Box 5. The Budget Inspectorate of the Ministry of Finance and the Internal Budget Directorates of Spending Ministries

Each spending ministry has its own Internal Budget Directorate. They are part of each spending ministry and have no formal ties to the Ministry of Finance. They are responsible for the finances of each ministry, including compiling the ministry's budget proposal and negotiating with the Ministry of Finance. These are quite sizeable directorates: for example, the Internal Budget Directorate in the Ministry of Education has a staff of 80. In many cases, the Internal Budget Directorates are headed by former officials of the Ministry of Finance.

At the Ministry of Finance, there is a special Budget Inspectorate. It is organised to shadow each of the spending ministries. It is responsible for scrutinising each budget proposal, and the underlying policy proposal, coming from the spending ministries. It has a staff of 100.

In the late 1980s and the early 1990s, considerable effort went into identifying areas for expenditure cuts in each ministry. Spending ministries generally were not willing to volunteer cuts in any of their programmes and the Ministry of Finance developed over this time a comprehensive knowledge of each ministry's programmes. It was common for a significant share of all savings proposals to originate from the Ministry of Finance.

This hands-on "mindset" would appear to still be in place at the Budget Inspectorate of the Ministry of Finance. They scrutinise proposals at a great level of detail and any transfers from one programme to finance another one within a ministry requires the approval of the Budget Inspectorate. The negotiations in May and June between the Ministry of Finance and the spending ministries focus on this level of detail.

The comment was made that the Internal Budget Directorates have a good relationship with the Ministry of Finance, but that their relationship with policy directorates within their own ministries was not always good. They were often

viewed as being *de facto* part of the Ministry of Finance. This, of course, applies in varying degrees in different ministries.

Following these discussions between the Ministry of Finance and the spending ministries, the final step in the budget formulation process is a Cabinet meeting in August. At this meeting, the revenue side of the budget is decided and any adjustments to the expenditure side are made. It is rare for any changes to be made to the expenditure side at this stage. The budget documentation, *i.e.* commentaries on individual spending programmes, will be prepared by each ministry for its own respective programmes, but the Ministry of Finance has to consent to it.

1.4. Conclusions

The budget policy aspects of the Coalition Agreements have been the key to the successful turnaround of public finances in the Netherlands. They have proven to be an excellent instrument for the control of public finances and are exemplary as such.

There are signs that the discipline inherent in the Coalition Agreement is under strain in the current environment of budget surpluses. In this context, it is important for policy-makers in the Netherlands to highlight the future fiscal pressures associated with the ageing population and the concomitant expenditures for health and social security programmes.

The Central Planning Bureau (CPB) plays a key role in the budget formulation process. Its role is unique among OECD Member countries. It is important to maintain its independence and the trust that it commands from all political parties and the public at large.

As budget policy plays such an important role in the Coalition Agreements, consideration should be given to the Ministry of Finance having a formalised institutional role in advising the political parties in this area when the Coalition Agreements are being negotiated.

Consideration should be given to reassessing the role of the Budget Inspectorate of the Ministry of Finance *vis-à-vis* the Internal Budget Directorates in spending ministries. The challenge is to find the correct balance between “steering” from the Budget Inspectorate and permitting the Internal Budget Directorates more flexibility in managing their own budgets, and also for the Internal Budget Directorates to integrate themselves more with the policy directorates in their respective ministries.

All in all, the budget formulation process in the Netherlands is on par with the best found in any OECD Member country.

2. The role of Parliament

2.1. Introduction

There are no constitutional restrictions on the role of Parliament in the budget process in the Netherlands and a vote on the budget is not automatically considered a vote of confidence in the government. Parliament does in fact amend the government's budget proposal each year, but these amendments are generally minor. This is primarily a function of the Coalition Agreements. As they are agreed by the political parties forming the government, they *by definition* establish the framework for Parliament's deliberation of the budget and its room for manoeuvre in this area. The current political environment of strong majority government reinforces this as well.

This chapter outlines the formal parliamentary budget process in the Netherlands. Dutch officials emphasised, however, that much of Parliament's discussion of the budget took place in various internal political party gatherings. These are, however, beyond the scope of this paper.

Box 6. Dutch Parliament

The Dutch Parliament consists of two chambers. The Lower Chamber has 150 members, which are directly elected on the basis of proportional representation. The Upper Chamber (Senate) has 75 members, which are not directly elected. Rather, they are elected by the 12 provincial state councils. In practice, the Lower Chamber enjoys pre-eminence in budget matters. The Upper Chamber can only accept or reject the budget in total; it can make no changes. The discussion in this chapter focuses exclusively on the Lower Chamber.

The Netherlands has many political parties, which is a direct function of its proportional representative electoral system. The threshold for parties gaining a seat in Parliament is only 0.66% of the national vote. Eight parties currently sit in the Lower House. As noted earlier, no single political party enjoys a majority in Parliament and the current government is a coalition of three political parties. The next elections must take place no later than 2002.

2.2. The parliamentary budget process

It is useful to divide the parliamentary budget process into two stages. The first stage coincides with the opening of each session of Parliament and consists of general policy deliberation in plenary session. The second stage consists of

specific deliberation of each ministry's budget proposal. Much of this work takes place in committees before being brought to plenary session for final approval.

Box 7. Budget approval process

3rd Tuesday in September	Opening of Parliament by the Queen (Princes Day). Minister of Finance introduces the budget.
End September	General Policy Debate – Plenary Session.
Early October	General Budget Policy Debate – Plenary Session.
Mid-October	Committees begin scrutinising each budget bill.
Late October-End-December	Individual budget bills approved one by one in two-round plenary session.
1 January	Start of fiscal year.

2.3. First stage – general deliberations

The introduction of the budget is the outstanding event in the annual parliamentary calendar and coincides with the opening of Parliament's annual session. In accordance with provisions of the Constitution, this takes place on the third Tuesday of September each year and is known as Princes Day. The Queen formally opens Parliament in Joint Session in the morning with an address. The Queen's Speech is written by the Cabinet and highlights the government's plans for the coming year. Immediately following the Queen's speech, the Minister of Finance introduces the budget to the Lower House.

The budget is a term used broadly to encompass a *budget memorandum* and 23 separate *budget bills* introduced in Parliament. The Minister of Finance's budget memorandum contains an overview of the budget and major policy initiatives. The memorandum is not enacted into law. The Minister of Finance then introduces 23 separate budgets to Parliament on behalf of the ministers responsible for each policy area. As noted in the previous chapter, the practice of having separate budgets is to reinforce the principle that each minister is personally responsible for his budget. This, however, does not diminish the role of the Minister of Finance in any way. He must consent to each budget; otherwise they cannot be introduced in Parliament. Each of these 23 separate budgets is individually enacted into law.

In the days after Princes Day, a General Policy Debate takes place on the basis of the Queen's Speech and the government's budget proposal. This is the

most important “confrontation” between the Cabinet and Parliament. Practically all members of Parliament and Cabinet ministers are present at this time. Normally, this debate on government policy takes two days.

Following this debate, members of Parliament have two weeks to submit written questions to ministers. The number of questions is very large, ranging up to 400 questions asked of each minister on average. This was even greater in the past with over 1 400 questions typically being asked of each minister. This is the primary opportunity for members of Parliament to gain additional information on the government’s policy objectives. Most of the questions are technical in nature and relate directly to the budget. In fact, the questions are generally dealt with in the context of the committees of Parliament as they review each budget.

Box 8. Shadow Budgets

Opposition political parties have presented their own *Shadow Budgets* shortly after the government has presented its budget proposal. These were not comprehensive documents but rather highlighted 10-20 specific measures that differed from the government’s proposal. The Shadow Budgets were generally three to four pages in length.

What made the Dutch Shadow Budgets quite unique, however, was that all the specific measures contained in each of them were fully costed and their impact assessed by the Central Planning Bureau prior to being made public. (See Box 3.) This highlighted the culture of fiscal responsibility that generally typifies the budget debate in the Netherlands. A political party that would not have the Central Planning Bureau review its proposals would not be deemed responsible.

It is an unwritten rule in the Netherlands that a political party would identify sources of financing for any new proposal, either by reducing another item in the budget or by identifying specific revenue sources for the new proposal. The fact that the Netherlands is now enjoying a budget surplus may, however, be straining this unwritten rule.

Two weeks following the General Policy Debate, a General Budget Policy Debate takes place. This is in effect a continuation of the General Policy Debate, although formally it is to look specifically at the financial aspects of policy. The Cabinet is represented by the Minister of Finance at this debate.

It must be emphasised that these general deliberations are not a comprehensive examination of the budget in any sense. They focus on several politically sensitive issues for the most part. There is simply not enough time for members of Parliament to be acquainted with the budget at anything more than a superficial

level in the weeks immediately following the introduction of the budget. It should be noted in this context that there are no pre-budget reports, or pre-budget consultations in the Netherlands. The more comprehensive examination is reserved for the second stage of the parliamentary budget process.

No votes on the budget are taken at the end of these general deliberations. This is, however, the last opportunity for all practical purposes to reallocate funds between the 23 separate budget bills that were introduced, as the second stage of the parliamentary budget process focuses on each budget bill in isolation. There have been examples of Parliament voting on non-binding resolution at the end of the general deliberations. These non-binding resolutions can contain proposals for reallocation, but this is exceptionally rare. For all practical purposes, reallocation between the separate budget bills simply does not occur.

2.4. Second stage – specific deliberations

As noted above, the more specific deliberations of each budget bill is reserved for the second stage of the parliamentary budget process. This stage starts with each budget being referred to a committee for scrutiny. It is quite noteworthy that there is no specific budget committee in the Dutch Parliament that has overall responsibility for scrutinising the budget in aggregate terms and allocations between different sectors. In practical terms, this means that the aggregate allocation to each sector is taken as a given.

Each sectoral committee will scrutinise the budgets under its mandate. For example, the Committee on Education would scrutinise the budget for the Ministry of Education. There are 14 sectoral committees in the Dutch Parliament, so most committees will receive one or two budget bills for scrutiny. Each committee consists of 25 members with an equal number of alternates. Each committee is assisted by a clerk (most often with a legal background), and by a secretariat staff member specialised in the relevant policy field.

Somewhat paradoxically, the Parliament does have a special Committee on State Expenditure. The Committee, however, does not discuss the budget. It is responsible for general oversight of expenditure management systems, such as the basis of accounting to be applied and the presentation format of the budget documentation. In fact, this Committee played a leading role in the development of the planned accrual-basis, outcome-focused budget reforms that are discussed in Chapter 5 of this report. The Committee on State Expenditure has three secretariat staff members – all of whom are specialists in budget related issues. These staff members provide technical advice to the other committees during their examination of each individual budget bill.

The examination of the budget by the sectoral committees consists of the *Budget Investigation Session* that most committees conduct. This is a two to four hour

session whereby the minister responds to the committees' questions. This session is prepared extensively by the staff member serving the committee and the staff of the Committee on State Expenditure. Specifically, they prepare a 10-15 page report highlighting main points of inquiry. Issues for committee members to discuss will often have emerged from the general deliberations and the written questions asked of ministers. The minister formally receives notification of the main issues that the committee would like to discuss with him. Following this session, a verbatim (word-for-word) report is issued of their discussions with the minister. Dutch officials emphasised that it would be incorrect to characterise the committees as only devoting this two-hour hearing to scrutinising the budget. The committees meet frequently and budget issues are often raised during their meetings, although that is not explicitly the focus of the meetings.

The relationship between Parliament and the government is very formal. It is a basic principle that no member of Parliament, or employee of Parliament, will speak to an official of a ministry without the minister or state secretary (deputy minister) being present as well. Officials (career civil servants) of ministries do not appear before the committees. This, *inter alia*, explains the large number of written questions to ministers. This is a function of the principle of ministerial responsibility, as practised in the Netherlands.

Following the report of the committees, each budget bill is discussed separately in plenary session in two rounds before being approved as law.

During the first reading of each budget bill in plenary session, the spokesmen for the different political parties on the committee make detailed comments concerning the contents of the budget and propose amendments, if deemed necessary. Following the intervention of each spokesman, the minister responds. These sessions tend to last for four to five hours and are generally only attended by the spokesmen and the minister.

The second plenary session follows a few days later. It follows a similar format, although it is more interactive with not only the spokesmen making interventions. It tends to last for 10-15 hours and is generally attended by a greater number of parliamentarians, although it varies greatly from one budget bill to another.

There are no restrictions on the ability of members of Parliament to propose amendments to the budget. It is not uncommon for a total of 60-120 amendments to be proposed for the budget bills and for about 5 to 10 of them to be approved. The monetary value of these amendments is generally not great.⁴ Again, there is the unwritten rule that members of Parliament should identify another area for reduction in funding, or a new revenue source, in order to finance any new proposal.

It must be emphasised that these amendments concern each budget bill in isolation; it is *extremely* rare for any reallocation to occur between different budget

Box 9. Netherlands Court of Audit

The mission of the Court of Audit is “to audit and improve the performance of the state and its associated bodies. To this end, it provides the government, the [Parliament] and those responsible for the bodies audited with information based on its audits. Such information consists of audit findings, conclusions and recommendations on organisation, management and policy.”

The Court of Audit devotes about one-third of its time to traditional financial compliance audits and two-thirds of its time to value-for-money performance audits. The relatively small time devoted to traditional financial compliance audits is explained by the fact that each ministry has its own Internal Audit Directorate.

The Court of Audit has been a very vocal critic of the governance arrangements in place for certain semi-autonomous public bodies, as discussed in the next chapter.

The Court of Audit is not actively involved in Parliament’s deliberations of the government’s budget proposal.

bills. All of the bills will be passed into law at different times during the session. The first ones will be approved in late October and the last ones in December.

2.5. Conclusion

Parliament is not a very active player in the annual budget process, despite there being no restrictions on its role. As noted earlier, this is primarily a function of the Coalition Agreements. As they are agreed by the political parties forming the government, they *by definition* establish the framework for Parliament’s deliberation of the budget and its room for manoeuvre in this area. The current political environment of strong majority government reinforces this as well. It must, however, be emphasised – as Dutch officials do – that much of Parliament’s deliberations of the budget takes place outside of the formal parliamentary processes, *i.e.* in internal political party meetings.

The very disaggregated manner for discussing the individual budgets makes it very difficult to get an overview of the budget as a whole and to shift funds from one area to another. The discussion in plenary session at the time the budget is introduced are not effective for an in-depth analysis of the budget, especially allocations between the different budgets. The detailed deliberations on each budget in its respective sectoral committee would appear to be a very productive method of work. Consideration should, however, be given to the establishment of a co-ordinating committee that would deal with the budget aggregates and the

allocations between the different budgets.⁵ Such a system would imply additional resources being made available to Parliament for deliberating the budget.

It should be emphasised that Parliament has been very supportive in general of the various reforms being planned to the Dutch budget process, which are discussed in Chapter 5. It is, however, too early to assess what impact these will have on Parliament's deliberation of the budget.

A final feature, which is quite striking, about the operations of the Parliament is the very formal nature of its relations with the government, as best exemplified by the tradition that an official would not give information of any kind to Parliament without his minister (or deputy minister) being present. This would appear to have resulted in the large amount of written questions presented to ministers each year.

3. Managerial flexibility

3.1. Introduction

Following the strengthening of expenditure controls as described above, the late 1990s have been characterised by an increasing focus on achieving lower output prices, increased output quality and "quality of the organisations" through changes in management practices (Van Oosterroom 2001:3).

Several management reforms have been undertaken. Agencies have been established; ministries and their agencies have been given increased financial flexibility; central control of personnel policies have been somewhat relaxed. Specifically, the establishment of agencies has been undertaken with the aim of establishing elements of a purchaser-provider split and increasing the focus on results in public policy implementation. In these respects, the Netherlands has followed international trends.

3.2. Ministries, agencies and semi-independent public entities

The public sector in the Netherlands has three key elements: Ministries, Agencies and Semi-Independent Public Entities.

3.2.1. Ministries

There are 13 ministries in the Netherlands. Each ministry is headed by a politically elected minister. Strong emphasis is placed on the accountability of the minister and they are ultimately held accountable by Parliament and the general public for all activities within the ministry's preview.

Box 10. Reform approach, roles and responsibilities

Development of overall management reform policies is the responsibility of the *Ministry of Finance*. In the Netherlands, the Ministry of Finance is strong but this strength is used selectively and line ministries have a relatively large degree of freedom in regard to how they want to manage themselves. Responsibility is thus shared with spending ministries. This is a reflection of strong ministerial responsibility and accountability, giving the line ministers a primary role in policy implementation.

The value of more freedom for line ministries is that it allows them to adapt general approaches and tools to their particular organisational and political context. The downside is that there is no built-in incentive to reform and therefore to promote effectiveness and efficiency. In the Netherlands, officials point to professional satisfaction and the general will of civil servants to serve the public good as the primary factors driving reforms in ministries and agencies.

Policies related to human resource management, including remuneration, is the responsibility of the *Ministry of the Interior and Kingdom Relations* (hereafter the Ministry of the Interior). During the 1990s, a number of personnel responsibilities have been devolved to the line ministries and line managers. However, many fundamental characteristics of personnel management remain the prerogative of the Ministry of the Interior. Until 1993, the ministry acted as the only central government employer. In 1993, the minister was replaced by eight separate "employers", each representing one of the following sectors: central government, defence, education, the judiciary, the police, the municipalities, the provinces, and water control corporations. However, these "employers" still reside within the Ministry of the Interior.

The 13 ministries employ about 80 000 people in full-time equivalents, or 70% of the total central government personnel. Total expenditure was around 172 billion guilders (78 billion euros) in 2000.

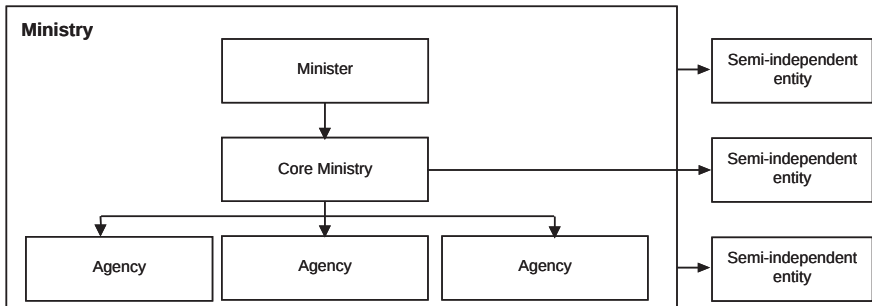
Until recently, ministries were the sole element of central government and they consequently were in charge of policy development as well as implementation. Ministries were consequently comparatively large.

Since 1994, an increasing number of agencies have been carved out of the core ministries, dividing the policy formulating function and the policy execution function.

3.2.2. Agencies

An agency in the Netherlands is an organisation with a separate corporate identity under direct ministerial control, subject to supervision and instruction by its core ministry. An agency publishes separate financial accounts and managerial

Figure 2. Ministers, core ministries, agencies and semi-independent public entities



freedoms are negotiated with the parent ministry. The first four agencies in the Netherlands were established in 1994 within the areas of Justice, Agriculture, Defence and Economic Affairs. The total number of agencies is now 23. It is expected that about 25 more agencies will be established in the near future. This development, which will include agencification of the very large tax and public works areas, is expected to bring the share of government employees working in agencies to approximately 80% of total government employment.

Total expenditure for agencies was around 7 billion guilders (3 billion euros) in 2000, or 7% of the total government expenditure. The number of agency employees in 2000 was 30 000 full-time equivalents, or 30% of total central government employment. The largest agency is the Judicial Institutions Service (prisons), which has around 16 000 employees, whereas the smallest is the Centre for Promoting Import from Developing Countries with only 17 staff. Five agencies have more than 1 000 employees.

Since the minister is held accountable for activities in agencies, agencies do not have boards.

3.2.3. *Semi-independent public entities*

Semi-independent public entities can be defined as “organisations which... are charged with the implementation of one or more public policies, and which are funded publicly, but which operate at arms-length of government.” These entities have been in existence in the Netherlands since the beginning of the 20th century, but the number increased markedly in the 1960s and 1970s. No exact count of semi-independent public entities exists, but several analyses converge around

Box 11. Conditions for establishing agencies

A new agency has to fulfil 12 criteria set down by the Ministry of Finance and approved by the Council of Ministers.

1. The organisation must have an unambiguous management model.
2. Products, services and quality indicators must be quantifiable.
3. Operational processes must be described.
4. A cost-price model must have been set up.
5. A system of stimuli for efficiency must have been put in place.
6. The organisation must set up an internal results-oriented planning and control cycle and a suitably external planning and control cycle.
7. A risk management model must be in place.
8. An opening balance scenario must have been drawn up.
9. A campaign plan for enhanced financial management must have been established.
10. There must be access to a statement of approval from an accountant.
11. The potential agency must have had a trial-run of a results-oriented management model.
12. The potential agency must have undergone a trial-run with accrual accounting.

The part of a ministry, which is potentially being transformed into an agency has to adhere to these 12 requirements. The Ministry of Finance determines whether this is so. Several potential agencies have had their implementation schedules prolonged because they did not live up to all 12 requirements. The difficulties with establishing new agencies are probably the same as before, but they are now being resolved before the establishment of the agency. Establishment of agencies has to be approved by the Council of Ministers, the Ministry of Finance, the Ministry of the Interior and Parliament.

Source: Ministry of Finance.

the number 600 as the total in the 1990s.⁶ There is no official overview as to their level of employment, expenditure or number.

These entities have considerable managerial and financial freedom and the ministerial responsibility for the operations of the entities is limited to that explicitly defined by law. Almost all semi-independent public entities operate on an accrual basis.

Most services and social insurance programmes, which are organised and entirely or partly financed by central government, are delivered by semi-independent public entities, who in many instances are supervised and regulated by a combination of ministerial oversight and a web of semi-independent supervisory bodies. Some semi-independent public entities are fully financed by central government, while others include an element of either direct user charging or indirect charging through insurance arrangements. In some sectors, these insurance arrangements are in themselves organised as semi-independent public entities.

There is no uniform approach in the Netherlands to issues of performance control, accountability and transparency of semi-independent public entities in regard to financial management, reporting or implementation evaluation. The fact that a major part of public expenditure and government service delivery is provided under such conditions has given rise to concern.

Addressing the heterogeneous mass of semi-independent public entities in the Netherlands in-depth is beyond the scope of this analysis. However, the application of the principles behind the establishment of agencies – *i.e.* enhanced disclosure of performance information coupled with clearer procedures for holding managers accountable – might be considered in addition to the very serious issues already raised by the Court of Audit in the Netherlands (see Box 12).

It has recently been decided to transform two semi-independent public entities into agencies under ministerial responsibility. It is expected that more semi-independent entities will follow suit in the coming years.

3.3. Input controls

Principally, government entities have been given discretion over accommodation issues in recent years and some aspects of human resource management have been decentralised.

3.3.1. Human resource management

Until 1993, the Ministry of the Interior acted as the central government employer. In effect, the Ministry of the Interior employed all staff in all other ministries under a single collective agreement. In 1993, this construction was modified by splitting the employer function into eight separate wage sectors: central government, defence, education, judiciary, police, municipalities, provinces, and water control corporations. This is to reflect the differences in working conditions between the different sectors.

Wage negotiations in the eight wage sectors, however, are still undertaken within the auspices of the Ministry of the Interior, which now acts as eight different employers instead of one. The elements of pay and working conditions that are

Box 12. The Court of Audit on semi-independent public entities

In a recent report by the Netherlands Court of Audit, a number of concerns were raised about semi-independent public entities:

- *Reporting* on the use of public resources is not uniformly in place although plans are under way to improve reporting in the health care sector from 2001.
- Ministers form an opinion on these reports in only a limited number of cases, notably in the social security and labour market sector.
- Semi-independent public entities do not generally report on their *financial management* and ministries consequently generally do not have a “clear idea as to the orderliness and verifiability of the financial management conducted by institutions”.
- With some exemptions, ministries have generally not developed *supervisory systems* in regard to substance.

On this background, the Court of Audit has recommended that adequate reporting and supervisory procedures be set up and that decisions on the appropriate level of detail in this reporting and supervision be established. The Court of Audit has acknowledged that the upcoming budgeting and accounting reforms have the potential to form a good point of departure. However, it notes that ministers have not determined who will ultimately hold semi-independent public entities accountable. Furthermore, it is unclear whether ministers accept the proposition of the Court of Audit that a larger degree of uniformity must be applied to reporting and accounting procedures throughout the semi-independent sector.

Some steps towards harmonisation will be taken in a forthcoming “Framework Act for Autonomous Administrative Authorities”, but this framework law is expected to be rather flexible.

A self-assessment by ministries of their supervisory arrangements on semi-independent public entities, which was to be published in late 2000, is still awaiting publication.

Source: Court of Audit.

negotiated at ministerial or agency level remain very limited. As one official in the Netherlands summarised: “those paying wages are not negotiating them.”

The Ministry of the Interior also establishes the job classification system, the systems of pensions and social security, and general conditions of employment. Furthermore, the ministry has defined actions to establish a representative public service in regard to gender, ethnic minorities and disabled citizens.

Direct central determination of the number of staff in each government entity has been abolished, so that each line ministry has degrees of discretion in regard to the number of employees in the organisation. Control systems on the overall number of employees are set up through the budget (*i.e.* the limit on wage expenses), and every ministry has to report the number of staff to the Ministry of the Interior annually.

With the exception of senior positions, each organisation selects its own personnel, often through external public advertisement. Staff in ministries are employed as civil servants proper, whereas newly employed staff in agencies are hired on contractual terms not very different from the private sector. New staff transferred to agencies remain civil servants.

For the Senior Public Service, the Ministry of the Interior plays a significant role in recruiting and/or transferring them.

The legal framework allows ministries to introduce performance related pay and to undertake performance reviews of personnel. The decision on whether to introduce such systems is delegated to each ministry. Ministries negotiate with their associated agencies on which degrees of freedom the agencies will have in this regard.

Generally, ministries and agencies have not chosen to introduce systematic reviews of individual staff performance and performance related pay is not widespread. The actual amounts paid are symbolic where they have been introduced – 100 € annually is cited as a typical amount in one agency.

The framework for human resource management in agencies is identical to that of the parent ministries.

3.3.2. *Accommodation*

Agencies pay a charge for accommodation. If the accommodation is publicly owned, payments are transferred to the parent ministries who in turn pay the central accommodation agency. If office space is rented from private providers, rents are paid directly from the agency to the private landlord.

Rents for publicly owned accommodation are set at modified market rates in accordance with a procedure approved by Parliament, based on the assessed value of the building, provisions and financing costs.

The payment of rent is related to managerial freedom for agencies to change accommodation as they see fit within the limits of rental contracts. After some initial lack of clarity when charging was introduced in 1997, agencies are now in principle not required to move into empty facilities owned by government. In practice, however, agencies are reported to be under very strong pressure not to leave government-owned buildings.

3.4. Financial management

3.4.1. Reallocation of appropriations

Government organisations generally receive one appropriation for all their operating expenditures. This implies that it is not specified how an appropriation must be distributed among different operating expenditures. Contrary to practice in most other countries, Dutch Government organisations are allowed to transfer expenditure between operating, capital and transfer programmes.

In some countries, this flexibility implies that management in government agencies can freely allocate expenditures between, for example, wages, consultants and accommodation. This is generally not the case in the Netherlands. In practice, agencies will have to allocate resources in close consultation with their parent departments and the Ministry of Finance has to approve them. Similarly, the Ministry of Finance has to approve changes in resource allocation internally in ministries. The budgetary flexibility is thus generally implemented rather cautiously.

Programme expenditure is generally budgeted and managed by ministries even if the activities are implemented by agencies.

3.4.2. Savings and loans

Before 1999, agencies had two sources of finance for capital investments: an agency could accumulate the money (unused appropriations and other sources of funding), or it could receive an extra appropriation as part of the annual budget process. This system was held to be too inflexible. First, an agency would not always have sufficient savings. Second, investment needs might be out of sync with the budget process. Third, investments might be incompatible with overall annual funding possibilities and policies.

As of 2000, a loan and deposit facility has been established allowing agencies to borrow capital for fixed assets (investments) from the Ministry of Finance at rates somewhat below the market rates. As regards operating costs, a current account facility has been established. This account is allowed to stay in deficit for one million NLG at the end of the year, and unlimited throughout the year. In principle, a very limited borrowing facility has thus been established for operating costs as well.

The borrowing facility does not apply to ministries. It is not yet decided whether this will change with the introduction of accrual accounting and budgeting.

In the Netherlands, ministries can carry 1% of a year's budget over to the following financial year. Agencies can only borrow only up to 1% of operating costs.

Loans by agencies have to be approved by the parent ministry and the Ministry of Finance. The justification for having the parent ministry approve a loan is that it is the ministry that in the end funds the agency through “purchases” of the agencies’ services. The approval by the Ministry of Finance is justified with reference to the need for macroeconomic balance, including the EMU requirements. The total amount of borrowing and saving are approved by Parliament through the regular budget procedure.

Savings facilities occupy an ambiguous position in budgeting practices. On the one hand, savings facilities can be seen as a necessary mechanisms to increase efficiency and to avoid waste because the public organisation with possibility of keeping its savings will have an incentive to minimise the use of resources, other things equal. In particular, saving facilities tend to reduce excessive end-of-year spending. On the other hand, savings – especially savings recurring year after year – can be seen as indicating that the public organisation in question receives more funding than it needs. Why should an agency keep receiving a higher level of funding than is apparently necessary to deliver the desired outputs and outcomes?

In the Netherlands, this conflict became tangible in the case of one agency having accumulated substantial savings. When the savings reached a level where it attracted political attention, the savings were transferred to the Ministry of Finance and included in the annual budget negotiations. Furthermore, it was established as a general rule that a maximum of only 5% of an agency’s equity can be accumulated as reserves. All amounts above this threshold will be transferred to the parent ministry. This threshold is justified with reference to the possibility of taking loans for investments, which is supposed to reduce the need to generate large savings.

It is not possible to say yet whether this will turn out to be a good or a bad change. On the one hand, this event will reduce the efficiency promoting effect of the savings facility. Furthermore, the fact that agencies saw the transfer as a sudden policy change might influence agencies’ expectations in regard to the duration of management and budgeting reform initiatives in the future. On the other hand, large savings do constitute a political problem and can be seen as results of unnecessary funding.

3.4.3. *Accrual accounting*

Since 1994, it has been a requirement that agencies operate with accrual accounting and budgeting. At the same time the rest of central government continues to budget and account on a cash basis. In practice, this has meant that accrual based budget and accounting documents for agencies have been translated to a cash basis and included as such in the whole of government documents. This

“co-habitation” of cash and accruals is reported to have operated without substantial problems.

3.5. Conclusion

Line ministries and their agencies enjoy increased flexibility in regard to savings and loans for capital investments and can carry over funds. Furthermore, they have some discretion in regard to the use of appropriations. However, the degrees of freedom in this regard are less generous in the Netherlands than in other OECD Member countries having introduced similar reforms. The degree of freedom for agencies is determined between the agency and the parent ministry and consequently differs from one agency to another.

Decisions in regard to financial management, whether in ministries or their agencies, have to be approved by the Ministry of Finance.

A substantial part of public expenditure and employment is undertaken at arms-length from government in semi-independent public entities. This continues to give rise to concerns about accountability and transparency.

Following reforms in the 1990s, line ministries exercise discretion in recruiting, training, developing and placing their own employees.

Control over wage determination and working conditions is maintained at central level. Consideration should be given to decentralisation of these responsibilities.

The purpose of the reforms mentioned in this chapter was to lower output prices, increase output quality and strengthen quality of public sector organisations. It is not possible to assess whether this has been achieved since time-series data on these items is not available. Furthermore, it is not established up front how and when reforms will be assessed and whether intended goals are accomplished. Consideration should be given to formalised procedures in this area.

4. Accountability

4.1. Introduction

As outlined in Chapter 3, management flexibilities have been increased for agencies in regard to financial management and accommodation, and to a certain degree in regard to human resource management.

This development has been accompanied by a restructuring of accountability mechanisms through quasi-contractual arrangements between “parent” ministries and agencies. The use of such contracts is not mandatory and some ministries and agencies have chosen not to adopt this approach. Agencies established in recent years, however, have entered into contractual relationships and all future agencies will adhere to the 12 principles for agency creation outlined in Box 11.

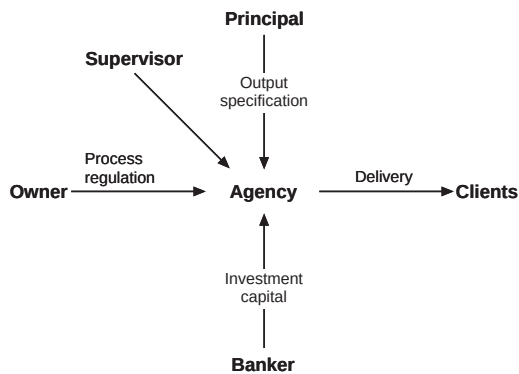
Expenditures for agencies are included in the appropriations for their parent ministry. They consist of one lump-sum line in the budget for each agency to cover their operational expenditures. The details of the use of this lump sum are negotiated between the “parent” ministries and their respective agencies.

The minister is accountable for the activities of agencies in the same manner as he is accountable for the activities of his core ministry. Agencies outputs are reported to Parliament in the budget and accounts of the respective ministries. Audit is undertaken by the internal audit functions of each ministry and by the Court of Audit, which may scrutinise the financial management of agencies in the same manner as it scrutinises ministries.

4.2. Specifying results and processes

Setting targets and specifying processes for agencies is *in principle* undertaken in a process involving parent ministries on the one hand and agency management on the other. This is outlined in Figure 3 below.

Figure 3. Roles in the Dutch agency model



The *principal*, which in practice equals the responsible policy office in the respective ministry, makes agreements with the agency about the quality, quantity and price of outputs to be produced by the agency and subsequently assesses the degree to which this has been achieved. In principle, a split between providers and purchasers has been established constituting an internal market. The market-like character of this arrangement is underlined by output costing being an explicitly formulated goal for the relationship between agents and principals. However, only a minority of agencies at present operate with output pricing and charging

according to quantity delivered. Operating with output pricing has been required since January 2000 and all new agencies are therefore expected to be operating with output pricing.

Agencies and parent ministries (as principals) will annually enter into a separate contract on outputs.

The *owner*, which in practice is the Deputy Secretary General of the parent ministry, must approve cost pricing models, investment policies, risk management policies, reporting requirements and general management control systems in the agency. The “owner role” is introduced with reference to the goal of increasing the “quality of the organisation”. In practice, this involves regulating a number of processes in agencies.

Agencies and parent ministries (as owners) will enter into a separate contract on these processes. This contract typically concerns a period of three to four years.

In the model, the *banker* equals the Ministry of Finance, which supplies investment capital and approves concrete investment projects. Furthermore, the Ministry of Finance establishes borrowing and current account facilities as described above.

The *supervisors*, which consist of the internal audit, personnel and finance units in the parent ministries, ensure that the activities of agencies are in accordance with the two contracts and other general regulations. The supervisors provide the ownership function, either directly or in an advisory capacity to other parts of the ministry exercising this function.

In sum, the framework used for the creation of agencies aims at clarifying management roles and their relations and thereby establishing a transparent division of labour. It is expected that the contracts and the framework will make it visible that parent ministries as well as agencies have to change their management practices.

The contracts on outputs and processes respectively are accessible to the general public but are not formally presented to Parliament. Prior to publication, the Ministry of Finance will receive the contracts for information and they will be used as part of that ministry’s budgetary oversight. There is thus an external scrutiny of the quality of the individual contracts.

Reporting to Parliament on the activities of agencies is part of the overall reporting of each parent ministry. In addition, agencies produce annual reports but these are not formally presented to Parliament.

Whereas the individual contracts are scrutinised, there is no overview of the general quality and number of contracts in the Netherlands. It is not known how

many agencies actually operate with contracts and how the quality of the contracts is evolving over time.

Dutch officials unanimously report that the degree of actual implementation of the general framework with owners, principals, supervisors, agencies and clients, varies significantly between ministries.

4.3. Reporting on results and processes

Reporting on results and processes of agencies is undertaken in four principal manners:

- Actual compliance with the two contracts mentioned above is reported upon in the annual reports of agencies. As noted above, annual reports are publicly available but not presented formally to Parliament. The annual reports may contain quantitative information on agency performance but in many agencies this is still in its developmental phase.
- Key results of agency performance are included in the budget and accounts of the parent ministries as presented to Parliament. In this context, no distinctions are made in regard to which part of the ministry has produced the outputs – *i.e.* whether the output is attributable to an agency or to the parent ministry itself.
- Every fourth year, the agency system is evaluated and assessed whether the agency model needs adjustments. The focus of the first evaluation in 1998 was on the organisational quality of individual agencies. The upcoming evaluation in 2002 will be supplemented by assessments of cross-cutting themes as for example the implementation of the split between owners and principals as described above. The first evaluation led to the establishment of the criteria for agency formation as outlined in Box 11. The evaluations are undertaken by the Ministry of Finance with assistance from private consultancy firms and supervised by an independent commission. These evaluations are presented to Parliament.
- It is mandatory for individual agencies to be evaluated after three years of existence and thereafter every fourth year. The purpose of these evaluations is to assess whether they are meeting the performance criteria set out at their establishment. These evaluations are typically undertaken by external private consultants hired by the agency in question. The Ministry of Finance is often consulted on the framework for evaluation, though this consultation is not mandatory.

Generally, no financial sanctions are applied for non-performance – neither in regard to the overall budget of the organisations involved nor in regard

to the management of that organisation. The public reporting of the assessed performance of individual agencies is considered as sufficient in this context.

4.4. Conclusion

The introduction of agencies and the accompanying accountability mechanisms can generally be judged to be a success. The rule of thumb in the Dutch Ministry of Finance is that the first three years of new agencies are difficult. Problems encountered in this implementation phase are generally not larger in the Netherlands than in other countries.

It should be noted that some of the more troubled agencies were judged to be “bad apples” even before they were made agencies. Problems encountered in these new agencies existed in their previous organisational forms, but are now being exposed with greater transparency as part of the agency model.

Changes in agencies need to be accompanied by parent ministries understanding their new roles: they will have to build capacity, devote resources and change business processes like agencies have to. Continued input-oriented management within a framework that is officially results-oriented will lead to frustration on the part of both parties.

It is acknowledged in the Netherlands that a weak point of the introduction of a performance focus in the agency model is the motivation of ministries in taking on their new roles as owners, supervisors and principals. And it is unclear if things are improving in this regard. In this regard, it can be raised as an issue whether the right balance in regard to individual ministerial responsibility and central devices have been found.

The conceptual model for specification and reporting on results in the Netherlands is inspired by principal-agent theory. One assumption within this approach is that the different actors in the model are separate and have different needs for control.

In the Dutch approach, the different control and delivery roles are integrated in the same ministry:

- The owner, principal and supervisory functions are integrated in the same relatively small organisational unit – the parent ministry.
- Agencies and their parent ministries are in many respects occupying a classical hierarchical relationship due to the strong emphasis on ministerial accountability. The umbilical cord seems to be in tact in most ministry-agency relations.

This gives rise to several questions: in the long-run, will it be feasible and effective to maintain the two separate roles of owner and principal? Will internal

supervision be effective? Will equal attention be given to the ownership and principal functions?

5. Outcome-based budget reform

5.1. Introduction

In May 1999, the Minister of Finance announced to Parliament that the government intended to introduce an outcome-based budget system to replace the present input-based one. The first official outcome-based budget was presented to Parliament in September 2001. In September 2000, the Minister of Finance further announced to Parliament that the government intended to introduce accruals as the accounting basis of budgeting to replace the present cash basis. The exact date for introducing the latter reform has not been finalised but the budget for 2006 is cited as the most likely deadline.

The impetus for these reforms would appear to be two-fold. First, there is strong political support. The Minister of Finance and the Prime Minister, who is himself a former Minister of Finance, are both strong proponents of these reforms. Parliament – especially the Committee on State Expenditure – has also been a strong proponent of the reforms. Second, and the apparent reason for the strong political support, is that the present system of budgeting is viewed as providing insufficient information on the government's activities and their true costs. The objective of the reforms is to make the budget more policy-oriented, recognising it as the government's primary policy document. This means that a link between policy, performance and resources must be made. It is also important to note that

Box 13. Minister of Finance on the reforms

“The Budget should tell us:

- What do we want to achieve?
- How do we want to achieve it?
- What should it cost?

The Annual Report should tell us the corresponding accountability questions:

- Have we achieved what we wanted?
- Have we done what we should have done in achieving it?
- Did it cost what we expected?”

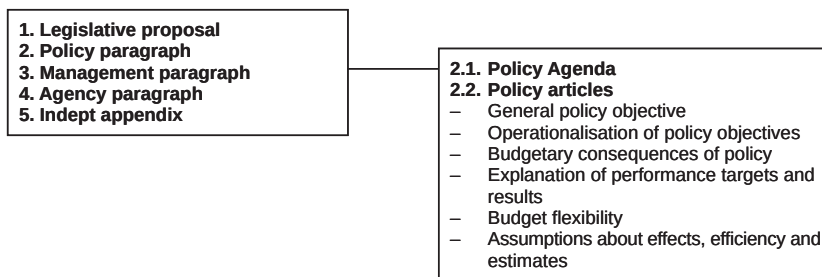
corresponding changes will be made to the *ex post* annual reports, where performance information will be audited on an *ad hoc* basis by the Court of Audit.

Among OECD Member countries only Australia is implementing reforms that are as far-reaching as the Dutch proposals in regard to the integration of outcome targets and evaluation in the policy and budget process. Countries like Canada, France, the United Kingdom and the United States are all working on enhancing the outcome focus of their budget procedures but generally this is not integrated in the actual budget document and expenditure is not linked directly to outcomes. Furthermore, the outcome documents are not systematically integrated in budget negotiations.

5.2. The structure of the new budget

In concrete terms, a fundamental reconfiguration of the budget documents will take place and for each ministry the budgets and annual accounts will be reorganised according to the structure outlined below.

Figure 4. The new structure of the budget and accounts



Besides the Policy Paragraph, which will be explained below, the budget will have the following elements:

- The Legislative Proposal, which will integrate the expenditure and the revenue under each department, though separate votes on expenditure and revenues will be upheld.
- The Management Paragraph, which will give an overview of major expected organisational changes in the ministry, such as creation of an agency or change of accounting standards.

- The Agency Paragraph, which will contain basic financial information on agencies connected to the ministry in question. Besides financial information, the inputs, outputs and outcomes of agencies will be integrated in the budget and accounting documents as if it was any other expenditure, *i.e.* they will be included in the Policy Paragraphs. This approach is justified with reference to the ministerial responsibility for agencies' activities. Every agency will still be treated as a section of the ministry to which it is part.
- The Appendix, which will include necessary technical information.

The key focus of the new budget, however, is the Policy Paragraphs, which will be divided into a Policy Agenda and a number of Policy Articles.

In the Policy Agenda, which will be no longer than 10 pages, the government's policies will be stated as well as the means that will be applied to achieve them and the financial resources allocated to them. It is hoped that this will reduce the need for publishing separate policy papers. There will be one policy agenda for each ministry.

Each Policy Agenda will be followed by a number of Policy Articles. These articles will replace the present sub-articles in the budget and will be restructured so that administrative and programme expenditure will be grouped under the policy targets to which they contribute. Expenditures, such as general management, that cannot be attributed to specific policies can be indicated under a general article for each ministry.

The first section of each policy article will be the General Policy Objectives. Here, outcome targets, including timing of expected achievement *i.e.* outcomes, will be stated and target groups for policies will be identified. Where possible, results on outcome realisations in two preceding years will be included.

If the General Policy Objectives cannot be operationalised directly into measurable outcome targets, the objectives will be translated into second order – or intermediate – targets. These targets will often have the character of output targets. Some policy articles will thus include a section on Operationalisation of Policy Objectives whereas others will not.

The next section in the Policy Articles will be the Budgetary Consequences of Policies, which will include an overview of financial information for the last two years and the forthcoming four years, including the budget year. Authorisations by Parliament (votes) are given at the total level of a policy-article. The number of votes will be reduced from about 600 to about 200. This will give ministries increased freedoms in regard to allocation of expenses and revenue.

This information will be supplemented by information on targets and results for outputs in the section on Explanation of Performance Targets and Results.

A particularly interesting part of this new structure will be the following section on Budget Flexibility. Here, the legal bindings on expenditure will be explained (international treaties, contracts, laws, commitments) and the percentage of the appropriation that can be reallocated should Parliament wish to is indicated. This section will also include a government proposal as how to allocate these “free” resources. The successful introduction of this section would represent international best practice for informing decision-makers on their room of manoeuvre.

The last section of the policy article will outline the budgetary assumptions as for example macroeconomic performance, demographic changes and structure of consumption.

5.3. *Cross-cutting issues*

The new budget will be structured around ministries, *i.e.* organisations. Organisational anchoring is deemed necessary for accountability purposes. However, this approach can imply that outcomes to which many organisations contribute (*i.e.* integration of immigrants, improvements in large cities or health) will appear in many places in the budget. This implies a danger that cross-institutional contributions to the realisation of such outcome targets are not adequately recognised.

To a certain extent the quest for clear accountability on one hand and policy-coherence across organisations on the other is a trade-off and there is no objective best balance. It is, however, important to make the choice explicit and to identify the risks connected with the choice taken.

This issue is partly addressed in the Netherlands with the introduction of the so-called “overview constructions” which are created in cases where several ministries contribute to policies. It is expected that the first new style budget will have four “overview constructions”. The constructions are not part of the budget bill but they are presented to Parliament for information. The types of overview constructions are shown in Box 14 below whereas an example of a draft overview construction is depicted in Annex 1.

A related issue is coherence across levels of government. This issue is not addressed in the reform, which leaves out activities of municipalities and provinces. The present rule that local governments automatically receive a fixed share of central government spending is being upheld. Though this focus might not be seen as in total harmony with the principles of the reform, addressing “vertical coherence” at the same time as a restructuring the national budget would probably overload the reform process.

Box 14. **Types of overview constructions**

Type 1. A collective policy objective

In this type, two or more ministries formulate a shared policy objective, including performance targets, target group and time horizon. In addition, the overview construction contains, for each ministry sharing the objective, a strategic policy objective and an operationalised objective. These can be regarded as a statement of how the ministry in question is contributing to the shared policy objective. This type of overview construction includes financial information, operational objectives and performance information for a five-year period for each contributing ministry. This type of overview construction will, for example, be used for expenditures related to international co-operation.

Type 2. Inventories of parts

No shared policy objective is formulated in this type of overview construction but policy areas which are thought to be related to each other are presented in the same construction. Ideally, this type of overview construction should include financial information, operational objectives and performance information for a five-year period for each contributing ministry. This type will, for example, be used for the area of asylum and immigration.

Type 3. Reference to policy articles

The most uncomplicated type of overview construction is a document compiling references to policy objectives of the ministries relevant to the policy theme in question. In this type, no long-term financial or performance information will be included. It has not been decided whether this type will be used in the first round of the new budgeting system.

5.4. *The budget reform and the three budgets*

As noted in earlier sections, there are three central budget documents in the Netherlands: the Core Budget Sector, the Health Care Sector and the Social Security and Labour Market Sector.

The description above concerns the core government budget but the reform is intended to be applied to the other two budget documents as well.

The operation of three budget documents must be understood on the background of the existing governance setting of the three budget sectors. In the long-run, there might be room for considerations on whether the operation of three budgets fully allow for the desired alignment of inputs, outputs to outcomes.

5.5. *Semi-independent public entities in the new budget*

At present, semi-independent public entities are only included in the budget documents as regards financial flows to and from these entities. In the future, the semi-independent public entities will take a more prominent place the budgeting as well as in the accounting documents.

Principally, the financial contribution of a ministry to a semi-independent entity will be treated as a “subsidy” from a ministry to individual citizens or companies. The accountability of the minister for the transfers will thus be like accountability for transfers to citizens and companies.

5.6. *Conclusions*

The move towards an outcome-based budgeting and accounting system is innovative and ambitious and has the potential of putting the Netherlands at the cutting edge of budgeting and management among OECD Member countries. The implementation, however, will be challenging and require substantial input and motivation from all stakeholders. Especially the formulation of outcome targets and the subsequent alignment of outputs and inputs will be challenging.

The question of issues cutting across organisational boundaries is addressed in the reform but generally the structure of the budget will remain faithful to the distribution of portfolios between ministers. The outcomes approach is thus not taken to its full “extreme”. This is justifiable with reference to the need for political accountability but entails the risk of not adequately addressing issues of policy coherence. This problem is a genuine trade-off and much will depend on the role given to “overview constructions”.

The main issue to be raised in regard to the reforms is the partial inclusion of the social security and labour market sector and the health care sector, which seems to be built more on existing governance arrangements than the principles behind the overall reform efforts.

The inclusion of semi-independent public entities in the main budgeting and accounting document has a potential of making accountability relations in that area clearer. However, the sorting out of these relations will probably be politically challenging and it is unclear if reformers have made up their mind in regard to what changes, if any, the new budgeting and accounting documents will have in this regard.

The internal audit directorates and the Court of Audit already have a substantial role in auditing performance information and this role will be further institutionalised with the new budgeting and accounting system. This has the potential of enhancing the quality of information provided in the budget.

Notes

1. This discussion draws on the annual OECD *Economic Surveys* of the Netherlands, especially the 1994 *Survey*.
2. "Study Groups" are typically appointed every four years by the Finance Minister to prepare a report on a specific topic prior to a new government taking office.
3. This is similar to the caps on discretionary expenditure applied in the United States, except they apply to all expenditure in the Netherlands. For a discussion of the United States experience, see Anderson, B. *"Surplus Budgeting in the United States"*, OECD, 2000.
4. Amendments can be presented at any time during Parliament's discussion of the budget. There are no procedural regulations designed to restrict them.
5. For a discussion of such a system, see Blöndal, J.R. "Budgeting in Sweden". *The OECD Journal on Budgeting*, 2001. Vol. 1, No. 1.
6. For an overview of these analyses and definitions see Sandra Van Thiel, *Quangocratization: Trends, Causes and Consequences*, Interuniversity Center for Social Theory and Methodology, Utrecht, 2000.

Annex I. **Draft overview construction on asylum and migration**

	Policy article	Operational goals	Performance indicator
Ministry of Interior and Kingdom Relations: Police	Issuance of a residence permit • Ladder for police-regions with asylum tasks • Testing regular applications • Issuing decisions on asylum and regular decisions Prevention of illegal stay • To deport aliens who are considered to leave	• To implement properly the tasks in the sphere of issuance of a residence permit, supervision of aliens and deportation as a consequence of the arrival of asylum seekers in a police-region • To test certain regular applications within the allowed period and to consider regular objections and to make decisions within the given budget • To issue decisions on asylum and regular decisions within the allowed period • To deport aliens who are considered to leave	• Amount of regular applications that have been considered • Time needed to consider regular applications • The percentage of withdrawal of regular applications • The percentage of nullification of regular applications • The average costs to consider a regular application • Amount of asylum procedures that are relevant to the police • Amount of taken decisions • The period that is needed to take a decision • The number of people who are considered to leave • The period that is needed to decide about leaving
Ministry of Interior and Kingdom Relations: Directorate for Co-ordination of Integration and Minorities Policy	Receiving asylum seekers • To accommodate asylum seekers with a permit of residence	To accommodate in time asylum seekers and holders of permissions of temporary stay in the regular reception	• The number of people that is accommodated • The average time that is needed to accommodate
Ministry of Defence (Royal Military Constabulary)	To prevent illegal stay • On behalf of the Ministry of Justice to maintain the legislation about aliens	• To patrol at the borders • To deport illegal aliens • To supply visa at the border • To superintend at the border to prevent illegal stay • To determine the identity of aliens by verifying documents in the Application Centre-phase	• The number of aliens that are withhold to enter the Netherlands • The number of aliens that is expelled • The number of visa that is supplied at the border • The number of illegal that are found at the border-area • The number of identities that are determined during the Application Centre-phase

Annex I. **Draft overview construction on asylum and migration** (*cont.*)

	Policy article	Operational goals	Performance indicator
Ministry of Foreign Affairs	Issuance of a residence permit	• To publish yearly high-quality country reports about main countries of origin • To publish, within three months, high-quality individual (about persons) reports • To further the return of non-permitted asylum seekers to their country of origin	• The number of country reports • The number of individual reports • The number of applications for a visa • The time that is needed for visa-application • The number of applications for authorisation of temporary stay • The time that is needed for authorisation of temporary stay • The number of people that return
	• Reports that are provided by the outposts (country and individual) • Consideration of authorisation for temporary stay-applications and visa-applications		
	Prevention of illegal stay		
	• Assistance • Return-organisation		

The Implementation of the Stability and Growth Pact*

Preface

by Ludger Schuknecht

This article explains the “new” institutional framework for fiscal policy-making in the EU countries agreed first in the Maastricht Treaty and later complemented by the Stability and Growth Pact. This framework introduces a – probably unprecedented – supra-national institutional framework for national fiscal policies. It also serves as a basis for monitoring and assessing fiscal policies and their compatibility with price stability-oriented monetary policy making.

The origins of the fiscal provisions of the Treaty and the Pact can perhaps be best understood from an historic perspective. From very early on, discussions on the institutional framework for a monetary union not only focused on institutional independence of the European Central Bank but also on securing a stability-oriented policy framework. There was ample reason for such concerns. Large fiscal deficits and growing public debt in the 1980s with adverse effects on price stability, real interest rates and economic efficiency and growth illustrated the failure of many governments to provide an appropriate fiscal environment. People were also concerned that a common – and for some countries lower – interest rate might weaken fiscal discipline once monetary union was in place.

EU member countries agreed to leave the responsibility for fiscal policies with national governments. But they also agreed to introduce a number of rules and institutions to secure fiscal discipline so as to achieve stable and sustainable public finances. The 3% ceiling for the deficit to GDP ratio and the medium-term target of “close to balance or in surplus” should secure sound fiscal policies with declining debt ratios and the free operation of automatic stabilisers. Moreover, the 60% ceiling for the debt to GDP ratio coupled with the prohibition on government

* Ludger Schuknecht is Principal Economist, European Central Bank, Frankfurt. This article was first published in the ECB's Monthly Bulletin, which is produced under the responsibility of the Executive Board of the ECB.

bailouts and the prohibition of monetary financing aim at strengthening the soundness of public accounts. Well-defined prevention, monitoring and sanction mechanisms enhance the credibility of the framework.

By the time the article was written, fiscal balances had improved significantly in EU countries and two years later further progress in deficit and debt reduction can be reported. Arguably due to the SGP framework, most countries now record sound budgetary positions close to balance or in surplus (with a few countries lagging behind in the achievement of this target). But this recent progress has been achieved in a favourable economic and fiscal environment. A less favourable conjunctural environment coupled with the desire to lower taxes may now put fiscal discipline and the credibility of the Stability and Growth Pact to a test. It is therefore very timely to recall the main principles and objectives of this framework.

1. Introduction

Attaining and preserving a macroeconomic balance as a prerequisite for economic and social progress has been the foremost objective guiding European economic and monetary integration in the 1990s. The aim both to buttress the mandate of the European System of Central Banks (ESCB) to safeguard price stability and to apply the principle of subsidiarity to non-monetary policies of participating governments figured high on the agenda of the founders of Economic and Monetary Union (EMU). At the same time they held the belief that sound government finances are an indispensable requisite for macroeconomic stability, and that financial stability is also rooted in disciplined fiscal policies. Hence an EU-wide commitment to sound public finances, such as that laid down in the Treaty and further developed in the Stability and Growth Pact, commands respect and constitutes a permanent guarantee that a responsible course of fiscal policy will be pursued.

The experience accumulated in past decades has shown that increased debt ratios – as well as the implicit debt associated with social security systems in ageing societies – cast a permanent shadow over economic prospects and, together with large deficits, constantly limit the scope for fiscal policy to act as a stabilising instrument. Long-term real interest rates are higher, private investment is lower and physical capital formation is at least partially crowded out. This reduces production, output suffers a permanent loss and consumption possibilities are diminished in the long-run. Indeed, empirical evidence points to a significant negative relationship between fiscal imbalances and total gross domestic investment, and between deficits and income per capita over the medium-term.

Moreover, fiscal laxity also appears to reduce the flexibility with which fiscal structures respond to economic fluctuations and help to dampen their effects on aggregate income. Fiscal structures have become more rigid over the past few decades. This has been partly due to discretionary policies to increase government

employment or implement high replacement ratios and early retirement dates for pensioners, and has been partly a budgetary by-product of adverse demographic trends which have increased the proportion of retirees in populations. Far from facilitating the smoothing of income through the different phases of the cycle, growing structural deficits have systematically impeded the policy-makers' response to severe recession, even when endogenous spending and tax adjustments were most needed.

Inflation is a monetary phenomenon in the medium- to long-term. Since the long-run association between the monetary financing of fiscal deficits and inflation is well established, a credible and definitive prohibition of this, along with an institutional framework that assigns the monetary authority a credible and lasting mandate to pursue an objective of price stability, are essential preconditions for the maintenance of price stability over the medium-term. However, the task of a stability-oriented monetary policy can also be affected by the stance of fiscal policies. In the short-run regulated prices and indirect taxes have a direct impact on HICP (Harmonised Index of Consumer Prices) inflation. Over an extended period of time, unbalanced public finances have a negative impact on economic efficiency and hence on the process of price formation. High structural deficits tend to divert resources from private capital formation and to increase the gap between aggregate demand and supply. This tends to alter the composition of aggregate supply and creates rigidities and bottlenecks that contribute to heightened pressures on prices. In this way, persistent deficits might force monetary authorities to keep short-term rates higher than would otherwise be necessary. By contrast, an institutional framework that guarantees sound government finances fosters macro-economic stability conducive to sustained growth in output and employment, and supports the maintenance of price stability as well as a steady improvement in living standards.

In certain circumstances, fiscal policies might also affect expectations and exacerbate the effects of economic and financial shocks. If market participants perceive fiscal structures to be overly exposed to economic fluctuations or changes in interest rates (*e.g.* because of insufficient safety margins built into primary balances to withstand adverse contingencies) such shocks might lead to increases in risk premia and long-term interest rates.

In a monetary union among sovereign states the case is strengthened for a responsible policy course with regard to fiscal choices. A newly established monetary union eliminates long-standing interest rate differentials which used to compensate investors for differences in inflation and depreciation prospects across the range of previously existing currencies. In this way, borrowers lose an element – a depreciating national currency – which used to signal market distress over misguided policies, not least on the fiscal front. At the same time, as national financial markets become more integrated, sovereign issuers can draw on a larger and more

liquid capital market than was possible under monetary autonomy. For those member countries that had been penalised in relative terms in the market for government loans, vanishing risk and liquidity premia may consequently make borrowing a more attractive policy option than non-deficit spending as a means of financing public expenditure. This feature, in turn, tends to lend a deficit bias to the area as a whole, which, again, provides a major incentive for an economic constitution which discourages unsound fiscal practices.

When the fiscal authority is dispersed, errant fiscal choices pursued by individual members of a monetary union can have negative repercussions on their neighbouring economies. These negative external effects are generally transmitted via long-term interest rates, as fiscal laxity in one country and the drain that this exerts on union-wide private savings both put pressure on the cost of long-term finance for the area as a whole. In principle, market forces could act as an effective deterrent against deviant policies. Indeed, even in the absence of explicit institutional constraints on fiscal deficits, the possibility of country-specific default premia penalising excessive borrowing could discourage deviation from fiscal discipline by individual governments. However, in practice there seems to be no firm evidence that the discipline exerted by financial markets has been sufficient to induce governments always to take heed of long-term budget constraints. Under such circumstances, unfettered fiscal regimes at the national level are inevitably conducive to tensions, and there is an obvious argument for supplementing market forces with commonly shared rules of fiscal restraint. These induce national policy-makers to internalise the area-wide impact of their decisions. In so doing, supranational rules improve co-ordination and inspire mutual trust among members.

2. The Treaty and the Stability and Growth Pact: institutional and procedural aspects

2.1. *The budgetary rules of the Treaty*

In Stage 3 of EMU budgetary policy remains an exclusive competence of the member states. This contrasts with the existence not only of a single monetary policy, but also of common policies in the areas of agriculture, trade and competition. Within the framework of the Treaty, the budgetary autonomy of member states is, in formal terms, absolute. However, the conduct of national budgetary policies is subject to rules of budgetary discipline and co-ordinating procedures at the Community level laid down in the Treaty (Title VII, Chapter I on "Economic policy"). (In this article all references to provisions of the Treaty are taken from the consolidated version provided by the Treaty of Amsterdam, which came into force on 1 May 1999.) The basic rule of budgetary policy enshrined in the Treaty is that member states shall avoid excessive government deficits. This norm is developed

in Article 104 (ex Article 104c) and in Protocol No. 5 on the excessive deficit procedure annexed to the Treaty. Article 104 (ex Article 104c) comes after general guidelines and rules for economic (non-monetary) policy co-ordination, as well as a set of restrictions on the financing of public sector borrowing requirements. These guidelines and restrictions are established in Articles 98 to 100 (ex Articles 102a to 103a) and Articles 101 to 103 (ex Articles 104 to 104b), respectively.

The general guidelines and rules provide that member states shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community (see Annex 1). According to Article 2 (ex Article 2) of the Treaty, these objectives are:

... to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member states.

Moreover, they must regard their economic policies as a matter of common concern, on the basis of the close co-ordination of member states' economic policies within the ECOFIN Council. The latter body is composed of the Ministers of Finance and Economy of the member states. The guiding principles set out in Article 4 (ex Article 3a) of the Treaty are stable prices, sound public finances and monetary conditions, and a sustainable balance of payments. The ECOFIN Council is required to formulate broad guidelines for the economic policies of the member states and to monitor economic developments within a multilateral surveillance framework. For this purpose, member states must forward, *inter alia*, information about important measures they have taken in the field of their economic policy responsibilities. Should the economic policy conduct of a member state be inconsistent with the broad guidelines or risk jeopardising the proper functioning of EMU, the Council may address a recommendation to the member state concerned and decide to make this recommendation public.

The restrictions on the financing of public sector borrowing requirements establish a prohibition on overdraft facilities or any other type of credit facility with the ECB or with national central banks in favour of any public sector institution at the national or the Community level (see Annex 2). They also prohibit the ECB and the national central banks from purchasing debt instruments directly from these institutions and the member states from granting them privileged access to financial institutions, unless this is based on prudential considerations. Moreover, the Treaty stipulates that the debts of public sector institutions of any member state shall not be assumed by the community or by any other member state. This provision, which is generally known as the "no bail-out clause", means that, in the event of the insolvency of any of these institutions, neither the

community nor the other countries will be held responsible for the debt of the insolvent institution.

With regard to budgetary policy, the rule is that member states shall avoid excessive deficits [see Annex 3, Article 104(1) (ex Article 104c(1))]. Compliance with budgetary discipline is to be examined on the basis of reference values for the general government deficit and gross debt in relation to GDP, whereby a number of qualifications can be applied. In particular, only an exceptional and temporary excess of the deficit over the reference value can be exempt from being considered excessive, and then only if it remains close to the reference value. In assessing the budgetary position, further information can also be taken into account, *e.g.* the level of public investment in relation to the government deficit. The decision as to whether a member state is in an excessive deficit position lies with the ECOFIN Council, acting upon a recommendation by the European Commission.

2.2. The budgetary rules of the Stability and Growth Pact

The European Council decided to provide clarification of the Treaty's budgetary rules in 1997 by implementing the Stability and Growth Pact, which lays down the rules for economic policy co-ordination and defines the conditions under which to apply the excessive deficit procedure in Stage 3 of EMU. The Pact mainly aims at: *a)* ensuring lasting compliance of fiscal policies with the requirement of budgetary prudence; and *b)* monitoring fiscal developments with a view to releasing early warnings in the event of budgetary slippage. In this context, the European Council underlines the importance of safeguarding sound government finances as a means of strengthening the conditions for price stability and strong sustainable growth conducive to employment creation. The Stability and Growth Pact, which provides for both prevention and deterrence, consists of a Resolution of the European Council (Amsterdam, 17 June 1997), in which the commitments of the member states, the European Commission and the European Council itself are specified, and two ECOFIN Council Regulations. Council Regulation (EC) No. 1467/97 of 7 July 1997 brings forward and clarifies the implementation of the excessive deficit procedure. Council Regulation (EC) No. 1466/97 of 7 July 1997 deals with the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies and defines the content of the stability and convergence programmes.

As the main provision to ensure sound budgetary policies on a permanent basis, the Resolution of the European Council on the Stability and Growth Pact incorporates the member states' commitment to respect the medium term budgetary objective of positions close to balance or in surplus (see Annex 4). This objective will allow all member states to deal with normal cyclical fluctuations, while keeping the government deficit at or below the reference value of 3% of

GDP. Deficits of above 3% of GDP will be regarded as excessive, unless they are expected to be temporary and have occurred under exceptional circumstances. In any case, the deficit has to remain close to the reference value. Circumstances are qualified as temporary and exceptional if the deficit overshoot is driven either by an unusual event beyond the control of the member state or by a severe recession. An excess over the reference value resulting from a severe economic downturn will, as a rule, only be considered to be exceptional by the European Commission if there is an annual fall in real GDP of at least 2%. A smaller decline in real GDP can only be considered as exceptional by the ECOFIN Council, on the initiative of the member state concerned, when this is suggested by supporting evidence, related in particular to the abruptness of the downturn or the accumulated loss of output relative to past trends. In evaluating whether or not an economic downturn is severe, as a rule member states will take as a reference point an annual fall in real GDP of at least 0.75%. The temporary nature of a deficit exceeding the 3% level will be apparent from budgetary forecasts as provided by the European Commission indicating that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn (see Annex 5).

If a member state's government deficit is considered excessive, the ECOFIN Council will formulate recommendations for the correction of this budgetary imbalance. Effective measures to this effect have to be taken by the member state concerned within four months. If, in the ECOFIN Council's judgement, such effective action is not taken, the Council can impose sanctions. These initially take the form of a non-interest-bearing deposit quantified in relation to the member state's GDP, which may be converted into a fine should the excessive deficit persist for more than two years.

In order to monitor budgetary developments and to receive signals of any potential budgetary slippage, as well as to facilitate the co-ordination of economic policies, an early warning mechanism has also been established in the context of the Stability and Growth Pact. For this purpose, member states shall submit to the ECOFIN Council and the European Commission annual stability programmes (if they have adopted the single currency) or convergence programmes (if they have not adopted the single currency) specifying their medium-term budgetary objectives. The content and format of stability programmes follow an agreed pattern (see Annex 6). The requirements for convergence programmes are similar. The Council shall deliver an opinion on the programmes and request adjustments, should it consider a strengthening of the objectives and contents to be necessary. Moreover, the implementation of the programmes shall be monitored by the Council and a recommendation shall be made to the member state concerned if the Council identifies any significant divergence of the budgetary position from the medium-term budgetary objectives laid down in the programme.

2.3. *The implementation of the excessive deficit procedure*

The different steps to be followed in the process of implementing the excessive deficit procedure (EDP) are summarised in Figure 1, which deals with the decision of the ECOFIN Council on the existence of an excessive deficit, and in Figure 2, which describes the follow-up procedure.

- Step 1 is preliminary and refers to the notification of budgetary data by member states to the European Commission by 1 March and 1 September of each year.
- In Step 2, the European Commission examines the compliance of member states with budgetary discipline on the basis of the criteria set out in Article 104(2) [ex Article 104c(2)] of the Treaty. If member states fulfil the requirements under both criteria on budgetary discipline (a government deficit of below 3% of GDP and a government debt of below 60% of GDP unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace) and if the European Commission is of the opinion that there is no risk of an excessive deficit, the excessive deficit procedure is not initiated. In other cases, or whenever the planned or actual government deficit of a member state exceeds the reference value of 3% of GDP [see Annex 3, Article 104(3) (ex Article 104c(3))], and Annex 4, commitment 3 of the European Commission), the European Commission shall prepare a report triggering the application of the EDP.
- In Step 3, within two weeks of the preparation of the European Commission's report, the Economic and Financial Committee – in which representatives of the governments and the ESCB participate – shall formulate an opinion on this report and submit it to the ECOFIN Council [Article 104(4) (ex Article 104c(4))]. Taking this opinion fully into account, the European Commission shall address an opinion to the ECOFIN Council [Article 104(5) (ex Article 104c(5))] together with a recommendation if it considers that an excessive deficit exists. If the European Commission finds that a deficit exceeding 3% of GDP is not excessive and if this opinion differs from that of the Economic and Financial Committee, the European Commission is committed to present the reasons for its position to the ECOFIN Council in writing.
- Step 4 is the decision of the ECOFIN Council on whether an excessive deficit exists in a member state, after an overall assessment, acting by a qualified majority on a recommendation from the European Commission, and having considered any observations which the member state concerned may wish to make [Article 104(6) (ex Article 104c(6))]. The decision should be taken within three months of the notification of budgetary data to the European Commission by member states.

Figure 1. The ECOFIN Council Decision on the existence of an excessive deficit

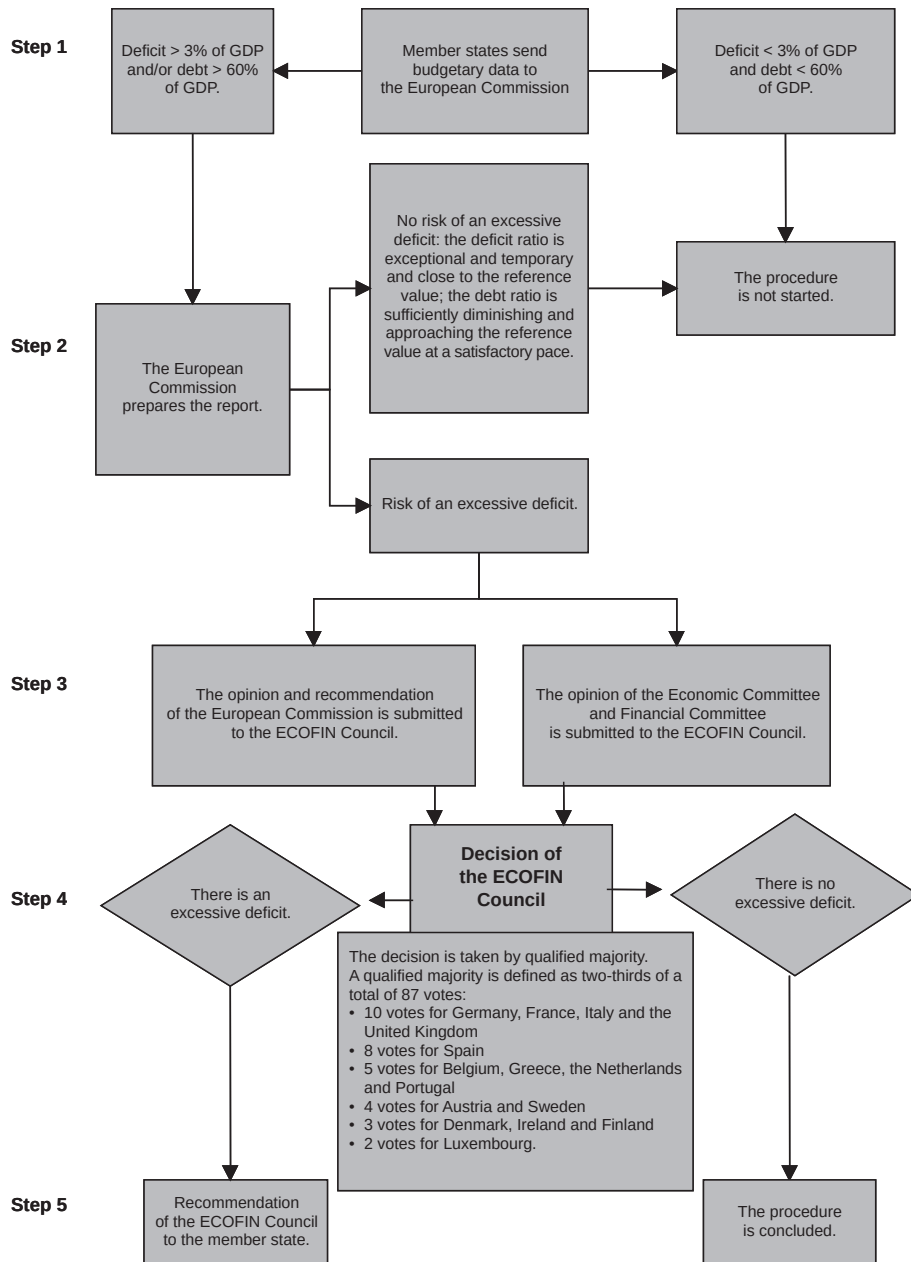
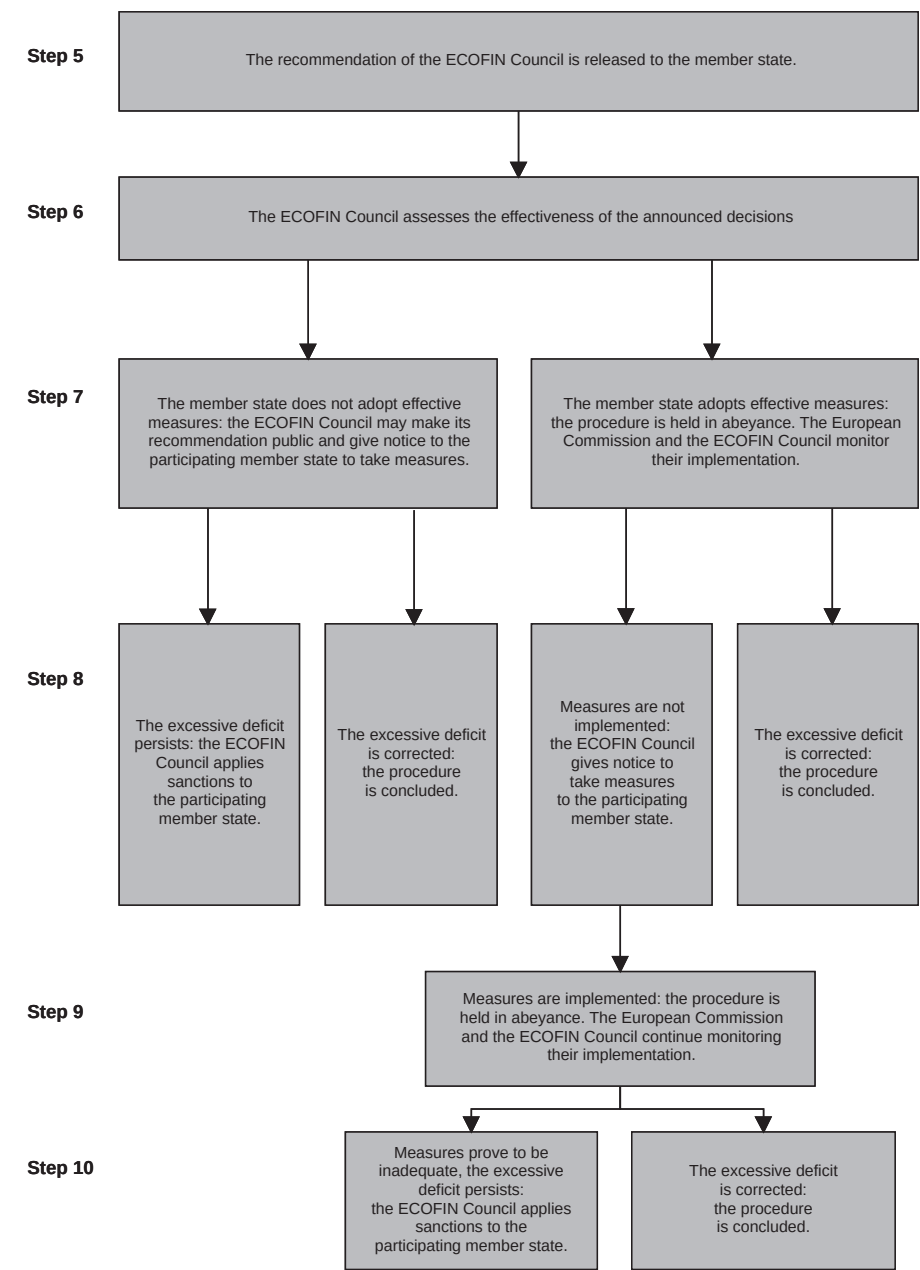


Figure 2. Follow-up of the ECOFIN Council Decision that an excessive deficit exists



- In Step 5, if the ECOFIN Council decides that there is no excessive deficit, the excessive deficit procedure is concluded. However, if the decision is that an excessive deficit does exist in a member state, the ECOFIN Council shall at the same time make recommendations to the member state under [Article 104(7) (ex Article 104c(7))]. These recommendations are adopted on a recommendation of the European Commission, by a qualified majority excluding the votes of the representative of the member state concerned, and are not made public. The ECOFIN Council shall recommend that excessive deficits be corrected as quickly as possible after their emergence (see-Annex 4), and shall establish two deadlines. One deadline is of a maximum of four months for effective action to be taken by the member state concerned. The other deadline is for the correction of the excessive deficit, which should be completed in the year following its identification, unless there are special circumstances.
- Step 6 (in Figure 2) initiates the follow-up to the ECOFIN Council decision that an excessive deficit exists in a member state. The ECOFIN Council will consider whether effective action has been taken in response to the recommendations it made in accordance with Article 104(7) [ex Article 104c(7)], and will base its decision on publicly announced decisions made by the government of the member state concerned. The decision is taken on a recommendation of the European Commission by a qualified majority excluding the votes of the representative of the member state concerned.
- If, in Step 7, the ECOFIN Council decides that no effective action has been taken, it may make its recommendations public under Article 104(8) [ex Article 104c(8)] immediately after the expiry of the deadline set previously (a maximum of four months). In that case, for participating member states only and within one month of the decision, the ECOFIN Council may decide – under Article 104(9) [ex Article 104c(9)] – to give notice to the participating member state concerned to take, within a specified time limit, measures to reduce the deficit. This decision and the subsequent decisions within the procedure shall be taken on a recommendation of the European Commission by a qualified majority excluding the votes of the representative of the member state concerned. However, if the ECOFIN Council decides that the member state concerned has taken effective action in compliance with its recommendations under Article 104(7) [ex Article 104c(7)], the excessive deficit procedure shall be held in abeyance. The European Commission and the ECOFIN Council shall monitor the implementation of the action taken.
- In Step 8, if – in the view of the ECOFIN Council – the excessive deficit has been corrected, it shall abrogate some or all of its decisions on recommendations and notices given. If the recommendations have been made public,

the ECOFIN Council shall make a public statement that an excessive deficit no longer exists in the member state concerned. However, if a participating member state fails to act in compliance with the successive decisions of the ECOFIN Council giving recommendations and notices, the Council shall impose sanctions in accordance with Article 104(11) (ex Article 104c(11)), no later than two months after the decision giving notice to the member state concerned and within 10 months of the reporting dates for submitting budgetary data to the European Commission. Moreover, an expedited procedure can be used in the case of a deliberately planned deficit that the ECOFIN Council considers to be excessive. Another possibility is that, while the excessive deficit procedure is held in abeyance, action by a participating member state is not being implemented or actual data regularly notified by member states to the European Commission by 1 March and 1 September of each year indicate that the excessive deficit has not been corrected by a participating member state within the time limits specified in the recommendations issued under Article 104(7) [ex Article 104c(7)]. In such a case, the ECOFIN Council shall immediately take a decision to give notice to the participating member state concerned to take, within a specified time limit, measures to reduce the deficit.

- In Step 9, if the participating member state acts in compliance with the notices issued by the ECOFIN Council in accordance with Article 104(9) [ex Article 104c(9)], the excessive deficit procedure shall be held in abeyance. The period for which the procedure is held in abeyance shall be included neither in the two-month period nor in the 10-month period mentioned in Step 8 as deadlines for the imposition of sanctions. The European Commission and the ECOFIN Council shall monitor the implementation of the action taken.
- In Step 10, if – in the view of the ECOFIN Council – the excessive deficit has been corrected, the procedure will be concluded as described in Step 8. However, if the action taken by the participating member state is proving, in the view of the ECOFIN Council, to be inadequate or if actual data regularly notified by member states to the European Commission by 1 March and 1 September of each year indicate that the excessive deficit has not been corrected by a participating member state within the time limits specified in the notices issued under Article 104(9) [ex Article 104c(9)], the ECOFIN Council shall immediately take a decision to impose sanctions in accordance with Article 104(11) [ex Article 104c(11)]. The sanctions will consist, as a rule, in a non-interest-bearing deposit and the ECOFIN Council may decide to supplement this deposit with the measures provided for in the first and second indents of Article 104(11) [ex Article 104c(11)]. When the excessive deficit results from non-compliance with the deficit criterion, the amount of the first deposit shall comprise a fixed component equal to 0.2%

of GDP and a variable component equal to one-tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP. In each following year, Step 10 is repeated until the decision on the existence of an excessive deficit is abrogated. In its annual assessment, the ECOFIN Council shall decide to intensify the sanctions unless the participating member state has complied with the Council's notice. If a decision is taken in favour of an additional deposit, it shall be equal to one-tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP, without exceeding the upper limit of 0.5% of GDP. A deposit shall, as a rule, be converted into a fine if, two years after the decision requiring the participating member state concerned to make a deposit, the excessive deficit has not been corrected. These fines shall be distributed among those participating member states not running an excessive deficit, in proportion to their share in the total GNP of the eligible member states. In accordance with Article 104(12) [ex Article 104c(12)], the ECOFIN Council shall abrogate the sanctions referred to in the first and second indents of Article 104(11) [ex Article 104c(11)] depending on the significance of the progress made by the participating member state concerned in correcting the excessive deficit, and all outstanding sanctions shall be abrogated if the decision on the existence of an excessive deficit is abrogated. However, fines will not be reimbursed.

3. The implementation of the Stability and Growth Pact

The procedure for the implementation of the Stability and Growth Pact starts with the presentation of the stability and convergence programmes by member states. After that, the European Commission has to adopt a recommendation on each programme. This recommendation will constitute the basis on which the ECOFIN Council will elaborate an opinion, after consulting the Economic and Financial Committee, within two months of submission. The ECB participates in the Economic and Financial Committee, where its members have the opportunity to discuss in-depth the programmes presented by member states. If the ECOFIN Council considers that the objectives announced in the programme should be strengthened, it invites the member state concerned to do so. In the event of significant divergence from the objectives set in previous programmes being detected, the ECOFIN Council has the prerogative to issue a recommendation urging the member state concerned to adopt offsetting measures. Annual updates of the programmes shall provide a detailed account of plans to offset deficit overruns in the short-term. This latter requirement is aimed at preventing the medium-term objective of a budget in balance or in surplus from being deferred indefinitely.

In view of the fundamental role of the stability and convergence programmes in the process of multilateral surveillance, it was considered important for their information content to be appropriate and to allow for comparison across member states. Since member states had to draw up their programmes for submission before the end of 1998, as agreed by the ministers in their joint declaration of 1 May 1998, the Monetary Committee (now the Economic and Financial Committee), drawing upon useful contributions from European Commission staff, discussed possible complementary guidelines and agreed upon an Opinion addressed to the ECOFIN Council. This Opinion was endorsed at the ECOFIN meeting in Luxembourg (12 October 1998). This section first presents this Opinion, which established a code of conduct on the format and content of the stability and convergence programmes. It then describes formal compliance with this code of conduct in the steps taken to date to ensure implementation of the Pact. Finally, three key issues of substance are stressed which, in accordance with the Opinion of the former Monetary Committee, were addressed by the ECOFIN Council when examining the medium-term budgetary objective of positions close to balance or in surplus proposed in the stability and convergence programmes.

3.1. A code of conduct on the stability and convergence programmes

The former Monetary Committee considered that the essential requirements of the stability and convergence programmes set out in Council Regulation (EC) No. 1466/97 might usefully be complemented by a number of guidelines on the content and format of the programmes, building upon the previous “code of conduct” presented in the former Monetary Committee’s report of 14 February 1994. The experience gathered so far with the “old” convergence programmes showed, according to the Opinion of the former Monetary Committee, that such guidelines not only assist the member states in drawing up their programmes, but also facilitate their examination by the European Commission, the former Monetary Committee and the ECOFIN Council. The agreed guidelines and suggestions on the format and content of the stability and convergence programmes (see Annex 7), acknowledging the fact that the programmes are the responsibility of national authorities and that possibilities and practices differ from one country to another, are of an indicative nature.

The main considerations included in the Opinion of the former Monetary Committee can be summarised as follows:

- A fundamental element of the stability and convergence programmes is the medium-term objective for the budgetary position to be close to balance or in surplus. It was therefore clear, according to the Opinion of the

former Monetary Committee, that the assessment of the appropriateness of member states' medium-term objectives and the examination of their fulfilment had to take explicit account of the cyclical position and its effect on the budget. The time frame, in terms of the interpretation of "medium-term", would therefore be the length of the business cycle. In practice, an approximate approach has to be adopted when assessing how actual and expected budgetary developments compare with the requirement of medium-term budgetary positions close to balance or in surplus. In particular, the likely impact of cyclical effects on current and future developments in budgets must be assessed. This exercise requires the adoption of an appropriate method.

- Obviously, each method has its strengths and weaknesses and therefore the results need to be interpreted with caution. Bearing this in mind, the former Monetary Committee adopted the present European Commission services' cyclical adjustment method which was considered to be a useful approach for assessing budgetary developments. Further analysis, taking into account other relevant factors including country-specific circumstances, would be needed to arrive at more firmly based judgements. In making such judgements, where appropriate, results from other methods may also be considered.
- On the basis of their cyclical adjustment method, European Commission staff examined for each member state which underlying (cyclically adjusted) budget balance would allow it to deal with adverse cyclical developments while respecting the government deficit reference value. Clearly, other considerations are also of major importance in setting an appropriate medium-term objective which observes the requirements of the Stability and Growth Pact, such as the need to take account of other sources of variability and uncertainty in budgets, to ensure a rapid decline in high debt ratios and to cater for the costs associated with population ageing. In line with this, member states that wish to make use of discretionary policy should create the necessary room for manoeuvre.
- It is important to prevent the medium-term budgetary position of close to balance or in surplus from becoming a moving target. The former Monetary Committee considered that the stability and convergence programmes to be submitted at the latest by the end of 1998 should show the medium-term objective of the Stability and Growth Pact as being achieved as quickly as possible. Furthermore, the former Monetary Committee held, on the basis of the European Commission's analysis, that this objective should be achieved by the end of 2002 at the latest.

3.2. Compliance with the code of conduct

In conformity with the Council Regulation on the Stability and Growth Pact referred to above, all EU countries submitted their stability and convergence programmes to the ECOFIN Council and the European Commission before the deadline of 1 March 1999. Most programmes arrived before the end of 1998, as had been agreed by the ministers in their joint declaration of 1 May 1998.

Stability and convergence programmes were generally found to comply formally with the code of conduct outlined above with regard to the length of the time horizon covered, the breadth of the information provided and the depth of the commitment to stability-oriented policies manifested by governments. Some countries went beyond the minimum standards agreed, by providing far-reaching accounts of the evolution of important expenditure items in the longer run.

However, a few formal shortcomings were also identified during the discussions held by the Economic and Financial Committee. Four programmes did not extend the planning horizon beyond 2001, thus failing to provide valuable information on the end of the time span recommended by the guidelines. While generally deemed realistic, external and domestic macroeconomic assumptions were sometimes found to be either outdated or even slightly optimistic in view of the uncertainties surrounding medium-term economic forecasting. Great determination with regard to the policy action needed to achieve the targets was often affirmed, but this was not always substantiated in detailed sets of measures. Nor was it always possible to clearly discern trend or planned developments in the primary budgetary components. In addition, given that government investment in most countries was subject to a disproportionate adjustment in the years up to 1997, it was felt that more attention should probably be given to this expenditure component in future updates of the programmes. Finally, in a few instances the Economic and Financial Committee lamented recourse to highly aggregated projections or an outright lack of evidence on key economic variables as clouding the transparency of the underlying scenarios. In some cases, the scant information provided – and the absence of sound indications as to the sensitivity of the official targets to changes in macroeconomic assumptions – were seen as preventing a fully grounded judgement within the context of the mutual surveillance exercise.

3.3. The notion of a budgetary position close to balance

In addition to the criteria for formal compliance outlined above, a comprehensive judgement on individual countries' programmes needs to be supported by more substantive considerations. The question arose as to whether the pace of deficit reduction envisaged in the programmes could be considered adequate to place the countries on the sound footing recommended by the Stability and

Growth Pact. In general terms, this issue can be considered from at least three angles.

- First, one aspect which can be explored is whether the targets set by the member states not yet in compliance with the rules of the Stability and Growth Pact are consistent with the requirement to avoid excessive deficits in the face of normal cyclical fluctuations. As already highlighted above, a country could be considered to have reached a position sufficiently “close to balance” provided that its economic structure is comfortably resistant to macroeconomic shocks or that its fiscal structure is relatively non-reactive to cyclical swings.
- Second, the time span chosen for the completion of the process of fiscal consolidation can also be questioned. In particular, it should be clear whether the time profiles indicated by the programmes for achieving full compliance with the deficit objectives conform to the Opinion of the former Monetary Committee, as endorsed by the ECOFIN Council, which requested that the programmes “should show the medium-term objective of the Stability and Growth Pact as being achieved as quickly as possible”.
- Third, there is the question of whether current plans build into budgets sufficient room for manoeuvre to enable countries to withstand events not necessarily related to the cyclical position of the economy without contravening the Stability and Growth Pact. Unforeseen shocks to interest rates, for instance, and expected demographic developments can greatly impinge on budgetary positions and divert countries from previously prepared plans. Both sources of disturbance can be totally unrelated to short-term macroeconomic developments. In this connection, the former Monetary Committee acknowledged the need to ensure a rapid decline in high debt ratios and to cater for the costs associated with population ageing as considerations of major importance in setting the appropriate medium-term objectives in line with the requirements of the Stability and Growth Pact.

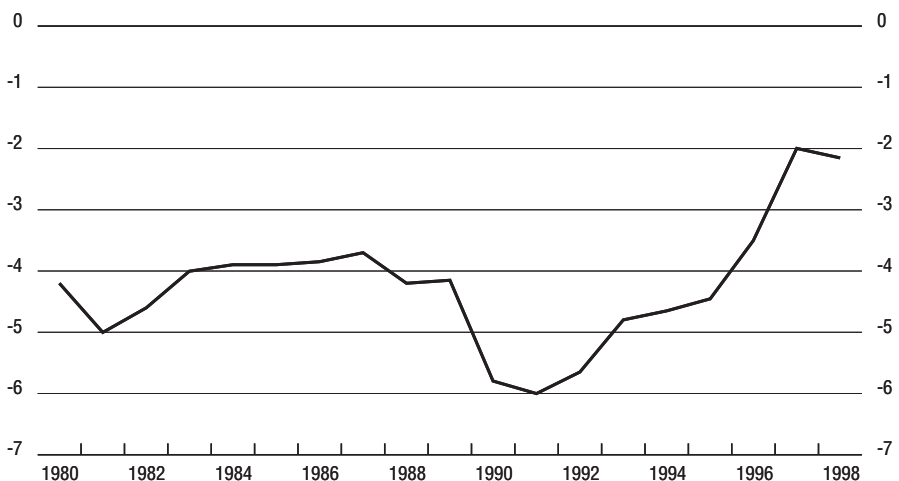
The European Commission observed its mandate to assess the adequacy of member states' programmes, taking due account of national differences and diverse starting conditions. On the basis of the European Commission's recommendations, the ECOFIN Council judged that budgetary strategies, as detailed in the programmes, were in broad compliance with the requirement to bring public finances to positions that are sufficiently resistant to the budgetary effects of normal economic fluctuations. In this sense, the ECOFIN Council considered that countries are currently moving towards the medium-term objective recommended by the Pact. In some cases, however, the ECOFIN Council called for more ambitious budgetary targets, and it advised certain countries to

continue their consolidation efforts beyond the horizon covered in order to be in a position to cope adequately with the consequences of population ageing. For high debt countries, in particular, it stressed the importance of maintaining high primary surpluses in order to reduce government debt ratios.

4. Assessment of the implementation of the budgetary rules of the Treaty and the Stability and Growth Pact

Fiscal performance in the very recent past and budgetary plans for the near future need to be set in the context of the considerable adjustments made since the beginning of the decade. Following the sharp deterioration in underlying fiscal positions that accompanied the cyclical upswing of the late 1980s, countries in the EU embarked on a large-scale turnaround in budgetary policy which marked an improvement in structural fiscal positions of almost four percentage points of GDP over the five years from 1992. Prospective participants in EMU, in particular, found in the Treaty's framework for sound macroeconomic conduct a decisive impulse towards fiscal consolidation (see Figure 3). Some of these countries, by decidedly embracing the stability culture imposed by the Treaty, were able to prevent impending confidence crises from developing into fully-fledged financial turmoil of unpredictable dimensions.

Figure 3. **Cyclically adjusted budget balance in the Euro area**
(as a percentage of GDP)



The trend towards fiscal discipline accelerated after the hiatus in 1995. In the 11 member states that adopted the single currency on 1 January 1999 the uncompromising remit to meet the qualifying criteria for participation in EMU from its outset imposed the adoption of fiscal measures of an unprecedented scale. In some countries the magnitude of the required adjustment suggested that recourse to *ad hoc* provisions with a limited political backlash would be necessary as a useful complement to more substantive and lasting interventions. Government investment cutbacks and adjustments of a temporary nature were thus implemented on the understanding that, after the start of Stage 3 of EMU, a more favourable economic environment would permit a prompt replacement of temporary corrections with sustainable and definitive improvements in the underlying positions.

Nineteen-ninety-eight offered a unique opportunity to fulfil this promise. Economic activity was robust in a large proportion of the EU, to an extent that had not been observed since the beginning of the 1990s. A rapid convergence towards the new key interest rate decided in December for the Euro area brought substantial cuts in the cost of servicing short-term liabilities for many member states, at a time when vanishing exchange rate risks were driving long-term interest rate differentials to historical lows. This favourable scenario could have assisted governments in bringing to fruition those tasks which had yet to be completed.

However, the opportunity was largely forgone. Only six EU countries (Denmark, Ireland, Luxembourg, Finland, Sweden and the United Kingdom) literally fulfilled, on the basis of 1998 accounts, the Stability and Growth Pact requirement of a budget close to balance or in surplus. It is remarkable that only three of the six countries mentioned (Ireland, Luxembourg and Finland) figure among the member states already participating in the Euro area. All the remaining EU member states were still relatively far from the targets that they had indicated in their programmes. Of those countries now participating in Stage 3 of EMU, five (Germany, France, Italy, Austria and Portugal) recorded deficits of 2% of GDP or more. The two largest (Germany and France), while both operating close to potential output, posted imbalances not sufficiently far from the value of 3% of GDP set as a reference for deficits at the trough of an economic downturn.

The envisaged strategy for the future provides inadequate reassurance. Plans generally confirm countries' resolve to continue along the path of fiscal prudence seen in the recent past. Indeed, the determination expressed by some to earmark tax windfalls from unexpected spurts of growth for further debt reduction should, in some cases, insure against the historical proclivity to loosen the fiscal stance in prosperous times. Nonetheless, the scant safety margins built into budgets so far and the time profile of the adjustment envisaged do not augur well for the capability of public finances in the Euro area to withstand a serious turnaround in economic prospects.

Only the stability programmes of Belgium and Spain, of those presented by the member states not yet in line with the norms of the Stability and Growth Pact, explicitly incorporate balanced accounts by the end of the period covered (see Table 1). The remaining Euro area countries (Germany, France, Italy, the Netherlands, Austria and Portugal) implicitly consider a net borrowing of around 1% of GDP by 2001 or 2002 as the conclusion of their consolidation efforts. The three larger economies aim for a primary adjustment, between 1998 and 2001 or 2002, falling short of one percentage point of GDP on average. Two other countries expect their primary surpluses either to virtually stabilise at current levels (Austria) or even to decline (the Netherlands).

While broadly – sometimes only vaguely – respecting minimum benchmark positions that would allow them to absorb normal fluctuations without breaching the Treaty's reference value for deficits, countries have been regrettably unambitious. The prevailing minimalist approach to fiscal stability is not satisfactory for a number of reasons.

First, it seems to reflect the concept of a trade-off between consolidation and structural reform. Some programmes build on the notion that the structure of the adjustment should be regarded as a priority, the magnitude of the necessary correction being less important. This stance is not warranted. Focusing policy plans, to an extent unprecedented in the recent past, on tax reductions rather than tax increases is certainly critical for the compensation of efficiency losses that have been accumulated through decades of unrelenting growth in the size of governments. In addition, the aim expressed by countries with mature welfare systems to rebalance government expenditure away from current transfers and in favour of public investment can be an instrument to revitalise the growth potential of their economies. However, deficit correction is an indispensable part of the same policy of structural reform. Those countries within the EU which have been front runners in redressing fiscal imbalances, while at the same time implementing wide-ranging structural measures, give the lie to the idea that the two policy lines should be seen as alternative options. They should rather be pursued as complementary and mutually reinforcing aspects of the same strategy.

Second, governments in a large proportion of the EU member states have no substantial policies to reduce cyclically adjusted deficits. The deficit correction targeted entails very limited discretionary action and will only be brought about if growth is maintained in a context of financial stability. In the most optimistic scenario, at the beginning of the next century a number of important countries in the EU will be brought to a position from which it will be barely possible for them to withstand normal macroeconomic fluctuations without some risk of breaching the reference value for deficits. No additional scope will be available in their accounts to counteract shocks originating in the financial markets or to respond to unforeseeable events. EMU itself could add to the latter strains. Heightened tax bases

Table 1. **Macroeconomic assumptions and fiscal targets contained in member states' stability and convergence programmes**

	Real GDP growth				Government balance ratio (% of GDP)				Debt ratio (% of GDP)			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Belgium	2.4	2.3	2.3	2.3	-1.3	-1.0	-0.7	-0.3	114.5	112.2	109.6	106.8
Denmark	1.7	2.0	2.0	–	2.5	2.8	2.6	–	56	51	49	–
Germany	2		2½		-2	-2	-1½	-1	61	61	60½	59½
Greece	3.7	3.9	4.5	–	-2.1	-1.7	-0.8	–	105.8	102.5	99.8	–
Spain	3.8		3.3		-1.6	-1.0	-0.4	0.1	66.4	64.3	61.9	59.3
France	2.7		3.0		-2.3			-0.8	58.7			57.1
Ireland	6.7	6.4	5.8	–	1.7	1.4	1.6	–	52	47	43	–
Italy	2.5	2.8	2.9	–	-2.0	-1.5	-1.0	–	114.6	110.9	107.0	–
Luxembourg	3.4		3.7		1.1	1.2	1.3	1.7	– ¹	– ¹	– ¹	– ¹
Netherlands	2.9		2¼ (1999-2002)		-1.3	–	–	-1.1	66.4	–	–	64½
Austria	2.8	2.6	2.1	2.2	-2.0	-1.7	-1.5	-1.4	63.5	62.2	61.2	60.0
Portugal	3.5	3.5	3.2	3.3	-2.0	-1.5	-1.2	-0.8	56.8	55.8	54.7	53.2
Finland	4.0	2.7	2.6	2.6	2.4	2.2	2.1	2.3	48.5	46.4	44.8	43.2
Sweden	2.2	2.6	2.5	–	0.3	1.6	2.5	–	71.4	66.7	58.0	–
United Kingdom ²	1	2½	2¾	2½	-0.3	-0.3	-0.1	0.2	46.7	45.4	43.7	42.0

1. According to Luxembourg's stability programme, general government debt, which in total represented 6.7% of GDP in 1998, will not increase in the forecasting period.

2. Presented on a financial-year basis.

Source: European Central Bank.

and factor mobility within the Euro area could undermine the taxation-related power of those member states imposing larger tax burdens on the gross return from labour and capital services. This will not fail to erode the revenue assumptions on which budgetary plans are currently based. Prospective reductions in the transfer of EU structural funds to countries that are currently net recipients could lead to the same shortfalls in trend receipts. Some countries could also find themselves in need of additional budgetary freedom to provide for an active fiscal policy, as a substitute for the lost exchange rate lever, in order to be in a position to deal with asymmetric shocks. Early budgetary provision against all these contingencies could avoid possibly disruptive measures that would need to be engineered at a later date, when the risks may finally materialise.

Third, planned measures are generally postponed towards the end of the forecasting horizon. The tendency to backload convergence to the target adds political uncertainty – with regard to the priorities of the governments which will be in power two or three years hence – to the risks already implicit in the underlying scenarios. Thus, stepping up the pace of adjustment would have removed at least one source of risk.

Finally, and perhaps most importantly, very little has been done to prepare budgets for the strains that are expected to emerge after the middle of the next decade. It has been calculated that demographic transition will add some seven percentage points of GDP to pension and health expenditure in the Euro area by the end of the third decade of the next century. Recent studies have estimated the scale of the immediate fiscal correction that would be needed in Europe both to absorb the cumulative impact of these implicit commitments and to keep the debt ratios from rising. With minor exceptions, if countries were to observe this additional prudential margin, they would have to move from their current positions to balanced accounts immediately. Some of them would have to do more.

Early provision for the budgetary impact of these extraordinary developments has at least two aspects. One is, of course, to aim for an accelerated improvement in the net liability positions of governments in order to provide scope to deal with spending pressures when these finally intensify. Strict compliance with the letter of the Stability and Growth Pact norm of at least balancing the accounts over the medium-term (*i.e.* over the length of the business cycle, as interpreted by the former Monetary Committee, see Annex 7) would accelerate the decline in public liabilities as a fraction of output. This is calculated to free a significant amount of resources in debt servicing costs, which could usefully be directed towards partial financing of the growing spending exigencies. The second aspect, an early and thorough reform of benefit programmes, would make provision for the remaining portion of the anticipated increase in transfers to the elderly.

5. Concluding remarks

Progress towards fiscal consolidation has been made in the EU in the recent past. Government deficits, a constant drain on private savings and a net subtraction from productive resources, have been cut. Debt burdens, while still sizeable, have been diverted from previously ever-increasing trajectories.

The code of conduct on fiscal policy, to which governments anchored their policies when signing the Treaty and adopting the Stability and Growth Pact, is a useful instrument to safeguard sound government finances in the new policy regime. The stability and convergence programmes presented between late 1998 and early 1999 have reasserted political commitment to the continuation of the policies pursued in the recent past. Governments appear determined to ensure that fiscal retrenchment is durable, by compensating for past one-off measures the beneficial effects of which, in terms of curbing deficits, diminish over time. It is also reassuring that the targets previously set for 1999 have been reaffirmed in the notification submitted by member states to the European Commission.

Fiscal consolidation is, however, an ongoing progress that requires additional input. The prevailing attitude towards the scale and timing of consolidation is to aim for the least ambitious targets consistent with formal compliance with the Stability and Growth Pact. Some countries have prepared their programmes on the basis of predictions of a relatively favourable macroeconomic and financial environment that could, *ex post*, prove to be over-optimistic. In addition, while determined to overhaul their economic structures in a commendable way, some countries seem to believe that attempts to address structural issues could, at times, justify a more relaxed timetable for completing consolidation. This attitude is not warranted in the light of the most recent experience of those member states that have taken the lead in redressing both fiscal imbalances and long-standing structural problems.

In the event of a sudden worsening of domestic and international prospects, it is not totally clear precisely what the policy response is intended to be. It is also unclear as to whether, under such circumstances, the established horizon for full convergence with the target would be observed or whether it would be allowed to slide forward. These uncertainties are aggravated by the diffuse practice of back-loading the envisaged adjustment, whereby action is postponed until the more distant and thus more uncertain future. A lack of early provisions against adversities can leave fiscal structures vulnerable to sudden reversals of macroeconomic conditions. Lack of ambition, more generally, is bound to leave government finances in a number of countries unprepared to face the more fundamental challenges that lie ahead.

Sound fiscal policies and low tax burdens not only tend to contribute to lower long-term real interest rates, reduced uncertainty and increased private capital

formation, but thereby also to higher real growth and employment in the medium-term. They also facilitate the task of monetary policy to maintain price stability. The maintenance of price stability over the medium-term is the best contribution that monetary policy can make to improved growth and employment prospects in the long-run. This is the case regardless of fiscal developments. However, unsound fiscal policies tend to increase inflation expectations and force monetary policy to keep short-term rates relatively high, thereby reducing the net benefits associated with price stability.

Annexes

**1. The co-ordination of economic policies in Stage Three of EMU
(excepts from the Treaty) Annexes**

Article 98 (ex Article 102a)

Member states shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in Article 2, and in the context of the broad guidelines referred to in Article 99 (2). The member states and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4.

Article 99 (ex Article 103)

1. Member states shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council, in accordance with the provisions of Article 98.
2. The Council shall, acting by a qualified majority on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the member states and of the Community, and shall report its findings to the European Council.

The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the member states and of the Community.

On the basis of this conclusion, the Council shall, acting by a qualified majority, adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

3. In order to ensure closer co-ordination of economic policies and sustained convergence of the economic performances of the member states, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the member states and in the Community as well as the consistency of economic policies with the broad guidelines referred to in Paragraph 2, and regularly carry out an overall assessment.

For the purpose of this multilateral surveillance, member states shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.

4. Where it is established, under the procedure referred to in Paragraph 3, that the economic policies of a member state are not consistent with the broad guidelines referred to in Paragraph 2 or that they risk jeopardising the proper functioning of eco-

conomic and monetary union, the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the member state concerned. The Council may, acting by a qualified majority on a proposal from the Commission, decide to make its recommendations public.

The President of the Council and the Commission shall report to the European Parliament on the results of the multilateral surveillance. The President of the Council may be invited to appear before the competent committee of the European Parliament if the Council has made its recommendations public.

5. The Council, acting in accordance with the procedure referred to in Article 252, may adopt detailed rules for the multilateral surveillance procedure referred to in Paragraphs 3 and 4 of this Article.

Article 100 (ex Article 103a)

1. Without prejudice to any other procedures provided for in this Treaty, the Council may, acting unanimously on a proposal from the Commission, decide upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products.
2. Where a member state is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, the Council may, acting unanimously on a proposal from the Commission, grant, under certain conditions, Community financial assistance to the member state concerned. Where the severe difficulties are caused by natural disasters, the Council shall act by qualified majority. The President of the Council shall inform the European Parliament of the decision taken.

2. Restrictions on the financing of the public sector (excerpts from the Treaty)

Article 101 (ex Article 104)

1. Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the member states (hereinafter referred to as "national central banks") in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.
2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the ECB as private credit institutions.

Article 102 (ex Article 104a)

1. Any measure, not based on prudential considerations, establishing privileged access by Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states to financial institutions, shall be prohibited.
2. The Council, acting in accordance with the procedure referred to in Article 252, shall, before 1 January 1994, specify definitions for the application of the prohibition referred to in Paragraph 1.

Article 103 (ex Article 104b)

1. The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any member state, without prejudice to mutual financial guarantees for the joint execution of a specific project. A member state shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another member state, without prejudice to mutual financial guarantees for the joint execution of a specific project.
2. If necessary, the Council, acting in accordance with the procedure referred to in Article 252, may specify definitions for the application of the prohibition referred to in Article 101 and in this Article.

3. Budgetary discipline rules and the excessive deficit procedure [excepts from the Treaty, Article 104 (ex Article 104c) and the annexed Protocol (No. 5)]

Article 104 (ex Article 104c)

1. Member states shall avoid excessive government deficits.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the member states with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:
 - a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
 - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
 - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
 - b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

3. If a member state does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the member state.

The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a member state.

4. The Committee provided for in Article 114 shall formulate an opinion on the report of the Commission.
5. If the Commission considers that an excessive deficit in a member state exists or may occur, the Commission shall address an opinion to the Council.

6. The Council shall, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the member state concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.
7. Where the existence of an excessive deficit is decided according to Paragraph 6, the Council shall make recommendations to the member state concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of Paragraph 8, these recommendations shall not be made public.
8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.
9. If a member state persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the member state to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.

In such a case, the Council may request the member state concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that member state.
10. The rights to bring actions provided for in Articles 226 and 227 may not be exercised within the framework of Paragraphs 1 to 9 of this Article.
11. As long as a member state fails to comply with a decision taken in accordance with Paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:
 - to require the member state concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;
 - to invite the European Investment Bank to reconsider its lending policy towards the member state concerned;
 - to require the member state concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;
 - to impose fines of an appropriate size.

The President of the Council shall inform the European Parliament of the decisions taken.
12. The Council shall abrogate some or all of its decisions referred to in Paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the member state concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under Paragraph 8 has been abrogated, make a public statement that an excessive deficit in the member state concerned no longer exists.
13. When taking the decisions referred to in Paragraphs 7 to 9, 11 and 12, the Council shall act on a recommendation from the Commission by a majority of two-thirds of the votes of its members weighted in accordance with Article 205(2), excluding the votes of the representative of the member state concerned.
14. Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty.

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol.

Subject to the other provisions of this paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

Protocol (No. 5) on the excessive deficit procedure

Article 1

The reference values referred to in Article 104(2) of this Treaty are:

- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;
- 60% for the ratio of government debt to gross domestic product at market prices.

Article 2

In Article 104 of this Treaty and in this Protocol:

- government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;
- deficit means net borrowing as defined in the European System of Integrated Economic Accounts;
- investment means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;
- debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

Article 3

In order to ensure the effectiveness of the excessive deficit procedure, the governments of the member states shall be responsible under this procedure for the deficits of general government as defined in the first indent of Article 2. The member states shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty. The member states shall report their planned and actual deficits and the levels of their debt promptly and regularly to the Commission.

Article 4

The statistical data to be used for the application of this Protocol shall be provided by the Commission.

4. The commitments of member states, the European Commission and the European Council (excepts from the Resolution of the European Council of 17 June 1997)

The member states

1. commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives;
2. are invited to make public, on their own initiative, the Council recommendations made to them in accordance with Article 103(4);
3. commit themselves to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes once they receive an early warning in the form of a Council recommendation issued under Article 103(4);
4. will launch the corrective budgetary adjustments they deem necessary without delay on receiving information indicating the risk of an excessive deficit;
5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances;
6. are invited to make public, on their own initiative, recommendations made in accordance with Article 104c(7);
7. commit themselves not to invoke the benefit of Article 2 (3) of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in severe recession; in evaluating whether the economic downturn is severe, the member states will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission

1. will exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth Pact;
2. will present, without delay, the necessary reports, Opinions and recommendations to enable the Council to adopt decisions under Article 103 and Article 104c; this will facilitate the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure;
3. commits itself to prepare a report under Article 104c(3) whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the reference value of 3% of GDP, thereby triggering the procedure under Article 104c(3);
4. commits itself, in the event that the Commission considers that a deficit exceeding 3% of GDP is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council the reasons for its position;
5. commits itself, following a request from the Council under Article 109d, to make, as a rule, a recommendation for a Council decision on whether an excessive deficit exists under Article 104c(6).

The Council

1. is committed to a rigorous and timely implementation of all elements of the Stability and Growth Pact in its competence; it will take the necessary decisions under Article 103 and Article 104c as is practicable;
 2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104c(7), shall recommend that excessive deficits be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances;
 3. is invited always to impose sanctions if a participating member state fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council;
 4. is urged always to require a non-interest-bearing deposit, whenever the Council decides to impose sanctions on a participating member state in accordance with Article 104c(11);
 5. is urged always to convert a deposit into a fine after two years of the decision to impose sanctions in accordance with Article 104c(11), unless the excessive deficit has in the view of the Council been corrected;
 6. is invited always to state in writing the reasons which justify a decision not to act if at any stage of the excessive deficit or surveillance of budgetary positions procedures the Council did not act on a Commission recommendation and, in such case, to make public the votes cast by each member state.
- 5. The excessive deficit procedure in Stage Three of EMU [excepts from Council Regulation (EC) No. 1467/97 of 7 July 1997, Section 1: Definitions and Assessments]**

Article 1

1. This Regulation sets out the provisions to speed up and clarify the excessive deficit procedure, having as its objective to deter excessive general government deficits and, if they occur, to further their prompt correction.
2. For the purpose of this Regulation “participating member states” shall mean those member states which adopt the single currency in accordance with the Treaty and “non-participating member states” shall mean those which have not adopted the single currency.

Article 2

1. The excess of a government deficit over the reference value shall be considered exceptional and temporary, in accordance with Article 104c(2)(a), second indent, when resulting from an unusual event outside the control of the member state concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn.
2. In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

3. The Commission when preparing a report under Article 104c (3) shall, as a rule, consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%.
 4. The Council when deciding, according to Article 104c(6), whether an excessive deficit exists, shall in its overall assessment take into account any observations made by the member state showing that an annual fall of real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends.
- 6. The content of the stability and convergence programmes in Stage Three of EMU [excepts from Council Regulation (EC) No. 1466/97 of 7 July 1997]**

Section 1: Purpose and definitions

Article 1

This Regulation sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multi-lateral surveillance by the Council so as to prevent, at an early stage, the occurrence of excessive general government deficits and to promote the surveillance and co-ordination of economic policies.

Article 2

For the purpose of this Regulation “participating member states” shall mean those member states which adopt the single currency in accordance with the Treaty and “non-participating member states” shall mean those which have not adopted the single currency.

Section 2: Stability programmes

Article 3

1. Each participating member state shall submit to the Council and Commission information necessary for the purpose of multilateral surveillance at regular intervals under Article 103 of the Treaty in the form of a stability programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.
2. A stability programme shall present the following information:
 - a) the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio;
 - b) the main assumptions about expected economic developments and important economic variables which are relevant to the realisation of the stability programme such as government investment expenditure, real gross domestic product (GDP) growth, employment and inflation;
 - c) a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, and, in the case

of the main budgetary measures, an assessment of their quantitative effects on the budget;

d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

3. The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions referred to in Paragraph 2(a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 4

1. Stability programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually. A member state adopting the single currency at a later stage shall submit a stability programme within six months of the Council Decision on its participation in the single currency.
2. Member states shall make public their stability programmes and updated programmes.

Article 5

1. Based on assessments by the Commission and the Committee set up by Article 109c of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 103, examine whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the avoidance of an excessive deficit, whether the economic assumptions on which the programme is based are realistic and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective.

The Council shall furthermore examine whether the contents of the stability programme facilitate the closer co-ordination of economic policies and whether the economic policies of the member state concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the stability programme referred to in Paragraph 1 within at most two months of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article 109c, shall deliver an opinion on the programme. Where the Council, in accordance with Article 103, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the member state concerned to adjust its programme.
3. Updated stability programmes shall be examined by the Committee set up by Article 109c on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in accordance with the procedure set out in Paragraphs 1 and 2 of this article.

Article 6

1. As part of multilateral surveillance in accordance with Article 103(3), the Council shall monitor the implementation of stability programmes, on the basis of information provided by participating member states and of assessments by the Commission and the Committee set up by Article 109c, in particular with a view to identifying actual or

expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set in the programme for the government surplus/deficit.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address, in accordance with Article 103(4), a recommendation to the member state concerned to take the necessary adjustment measures.
3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is persisting or worsening, the Council shall, in accordance with Article 103(4), make a recommendation to the member state concerned to take prompt corrective measures and may, as provides in that Article, make its recommendation public.

**7. The format and content of the stability and convergence programmes
(Appendix to the Opinion of the former Monetary Committee on this issue,
endorsed by the ECOFIN Council and published after its 12 October 1998
meeting in Luxembourg)**

Status of guidelines

The Commission proposes that the guidelines set out in this report should be adopted as a code of good practice and checklist to be used by member states in preparing stability or convergence programmes. This will facilitate the examination and discussion of the programmes.

The Committee does not suggest that the guidelines be made obligatory, but any departure would have to be justified by the member states concerned.

Political commitment

In accordance with the provisions of Council Regulation 1466/97, the member states will submit stability or convergence programmes. It is therefore clear that the governments assume responsibility for them. Each programme might usefully indicate the extent to which it has received support at other levels, notably in the national parliament. In particular, the state of implementation of the measures presented in the programme should be indicated.

Status of data

The status of the quantitative information in the programmes should be clearly established. In order to facilitate assessment, the concepts used should be in line with the standards established at European level, notably in the context of the European System of Accounts. This information may be complemented by a presentation of specific accounting concepts that are of particular importance to the country concerned.

Content

Articles 3 and 7 set out the basic information to be covered by stability and convergence programmes.

Objectives

The programmes should present the medium-term objective for the budgetary position of close to balance or in surplus and, where appropriate, the adjustment path to it, as well as the projected path for the debt ratio [Articles 3(2a) and 7(2a)]. The time frame for interpreting the medium-term would be the length of the business cycle. The medium-term budgetary position has to take account of the possibility to deal with adverse cyclical developments whilst respecting the government deficit reference value. Obviously, other considerations are also of major importance in setting the appropriate medium-term objective which respects the requirements of the Stability and Growth Pact, such as the need to take account of other sources of variability and uncertainty in budgets, the need to ensure a rapid decline in high debt ratios and the need to cater for the costs associated to population ageing. In line with this, member states that would wish to make use of discretionary policy should make the necessary room for this.

Member states should specify and explain the factors underpinning their choice of the medium-term budgetary objectives. Where appropriate, government investment objectives might be specified. Convergence programmes shall also present the medium-term monetary policy objectives and their relationship to price and exchange rate stability.

To permit a fuller understanding of the paths of the government balance and the debt ratio and of the budgetary strategy in general, complementary information should be provided on expenditure and revenue ratios, with interest payments separately identified, and on privatisation receipts and other factors influencing the debt ratio. Obviously, the further forward the year considered, the less accurate the information will be.

The budget balances should be broken down by sub-sector of general government (central government, local authorities, social security) where this breakdown is significant.

Assumptions

The programmes should present the main assumptions about expected economic developments and important economic variables which are relevant to their realisation such as government investment expenditure, real GDP growth, employment and inflation [Articles 3(2b) and 7(2b)]. The assumptions on real GDP growth should be underpinned by an indication of the expected sources of growth. Furthermore, the programmes should provide sufficient information about GDP developments to allow an analysis of the cyclical position of the economy. Where these are particularly important to public finances, technical assumptions on interest rates should also be presented.

While there was considerable support in principle in the Committee for the use of a common set of macroeconomic projections, the practical difficulty of arriving at an agreed set of projections was acknowledged. Accordingly, the use of a common set of macroeconomic projections for all programmes is not recommended. However, the macroeconomic projections for the domestic and the world economy underlying the programmes should be clearly specified and the Commission should draw attention to any significant differences from their own projections, the member state concerned standing ready to justify its assumptions.

Reflecting the general point made above on the standardisation of quantitative information presented, inflation assumptions should be presented in terms of the GDP deflator and, if a member state considers it useful, the Harmonised Index of Consumer Prices (HICP).

Measures

The programmes should describe the budgetary and other economic policy measures being taken or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget [Articles 3(2c) and 7(2c)]. The measures should be consistent with the broad economic policy guidelines. Measures having significant “one-off” effects should be explicitly identified. Member states have committed themselves to take the corrective action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives. Structural reforms should be covered where they could contribute to the achievement of objectives of the programmes. Spill-over effects on other member states should be dealt with by the Commission in its analysis, which does not preclude the member states from dealing with these effects in their programmes. The programmes could also usefully describe changes introduced to improve expenditure control, tax collection efficiency, and so on. Where appropriate, the programmes should also indicate other possible institutional reforms especially in the budget process.

Sensitivity analysis

The programmes shall provide an analysis of how changes in the main economic assumptions would affect the budgetary and debt position [Articles 3(2d) and 7(2d)]. This analysis should be complemented by a sensitivity analysis of the impact of different interest rate assumptions on the budgetary and debt position.

Time horizon

The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions shall be on an annual basis and shall cover, as well as the current and preceding year, at least the three following years [Articles 3(3) and 7(3)]; leaving it open to member states to cover a longer period if they so wish.

Updating of programmes

Annual updates of stability and convergence programmes should show how developments have compared with the programme objectives. When substantial deviations occur, the update should include the steps to be taken to rectify the situation.

A Framework for Public Sector Performance Contracting

by

Murray Petrie*

1. Introduction

OECD Member countries have grown increasingly interested in the use of contract type arrangements in the 1990s as a means of improving public sector performance. This interest reflects a number of broad challenges to traditional governance structures. These challenges include the demand for greater efficiency through highly adaptive and flexible public sectors and the increasing pressure of accumulated public debt and fiscal deficits. "Governments must strive to do things better, with fewer resources, and, above all, differently."¹

Many countries have pursued a strategy of developing a more performance-oriented culture in the public sector. This has generally involved two closely related elements:

- an increased focus on results, in terms of efficiency, effectiveness and quality of service;
- a move from centralised bureaucratic structures, to more decentralised managerial environments.

Public sector reform has not taken an identical approach across OECD Member countries. Different institutional arrangements, histories, and political circumstances have resulted in differences in reform programmes across countries (see Premfors, 1998). While the types and emphases of reform vary across countries, in many countries there has been a general shift to more decentralised management of resources to achieve specified government objectives. This new approach has been characterised as both letting managers manage, and making them manage.

Performance contracting has emerged as a tool of public sector reform.² It can provide greater clarity over what public agencies will achieve, while at the same time provide agency managers with greater flexibility to deploy resources to

* Murray Petrie is Principal, Economics and Strategy Group, New Zealand.

better achieve those goals. In this way, performance contracting has the potential to improve the effectiveness and efficiency of the public sector, while ensuring appropriate accountability is maintained for the use of public money.

The term performance contracting covers a variety of arrangements. The desirability of contracting arrangements depends to an important extent on the nature of the activities concerned, and on the broader environment in which they take place. There are significant risks from the inappropriate use of performance contracting.

The purpose of this paper is to set out an analytical framework for performance contracting in the public sector. It assesses why and how different approaches to performance contracting are appropriate in different circumstances. This framework combines insights from institutional economics, public sector management, and public law.

The framework highlights key factors for public sector advisors and practitioners that are important in determining the precise specification of performance contracting in any particular case. Due to the broad scope of funding relationships and the diversity of circumstances across the OECD, the framework is indicative. There is no substitute for careful case-by-case analysis of the appropriate design of performance contracting arrangements.

In this paper, the terms performance contracting, and contracting, are used to describe the application of the language of contracting to a wide variety of arrangements in the public sector. These include:

- organisational performance agreements between a minister and an agency head;
- resource or budget agreements between a central agency and a budget-funded agency;
- individual performance agreements for agency heads;
- performance agreements between an agency head and a lower level line manager within the same organisation;
- a partnership-style arrangement between two independent agencies, and arrangements for the supply of goods and services between different agencies;
- an agreement or understanding between central government and a sub-national government;
- a contract between a public agency and a private or not-for-profit organisation for the supply of goods and services.

These arrangements may involve legally enforceable contracts (for example, with private suppliers of goods and services). However, where the arrangements are between different public sector entities, they generally involve quasi-contractual

arrangements, agreements or undertakings. These arrangements feature some of the elements and language of legal contracts, but there is no intention, and in many instances no possibility, of creating legally enforceable contracts.

The structure of this paper is as follows:

- Section 2 outlines an economic and legal framework for contracts. The economic functions and legality of contracts in the private sector are analysed, with insights of this analysis applied to performance contracting in the public sector.
- First the governance approach to contract is considered. This approach outlines the need to consider the interactions between the nature of performance contracting arrangements and the broader institutional environment in which they take place. Secondly, public sector contracting is analysed from a legal perspective, and problems with using the private law instrument of enforceable contract in the public sector are identified. Finally, the principal/agent approach to the design of efficient performance contracting relationships is considered.
- Section 3 applies the framework developed in Section 2 to different funding relationships and activities within the public sector.
- Section 4 presents some concluding remarks.

2. An economic and legal framework

2.1. *The governance approach to contract*

The fundamental economic function of contracts is to facilitate voluntary exchanges, thereby increasing social welfare.³ Contracts take a variety of forms. The economic function they play needs to be considered in the context of the institutional settings in which they take place. There are significant risks from the inappropriate use of performance contracting.

Economists have paid increasing attention to these issues in recent years. Transaction cost economics or the new institutional economics views contracts as both influencing and in turn being influenced by the governance arrangements within which they take place. This approach has been described as the governance approach to contract.⁴

In this section, a transaction cost approach is used to consider the different types of contract and the role they play in influencing whether transactions are organised across markets or within hierarchies. Transaction costs arise basically when it is difficult to determine the value of goods or services.

2.1.1. *Different forms of exchange*

The simplest form of exchange is a spot transaction. This is a favoured means of exchange where the identity of the other party to the exchange is not important, and the exchange is completed “on the spot.” Specific arrangements to govern the terms of the transaction do not need to be negotiated beyond “on the spot” agreements over the price and quantity, with quality apparent at point of sale. As noted by Macneil, this is a world of “sharp in by clear agreement; sharp out by clear performance”, and corresponds to economists’ idealised world of perfect competition.⁵

Most exchanges are not of the classic spot market variety. Many exchanges involve a time delay before completion of the exchange. Other exchanges involve a stream of services over time. Exchanges may also require one party to invest in assets that have a greater value in the contracted-for use than in other uses (in Williamson’s (1985) terminology these are known as “specific assets”). These elements introduce uncertainty over the performance of the initial terms of the exchange and the possibility of opportunistic behaviour by one of the parties.

In the absence of the ability to enforce compliance with agreements, many exchanges would not take place. Others may take place, but only with costly efforts by the parties to protect themselves from loss or exploitation.⁶

The use of contracts that are enforceable by an independent third party is one solution to these problems. Contracts strengthen the credibility of and commitments of parties to perform. Therefore, they facilitate the achievement of co-operative outcomes.

Contracting can have substantial costs. There are costs involved in negotiating, monitoring and enforcing contracts – termed transaction costs.⁷ From a national welfare perspective, a contractual arrangement should only be used where it delivers net benefits to the parties, that is, where it is expected to minimise production and transaction costs.⁸

Different forms of contracting are suited to different institutional settings, and involve different costs and benefits. For example:

- “classical” contract law, is a strict legal rules regime. This form of contracting is suitable for situations where the parties do not have an on-going relationship, and have little interest in reaching agreement on mutual adjustment to contract terms, should the need arise. The focus is on formal documents, and the range of remedies is fairly narrow and predictable. Disputes are typically settled in the courts; and
- where the parties to a contract have a mutual interest in an on-going relationship, contracts tend to be more of the “relational” variety. They are less specific detailing the contingencies that might arise, providing more the

“spirit” in which adjustments for unforeseen events will be negotiated.⁹ Reputation, trust and custom can play an important role in “completing” a contract, especially longer term and repeated contracts where parties have an incentive to develop a reputation for fair dealing.¹⁰

Sen (1987, pp. 83-88) has noted the instrumental role of general social norms of behaviour in achieving co-operative outcomes. More specifically, Sako (1991), in an article on the role of trust in Japanese buyer-supplier relationships, argues that trust “economises on the costs of bargaining, monitoring, insurance, and dispute settlement.” Sako identifies three forms of trust:

- contractual trust (adhering to agreements);
- competence trust (belief in the competence of the other party); and
- goodwill trust (the willingness to go beyond minimum contract fulfilment in the interests of the other party).¹¹

In relational contracting, disputes that cannot be mutually resolved as they arise are likely to be referred to arbitration rather than court, with the intention of reaching a resolution more conducive to continued relations. Relational contracts are however enforceable, and enforceability is an important part of the context in which the less formal approach to dispute resolution occurs.¹² However, there are limits to the kinds of situations relational contracting can handle effectively. For example:

- a party may gain more from defecting from a contract than co-operating and continuing the contractual relationship. This may be the case in the presence of highly specific assets, where each party is dependent on the other;
- uncertainty over contingencies that might occur, and information imbalances between parties can make contracting problematic; and
- there are frequent difficulties in specifying precisely what is to be performed, and verifying whether it was delivered, which can make it extremely difficult to write a satisfactory contract.¹³ For example, complex interdependencies between different units or functions can make it impossible to determine respective contributions to output.

2.1.2. *Vertical integration of transactions within a hierarchy*

The costs of frequent re-negotiation or dispute will, at some level, suggest the need for alternative governance arrangements. In these situations, vertical integration within a hierarchy (*e.g.* a conglomerate) can be a transaction cost economising solution. Common ownership can reduce co-ordination and control costs, in comparison to arms length contracting.¹⁴ Specifically, ownership may economise on transaction costs where:

- each party is highly dependent on the other in a long-term relationship;

- transactions are frequent and/or complex;
- measuring performance is difficult; or
- contracts need frequent changes.

Internalising a transaction reduces uncertainty and opportunism through internal command and organisational culture, rather than negotiation between different organisations.¹⁵

Internalising co-ordination and control of a transaction within a hierarchy generally imposes costs, chiefly the loss of high-powered incentives and innovative behaviour in the bureaucratic setting. Therefore, common ownership is a choice where arms-length contracting relationships prove to be especially problematic.¹⁶

Contracting within hierarchies takes the form chiefly of employment relation, which is an incomplete contract. However, Williamson (1993) argues that, from a transaction cost perspective, the implicit contract law of hierarchies is that of “forbearance”. He goes on to say:

The underlying rationale for forbearance law is twofold: 1) parties to an internal dispute have deep knowledge – both about the circumstances surrounding a dispute as well as the efficiency properties of alternative solutions – that can be communicated to the court only at great cost; and 2) permitting internal disputes to be appealed to the court would reduce the efficacy and integrity of hierarchy. If fiat were merely advisory, in that internal disputes over net receipts could be pursued in the courts, the firm would be little more than an “inside contracting” system. The application of forbearance doctrine to internal organisation means that parties to an internal exchange can work out their differences themselves or appeal unresolved disputes to the hierarchy for a decision. But this exhausts their alternatives. Since “legalistic” arguments fail, greater reliance on instrumental reasoning results.¹⁷

In addition to internalising dispute resolution, there are a wide variety of control mechanisms available within a vertically integrated hierarchy. One of these is the role of organisational culture in developing a climate of trust, and limiting the more aggressive and opportunistic bargaining associated with arms-length contracting. Ouichi (1980) has noted that employee socialisation in Japanese firms is associated with the use of non-performance related criteria (such as length of service) that are relatively inexpensive to determine. The degree of employee identification with the company's goals reduces the need to verify employees' performance explicitly through the use of performance measures.¹⁸

Organisational culture can be a particularly important means of influencing performance where performance is very hard to measure (for example in many public sector activities).¹⁹ Compared to a purchaser under a contract, a hierarchy has easy access to the information required to monitor and evaluate performance. Further, there is a wide-range of rewards and sanctions that can be imposed within a hierarchy once a transaction is internalised that are not accessible to a purchaser.

These rewards and sanctions include the subtle use of employment, promotion, remuneration, and internal resource allocation processes.²⁰

2.1.3. *Conclusions*

A transaction cost perspective of contract suggests that different forms of contracting have different attributes and costs, and are suited to different institutional settings. Indeed, the role of and limits to contracting is a critical determinant of whether transactions are performed in an arms-length contracting arrangement or internally within hierarchies. Transaction costs can be minimised by assigning transactions (which differ in their attributes) to governance structures (which differ in their incentive and adaptive attributes) in a discriminating way.²¹

In terms of contracting arrangements in the public sector, the analysis suggests two key points:

- contracting between public sector entities in the form of enforceable contracts would generally be inefficient. Allowing recourse to an independent third party to resolve disputes is likely to involve high transaction costs, and to reduce the effectiveness of the co-ordination and control possibilities of joint ownership; and
- to the extent private sector contracting provides an appropriate analogy for the public sector, it is relational contracting, rather than a strict legal rules approach, that should be used as the model. Relational contracting is a feature where relationships are long-term. There are fewer attempts to set out in advance all the contingencies that might arise, and the relationship is based as much on trust and co-operation as on reliance on legal rules.

2.2. *Public sector contracting from a legal perspective*

The conclusion from a transaction cost analysis, that enforceable contracts will in general be undesirable in the public sector, is reinforced from a practical legal perspective. Many public sector agencies are not separate legal entities distinct from a minister or ministry, and therefore cannot enter into enforceable contracts with these parties. In some instances, public sector agencies are unable to enter into legally enforceable contracts with a government ministry or department, even though the agency may be a separate legal entity.²² Therefore, in most situations the relevant question is purely one of what form of quasi-contractual arrangement is most suitable in any particular case – a question that is explored in detail in Section 3.

An important general feature of public sector design, however, is the organisation of agencies into different institutional types, depending on their nature and purpose. Some agencies, such as core government ministries or departments, are

in a direct hierarchical relationship with a minister. Others, such as specialised or executive agencies, subordinate bodies or public enterprises, have varying degrees of independence from ministers and departments, and may be separate legal entities. Some of these are accountable in the first instance to their own Boards, rather than directly to a minister.²³

The existence of separate legal entities within the public sector makes it theoretically possible to implement performance contracting with these entities through enforceable contracts.²⁴ The remainder of this section will consider the legal implications of enforceable contracts within the public sector.

2.2.1. A legal perspective on enforceable contracts in the public sector²⁵

The private law instrument of contract creates specific rights and obligations on the parties to the contract. They generally take place in circumstances where the parties are in an arms-length relationship, enjoy freedom over whether or not to contract, and are able to choose between alternative contracting parties in a market. While the specific approach adopted by different legal systems varies greatly, there are generally three preconditions to a legally enforceable contract. These are contractual intention, offer, and acceptance.²⁶ Typically, if the terms of the contract are breached, a party can be sued for specific performance or damages.²⁷ A breach of contract could also result in the relationship being terminated.

As noted earlier, legally enforceable contracts between a purchaser and a supplier are often an efficient means of facilitating exchange. They strengthen the credibility of promises to supply, and to pay on delivery. They also tend to result in greater clarity over what is to be supplied, over the accountability of the respective parties, and over the consequences of non-performance.

However, in considering the potential application of contract law to the relationship between different entities within the public sector a number of issues are immediately apparent.

First, contractual intention refers to the desire of the parties to create binding obligations, which if breached can be the subject of legal action. The political reality is that governments generally do not intend that public sector agencies should be able to legally challenge them in court should a contractual dispute arise. Litigation between the government and an entity it owns would be a highly visible breakdown. There is also a difficulty in applying the private law instrument of contract to a situation where one contracting party, the government, has the ready ability to change the law through securing the agreement of the legislature.

For the government's part, the fact that it owns the other party means it is highly unlikely to sue for specific performance or damages, or to terminate the relationship and select an alternative provider. This is particularly the case where there is no other provider, and the outputs are necessary to fulfil the government's

obligations, such as providing compulsory education or access to justice. This illustrates the bilateral dependence between the government and some public sector entities, with ownership being the existing (although not necessarily the best) solution. More generally, because the government as owner has access to other forms of control, and the ability to vary the level of funding from year-to-year, it is highly unlikely to utilise the remedies available under enforceable contracts.

Secondly, the requirement for contractual agreement is problematic when applied to the public sector. It is generally difficult to characterise the funding the government determines appropriate for an agency as “an offer”. Sometimes there is only one provider of those outputs. In other areas the government may have created an agency as a monopoly funder or purchaser. While there will often be negotiation and haggling over the funding levels and terms, there is no real sense in which the government expects at the end of the day that its “offer” will be turned down outright.

The concept of contractual acceptance is even more difficult. Public agencies may be created under their own statute, and have a statutory duty to provide the particular services sought.²⁸ Further, there may be no way an agency has the ability to decline an offer or make a counter-offer. They must accept the funds provided, or find themselves unable to provide the services for which they were established.

An enforceable contract also requires sufficient certainty and completeness, which may raise the following difficulties:

- contractual certainty may be hard to achieve without encroaching on the independence of some agencies, for example those exercising quasi-judicial functions; and
- a contract prescriptive enough to ensure contractual certainty may result in breaching the principle in common law countries that the exercise of statutory discretion cannot be hindered by contract. For example, a public agency could face a legal challenge if a contract with the government failed to provide adequate funding for it to carry out its statutory duties.

As stated, legal considerations reinforce the conclusion from transaction cost analysis that a legalistic approach to contracting in the public sector would generally not be effective or efficient. However, enforceable contracts may be appropriate for some circumstances in the public sector. These circumstances are considered in Section 3.

2.3. *The principal/agent approach to contract*

While enforceable contracts are generally undesirable where government owns the supplier, there is clearly still scope for the government as funder to use other instruments to align incentives between parties. In any situation where an

owner is funding the supply of outputs from entities it owns it should be concerned with *ex ante* incentive alignment.²⁹ That is, it will want to ensure beforehand that the funding arrangements are such that it can expect to receive the services it wants, rather than just relying on its ability to order compliance with its requirements after the contract is in place. *The owner's objective should be to maximise the advantages of delegation of control, net of agency costs, through a combination of ex ante incentive alignment and ex post governance.* More specifically, for a given institutional setting, the efficient solution is to apply the form of contracting most appropriate to the attributes of the institution and the nature of the transactions in question. It is to the *ex ante* specification of performance that we now turn.

For a given institutional setting, the economic approach to the design of contracts focuses on the importance of *ex ante* incentive alignment between the principal and an agent employed by the principal to complete a particular task. Some agents are assumed to act opportunistically on occasions, and principals are unable to determine *ex ante* whether they will or not. Opportunism ranges from simply lacking motivation to pursue the interests of the principal, through various forms of actively promoting the agent's interests at the expense of the principal's, and at the limit potentially including dishonesty and fraud.

It should be repeated that the concept of contract here is much broader than contracts enforceable at law. It includes all types of relationships where agreement is reached between two parties for the provision of a good or service.

Principal/agent theory applied to the public sector generally views the government as a series of agency relationships,³⁰ namely:

- between electors and the legislature;
- between the legislature and the executive;
- within the executive, between the Prime Minister or President and the members of Cabinet;
- between ministers and ministries or departments, state-owned commercial enterprises and semi-independent public agencies; and
- between the Chief Executive Officer and his or her subordinate staff within individual agencies.

Agency theory analyses the "contracts" between these parties, both explicit and implied. The behavioural assumptions are those of public choice theory, where politicians are primarily interested in maximising their prospects of re-election, and bureaucrats are primarily interested in maximising the enjoyment of the benefits of public office (for example, prestige and influence). The focus is on information asymmetry: agents have much more information on their actual performance, and their real objectives and motivation, which create potential moral hazard and adverse selection problems.³¹ Principals face costs in trying to obtain information

required to monitor the agent's performance, and try to economise on these through designing efficient monitoring and incentive structures.

2.3.1. *Principles for design of principal/agent relationships*

Agency theory suggests a number of general principles for designing efficient and effective principal/agent relationships. The theory can accommodate very different political philosophies and priorities; it is a tool for achieving varying ends, independent of the ends themselves. Efficient design principles include:

- clear definition of the roles and accountability of the parties;
- the avoidance of conflicts between different roles, as for example when a single agency acts both as a regulator and a supplier of outputs;
- the avoidance of multiple principals, where it is unclear whose interests the agent should be pursuing, and therefore where it can be very difficult to hold an agent accountable for results;
- clear *ex ante* specification of the goods or services to be delivered, including the performance standards expected, to provide the basis for *ex post* accountability;
- methods of specifically aligning the incentives of the agent *ex ante* with those of the principal, through prior agreement to, or understanding of, the consequences that will flow from superior or inferior performance;³²
- delegating authority over the use of inputs to agents, and holding them accountable for outputs, or outcomes where feasible,³³ and monitoring of performance.

2.3.2. *Limitations of principal/agent framework in the public sector*

There are limitations on the use of principal/agent solutions as means of reducing agency costs in the public sector. For example:

- the absence of profit as a measure of performance can mean that measuring performance is difficult and there is less ability to tie compensation closely to performance;
- for many public sector activities there is a complex relationship between outputs and outcomes. Neither the outputs nor the outcomes may be readily observable. Many of the factors influencing outcomes are beyond an agency's control and/or are not well understood. The difficulties in specifying and measuring performance are precisely why many of these activities are conducted in the public sector;
- there are weaker incentives on principals to monitor performance because of the absence of residual claims (*i.e.* profits);³⁴

- when individual politicians are the principal they may focus their monitoring of an agency on aspects of performance that impact most on their own interests (for example, re-election); and
- there are often problems of multiple principals in the public sector, and multiple and conflicting objectives for a single agency. This can result in an agency being potentially pulled in different directions by competing stakeholders, or having different principals for different aspects of its operations.³⁵

Further, viewing the relationship between a minister and a public sector agency as a simple principal/agent relationship is not always appropriate, and in some instances may be highly inappropriate. There are a number of reasons for this:

- as noted earlier, the legislation establishing a public agency may set out some of its functions and the manner in which should be carried out. In this sense the legislature has chosen to place limitations on the decision rights allocated to ministers, and to make some public sector agencies accountable directly to the legislature for the conduct of some of their functions. Agencies have more than one principal, and this may be a deliberate attempt to build checks and balances into the system, restricting the ability of the government of the day to direct or “contract” for the performance it desires;
- where a public sector agency is involved in the exercise of judicial functions, performance contracts may in some instances cut across the doctrine, often enshrined at the constitutional level, of the separation of powers between the executive, legislative and judicial branches of government;
- there may be important conventions covering the manner in which department heads carry out their functions – for example a duty to provide the government with free and frank advice – that override or constrain the ability of an individual minister to contract for performance. One effect of such a convention might be to limit the politicisation of the public service, or the arbitrary intrusion of political considerations into particular decisions, that might otherwise occur; and
- aside from the ultimate principal and the ultimate agent, each person in the hierarchy acts as both a principal and an agent. This creates the possibility, for example, that the Prime Minister or President may intervene in the relationship between a minister and a department in the collective interests of the government.

A further problem in a simple principal/agent approach arises in agreements between the central government and subnational governments. There are a variety and complexity of intergovernmental relations in OECD Member countries, from unitary states through to various forms of federalism. In many countries, it is

highly inappropriate to view the intergovernmental relationship as a principal/agent relationship. Subnational governments are often vested with certain independent powers and responsibilities, and in some countries these are set down in the constitution. Nevertheless, the typical existence of a vertical imbalance between revenue capacities and expenditure responsibilities means that significant transfers from the central government are a feature of inter-governmental fiscal relations in most countries.³⁶ The issue arises as to what conditions should be attached to these transfers.

The two main types of intergovernmental transfer in use in OECD Member countries are untied block grants, and various types of specific grants, with the former becoming more common.³⁷ Specific grants include matching grants, designed to influence behaviour by sub-national governments, and arrangements with lower levels of government for the delivery of services for which the central government has responsibility, or where responsibility is shared.

The economic rationale for untied block grants is the comparative advantage subnational governments have in information about local needs. There is by definition no setting of detailed *ex ante* performance expectations by central government (although there may be a need for agreed guidelines or minimum standards). Matching grants similarly rest on a framework in which there is no clear principal/agent relationship between central and sub-national governments.

Arrangements or understandings between central and subnational governments for the delivery of services raise somewhat different issues. In these circumstances it is desirable for clear expectations of performance to be set out. For activities clearly the formal responsibility of central government, the relationship is more like a principal/agent relationship. However, in the case where formal responsibility is shared, both sides may set performance expectations, and the relationship is far more in the nature of a partnership or arms-length relationship than a principal/agent relationship.

2.3.4. Conclusions

The use of performance measures within a contract-type approach in the public sector should be approached with care. A simple principal/agent framework may be highly inappropriate in certain situations, and there can be severe difficulties in specifying and measuring desired performance. Care should be taken in the use of some of the theoretically efficient contracting principles described earlier in the design of funding relationships within the public sector.

3. The appropriate specification of performance contracting arrangements

This section uses the legal and economic framework developed in the previous section to address the question: what is the appropriate degree of specifica-

tion of public sector performance contracting arrangements under different circumstances?

It is clearly not possible to devise standard contract templates. The set of variables that can impact critically on the appropriate form of contracting arrangement is simply too extensive. There is no escaping the need for careful case-by-case analysis in every instance. Such analysis must focus on:

- the nature of the goods or services being supplied;
- the type of institution and its relationship with the executive and other branches of government; and
- the broader environment in which the relationship takes place.

3.1. The influence of the broader environment for performance contracting

The broad cultural, social and legal environments are important determinants of the need for, and usefulness of, more formal contract-like approaches. Trust and social conventions also play an important role in securing commitment and performance in long-term relationships, especially where output is hard to specify and measure. The importance of these factors varies across countries and cultures, and can be expected to result in considerable variation in the optimal form of performance contracting across public sectors, just as it results in variation across countries in the types of business and governance relationships found in the private sector (as noted in Section 2).

One public sector illustration of the different influences in countries is the divergent approach to the institution of a career civil service. Countries such as France, Germany and Japan focus on instilling loyalty and motivation, and enhancing competence amongst civil servants in an effort to align their interests with those of the state. Hood (1991) has suggested there can be tensions between an approach to administrative reform based on instilling values of honesty and fairness, and one of pursuing values of economy and frugality. He sees the former approach as suggesting multiple rather than single objective organisations, and a control framework focusing on inputs or processes rather than outputs. This is very different to the prescriptions of the contractual approach to administrative design. Ouichi suggests that, in situations where employees identify highly with the goals of their organisation, but where individual performance measurement is not possible, “performance evaluation takes place instead through the kind of subtle reading of signals that is possible among intimate co-workers but which... cannot withstand the scrutiny of contractual relations”.³⁸

Leadership can be used as an alternative to a contractual approach to reducing agency costs. Casson (1991) suggests that principals can reduce agency costs through either intensive monitoring or the use of “moral rhetoric” aimed at estab-

lishing a group norm of behaviour. Wallis and Dollery develop this idea with the suggestion that agency problems can be reduced if leaders forgo a contractual approach and exercise leadership by developing a distinctive culture which transforms agents into followers who can be trusted to carry out tasks delegated to them.³⁹ From a somewhat different perspective, Mintzberg has advocated greater reliance on a “normative-control model”, especially in areas like education and health.⁴⁰

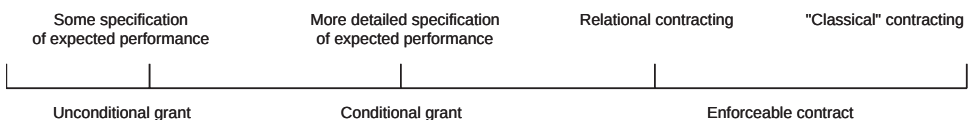
The political culture and the history of public sector institutional development will impact on efforts to introduce a greater performance orientation, that is, starting points and initial conditions matter. North (1990) stresses that those with the power in any society to implement changes are usually those who benefit from the status quo, and this greatly limits the set of feasible changes. Further, when formal “rules of the game” change significantly, actual behaviour may change much less so. The informal rules, such as social values and customs, change much more slowly. This suggests that caution should be taken in attempts to introduce new approaches to public sector management, and in particular attempts to transplant reforms from one country to another.⁴¹ Premfors (1998), in a detailed study of Swedish public sector management reforms during the last 20 years, concludes that they can be explained in terms of some basic features of Sweden’s institutional and policy heritage, rather than any general “more market” approach permeating across OECD Member countries.

3.2. Guidelines for performance contracting

With these important caveats in mind, it is nevertheless possible to provide some broad guidelines on the appropriate degree of specification of performance contracting arrangements.

In order to do so it may be useful to think in terms of a highly stylised continuum of possible performance contracting arrangements in which the government is funding the supply of goods or services – see Figure 1 below. Completely unconditional grants are at one end of the spectrum, and fully enforceable “classical” contracts at the other.⁴² As one moves along the spectrum, additional conditions are imposed on the grant recipient. These conditions create obligations

Figure 1. A stylised performance contracting continuum



on the recipient, and reciprocal obligations on the funder to provide the funding should the recipient meet the conditions. At some point it may be difficult to distinguish a highly detailed and prescriptive conditional grant from an enforceable purchase contract.⁴³

The “continuum” is not meant to imply any kind of simple linear relationship between degree of specification and enforceability. Some conditional grants may be quite detailed, while some contracts may be relatively simple. The intuition, however, is that, in general, the possibility of enforceability creates incentives to be very clear about just what the parties are committing themselves to. In addition, the terms must be sufficiently clear and certain for the agreement to be enforceable by law.

In general, it is inappropriate for governments to make completely unconditional grants, that is, a delegation of resources or authority with no conditions attached to their use.⁴⁴ It would fail to meet the usual requirement for the executive to account to the legislature for the use of tax payer's money.

At the other end of the spectrum, where government is funding the supply of goods or services from a supplier it does not own, for example, a private firm supplying IT services, an enforceable contract would seem desirable. In the absence of any ownership relationship, the government is entirely dependent on the funding relationship to ensure value for money and demonstrate accountability to the legislature for the use of public money. A full arms-length relationship would seem to be the most appropriate default funding mechanism in this situation.

However, given the wide variety of activities and types of supplier, an enforceable contract may not be desirable in every situation. For example:

- in funding the supply of social services by Non-Government Organisations (NGOs), there may be difficulties in specifying the services with sufficient certainty, and possible concerns over the impact of enforceable contracts on the motivation of those in the voluntary sector;⁴⁵ and
- an enforceable contract is not necessarily desirable where one level of government is funding the supply of goods or services by a lower level of government (see below).

For the majority of activity within the public sector, the issue is not whether to use enforceable contracts between public sector entities. Rather, the relevant issue in designing funding relationships is: what are the marginal costs and benefits (both financial and non-financial) of more detailed and prescriptive specification of performance, as one moves along the continuum from unconditional grants to highly detailed conditional grants.

3.3. *Costs and benefits of more detailed performance specification*

Drawing on the principles for efficient contract design suggested by agency theory, there are a number of potential benefits from a greater degree of performance specification. These include:

- avoiding ambiguity or uncertainty over roles, and clarifying agency accountability for the conduct of those roles. This is of benefit to both the principal and the agent. There is a risk that a high degree of delegation, in combination with poorly specified objectives or goals, could result in what James Q. Wilson has termed “mission madness”, that is, a manager charging off to implement his or her private version of some ambiguous public goal.⁴⁶ From the agent’s perspective, possible effects on their reputation in the labour market can be a powerful motivation for agency heads, creating an incentive for them to seek clarity;
- highlighting the presence of conflicting roles, and suggesting the need to reallocate roles among existing or new agencies;
- avoiding ambiguity or uncertainty over the precise nature of the services to be supplied. More precise performance measurement can create stronger incentives to perform;
- highlighting a need to assess the continuing relevance or priority of some services, for example whether they should be contracted out to the private sector, or whether they should continue to be funded at all. Similarly, specification can help to clearly signal a new or changing strategic priority;
- making it more likely performance will be effectively monitored, and pressure brought to bear where appropriate for greater effectiveness and efficiency;
- creating the confidence that resources and authority can be delegated without compromising accountability or risking ministerial responsibility;
- avoiding uncertainty over the circumstances that would justify intervention by the contract principal in the management and operation of the agency. Clear specification can reduce the scope for opportunistic or mistaken intervention by a minister, thereby strengthening ministers’ accountability to the legislature and the credibility of any commitment to operational independence. More generally, performance contracting can enable agencies to receive formal validation of their strategic initiatives by the centre. It can also result in better feedback to the centre about agency performance.

There are costs and risks in a greater degree of performance specification. These include:

- Costs involved for both parties in negotiating a more formal agreement, and in establishing systems to capture and report the information needed to assess performance. These costs are both direct and indirect. Direct costs

include the cost of specifying outputs or outcomes, costing outputs and devising performance measures, and assessing whether the outputs or outcomes have been delivered to the required quality and cost (costs may be minimised through some standardisation of performance agreements). Indirect costs include the opportunity costs of the time of ministers and the civil service.

- Loss of flexibility and adaptability in the face of unforeseen developments, due to the costs of renegotiating formal arrangements during the contract period. One important consequence may be an unwillingness of a minister to abide by the degree of delegated authority granted to an agency under a performance contract in the face of political challenge or stress. It is important that the degree of delegation and level of performance specification is politically robust.
- The risk of inappropriately restricting the freedom to manage. From an efficiency perspective, one of the main reasons for delegating decision rights is to take advantage of information advantages and specialist expertise not available to the centre. Highly detailed conditional grants may inappropriately restrict the ability of the supplier to manage his or her business.
- The possible loss of or damage to trust, and a general lowering of the quality of the relationship. Trust and a spirit of co-operation can have the effect of reducing transaction costs, and making co-ordination between the parties more effective. Trust is particularly important in long-term relationships and where output is hard to measure.
- The use of performance targets may induce counter-productive behaviour on the part of agencies, where outputs or outcomes are hard to specify *ex ante* and to measure *ex post* and where there are significant information asymmetries. For example, specifying targets for less critical but more easily measurable performance dimensions can result in dysfunctional behaviour. Agency managers can create the appearance of an improvement in performance by manipulating some indicators. Holding managers accountable for outcomes that are not sufficiently within their control is unlikely to have the desired incentive effects. Therefore, particular care is required in assessing the incentives created for agency managers by choosing a particular set of performance measures.⁴⁷ This is particularly the case where high-powered financial incentives are introduced, such as the ability to retain surpluses, or performance bonuses for management tied to achievement of pre-specified objectives. The stronger the incentives on the agency to meet performance targets, the more the contract principle will need to monitor agency performance.

- Too many performance indicators may be developed, and information not used. A contract should have a carefully designed and meaningful set of performance indicators that generates timely information useful both for internal managers and external users. In some instances (for example funding the outputs of a hospital) this may mean contracting broadly over the delivery of a capability to supply a range of outputs rather than specifying individual outputs in detail.⁴⁸
- The more formal the accountability mechanisms, the more managers will seek to define the performance expected of them in a narrow manner. This could lead to the compartmentalising of government, and a loss of focus on cross-cutting issues. Management may focus disproportionately on the efficient short-term funding level at the expense of longer term organisational capability and effectiveness issues.
- Specification of expected performance could in some instances cut across the statutory independence of some agencies, or cut across the separation of powers between the different branches or levels of government.
- A highly detailed conditional grant could be deemed by the courts in some common law countries to be, in effect, an enforceable contract.

3.4. Key general principles influencing the appropriate degree of specification

There are some general principles that can be used in determining the optimal degree of performance specification and delegation in any particular case. These include:⁴⁹

- optimal incentive-intensity in performance contracting depends on the incremental gains from additional effort by the agent, the precision with which performance can be measured, the agent's appetite for risk, and the agent's responsiveness to incentives;
- optimal risk sharing between the principal and the agent involves balancing the costs of risk sharing against the incentive gains that result;
- optimal degree of *ex ante* allocation of risks depends on the cost of allocating a risk, in comparison to the cost of allocating a loss should the risk materialise multiplied by the probability of the risk materialising; and
- optimal monitoring intensity depends on the strength of the link between performance and reward.

One crucial element is the ability to specify and measure desired performance. As noted earlier, many outputs of government are very hard to measure, which is precisely why many of them remain in the public sector. James Q Wilson has developed a matrix for assessing the appropriate approach to managing different types of public sector activities.⁵⁰ Wilson suggests that from a managerial

perspective public agencies differ from each other in two main respects, the ability of management to observe operational activities (are the outputs observable?), and the ability to observe the results of their activities (are the outcomes observable?). This gives a two by two matrix, shown in Table 1 below.

Table 1. **Wilson's managerial matrix of public sector activities**

		Outcome Observable	
		Yes	No
Outputs Observable	Yes	Production (<i>e.g.</i> payment of welfare benefits)	Procedural (<i>e.g.</i> policy advice)
	No	Craft (<i>e.g.</i> police)	Coping (<i>e.g.</i> education)

Where outputs and outcomes are both observable (for example in the processing of welfare applications or income tax returns, which Wilson labels “production organisations”), Wilson sees scope for designing a prescriptive performance management regime which will generate efficiency gains (although he warns of the danger of inducing dysfunctional behaviour). Where neither outputs nor outcomes are readily observable (for example, in education, which Wilson labels “coping organisations”) management is forced to focus efforts on recruitment and training, and the development of a culture which values performance rather than the use of formal performance indicators.⁵¹ Where either outputs or outcomes are observable, but not both, Wilson labels the organisations as procedural or craft organisations respectively. In procedural organisations the management focus is on instilling a sense of professionalism and quality processes. In craft organisations performance measurement in terms of outcomes is feasible, but management must also rely on the sense of duty and ethos of its operating staff.⁵²

Three further general factors impact on the desired level of performance specification for a particular case:

- the ability of government to influence performance through the power of the purse;
- the ability of government to influence performance through its ownership of the supplier; and
- the degree of contestability of the outputs being supplied.

In practice, a key lever government has in dealings with public agencies is the power of the purse. Non-commercial entities are generally highly dependent on the government for funding. An issue that arises is how the power of the purse should be exercised. For example, to what extent should financial penalties be a possible consequence for poor performance under a performance agreement?

There are a number of constraints on the ability of ministers and their advisers in deciding, within a funding period, that performance could warrant a financial penalty. The information demands may be severe (particularly given the complexity of the functions carried out by many public agencies) and it may be difficult to determine the quality of output. Better information about quality is available over a longer time period (just as it is, for example, in employment relationships, or for that matter, with respect to the quality of service provided directly to a minister by a government ministry or department).

In general, it may be desirable to view the annual (or the periodic) funding cycle as providing the natural opportunity for the government to decide on the funding level for outputs, and whether to vary the funding level (or the outputs). Varying funding levels from year to year is less informationally demanding of the centre and less damaging to the relationship, than within-year variations in funding.

However, there may be occasions when it is appropriate to respond to clearly identifiable non-performance of the terms of a conditional grant, by delaying funding during the financial year. For example, if an agency fails to report certain information, or uses resources for purposes outside the funding agreement, it may be appropriate to withhold further funding within the year until the failure has been remedied (or even to recover monies improperly spent).

Furthermore, the government will often own the supplier. Even where its ownership rights are constrained by an agency's statutory independence, a minister will often have the ability to exert pressure on a governing board through a variety of means. For example, the minister may have the power to issue a directive to a Board, or to withhold approval of a strategic business plan. Ultimately the minister has the ability to exercise effective influence through replacing the chairperson and other board members during or on expiry of their term.

A third factor influencing the degree of performance specification is the level of contestability of the outputs being supplied, both at the contract letting and contract renewal stages. Where there are a number of feasible suppliers, more detailed specification can assist in finding the appropriate supplier, with potential gains in productive efficiency. Where there is likely to be one feasible supplier only, for example, for the supply of a number of core government services such as foreign relations or the provision of justice, the potential efficiency gains from contestability are not available to offset the costs of establishing a more complex performance contracting system.

3.5. Use of enforceable contracts

The question remains as to whether there are circumstances where an enforceable contract between two public sector entities may be desirable. In comparison to a well-specified conditional grant, what additional benefits might be achieved by adopting an enforceable contract, assuming a contract is legally feasible?

An enforceable contract has the potential to result in:

- greater “buy in” from the agent, and therefore stronger accountability;
- less scope for ambiguity or uncertainty over exactly what is required to be delivered by each party;
- a greater likelihood that performance under the contract will be monitored; and
- a greater likelihood that conflicting roles will be highlighted, and fully contractible functions identified and contracted out to competing suppliers.

Implementing an enforceable contract, on the other hand, could impose significant additional transaction costs and risks, and may be counterproductive to the relationship. This is due to:

- substantial direct costs of lawyers and other negotiators on both sides of the contract. Legal advice is required initially to ensure all of the prerequisites are met; and, from time to time, as potential or actual disputes arise;
- risk of damage to trust and motivation, and to the quality of the relationship, as a result of adopting a legalistic, more adversarial approach to the relationship; and
- risk that formal contracts may undesirably restrict the flexibility of agencies to manage (although, as noted, this risk is also present with a highly detailed conditional grant).

An enforceable contract may be desirable where the government is funding the supply of non-commercial outputs from a state-owned commercial enterprise. This arrangement may be appropriate where the enterprise operates on a purely commercial basis, and the governance arrangements are such that the entity is directed to behave in a purely commercial manner.⁵³ The added transparency and formality of an enforceable contract might strengthen the credibility of a commitment by government not to direct public enterprises to provide non-commercial services without funding their supply.⁵⁴ This arrangement would be consistent with the manner in which the enterprise concerned conducts its business generally.

Similar reasoning suggests that state enterprises should use the arms-length commercial instrument of contract when supplying each other with commercial services. Further, where a government department is buying commercial services from a state-owned enterprise (*e.g.* electricity) there may be advantages in using

the same type of contractual basis applying to the enterprise's non-government customers.

Alternatively, an enforceable contract is undesirable for the supply of services between different government ministries or departments. The direct hierarchical relationship government generally has with ministries and departments provides relatively easy co-ordination and control possibilities compared to state-owned enterprises established under Boards of Directors. This suggests enforceable contracts would be less desirable than more informal arrangements. In any event, it may not be possible to use enforceable contracts in this situation if the ministries are not separate legal entities.

Whether a performance arrangement between a central government and a sub-national government for the delivery of a service entirely the responsibility of central government should be in the form of an enforceable contract is less obvious. The nature of the legal environment and political culture will be a crucial determinant of the appropriate approach to performance specification. In general, there is less of a problem of acceptance and agreement on the part of a sub-national government in this situation than is the case with a subordinate agency of central government. In a more arms-length relationship an enforceable contract is likely to result in some additional clarity of roles and expectations, and greater certainty of performance. However, this advantage should be balanced, against the additional transactions costs, and a potential loss of trust and co-operation (although a low level of trust at the outset may itself indicate the desirability of enforceable contract). "The challenge is to develop co-ordination and consultation mechanisms for a more comprehensive and coherent approach to target-based governance and which fit the cultural context and the 'style of relationship' in each country and sector."⁵⁵

4. Concluding remarks

The widespread interest in performance contracting has resulted from its potential to contribute to a more effective and efficient public sector. Performance contracting can establish greater clarity over what public agencies will achieve in a more decentralised management environment, while retaining the necessary accountability.

A transaction cost perspective suggests that performance contracting as a governance mechanism both influences and in turn is influenced by the broader governance arrangements within which the contract is embedded. Performance contracting must be viewed within this broader context. Indeed, the role of and limits to contracting are themselves critically important in determining whether transactions in the public sector can be more effectively undertaken across quasi-markets or controlled within a more direct hierarchical relationship.

In general, transaction cost analysis suggests that contracting between public sector entities in the form of enforceable contracts would be inefficient. Allowing recourse to an independent third party to resolve disputes is likely to involve high transaction costs, and to reduce the effectiveness of the co-ordination and control possibilities of joint ownership.

The analysis suggests that many funding relationships in the public sector should be considered as forms of informal long-term relational contracting, rather than more strictly legalistic and enforceable contractual relationships.

These conclusions are reinforced from a practical legal perspective. First, many public sector agencies are not separate legal entities. They are in a hierarchical relationship with a minister or ministry, and are not able at law to enter legally enforceable contracts with them. Secondly, even between separate legal entities, there are problems with the concepts of contractual intention, offer and acceptance in applying the private law instrument of contract to the public sector.

A key element in the design of performance contracting arrangements is the choice of the appropriate degree and form of *ex ante* performance specification, along a stylised spectrum from unconditional grant to enforceable contract. There is no simple template for deciding the optimal degree and form of specification. In particular, the optimal form will be very country-specific, reflecting the important role of social, legal and political culture, trust and the particular history of institutional development.

The nature of the transactions themselves impacts on the design of the contracting arrangements. In particular, the presence of specific assets, the complexity of the activities, the ability to specify and measure the outputs and/or outcomes, and the frequency with which the contract will need to be adapted all impact on the efficient design of the funding relationship.

In general, an enforceable contract is desirable where government is funding the supply of outputs by a non-government owned entity. In the absence of any ownership relationship, the government is entirely dependent on the funding relationship to provide the necessary clarity, certainty and accountability. However, there are exceptions to this conclusion (for example, where central government is funding the supply of outputs by a lower level government, this should not necessarily be through enforceable contract).

Legally enforceable contracts are not efficient, effective or robust for funding relationships between public sector entities except in relatively limited circumstances. Exceptions might include:

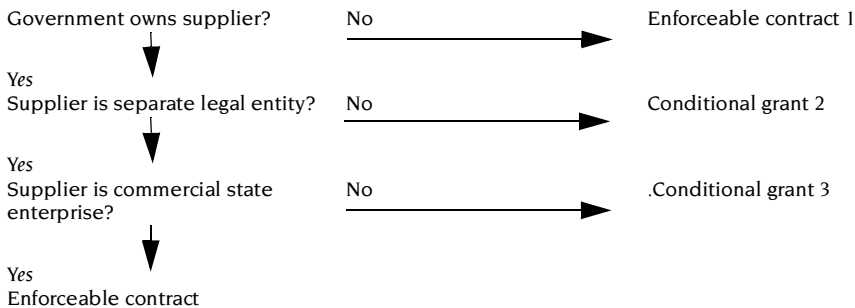
- a funding relationship with a fully commercial state enterprise for the delivery of non-commercial outputs to the government, where an arms-length contractual relationship may be appropriate;

- arrangements for the supply of commercial services between different state-owned enterprises; and
- between enterprises and government ministries or departments, and in some circumstances, arrangements between different levels of government for the supply of goods or service.

At the other end of the spectrum, a completely unconditional grant would not seem to provide the necessary assurance of accountability for the use of public funds.

Table 2 provides a stylised decision tree for choosing between a conditional grant and enforceable contract. It is meant to be suggestive rather than definitive, providing the starting point for a more detailed analysis in any particular case.

Table 2. **Conditional grant or enforceable contract?**



The bulk of public sector activity occurs at nodes two and three in Table 2. At these nodes the key issue that needs to be considered in designing funding relationships is: what are the marginal costs and benefits (financial and non-financial) of more detailed and prescriptive specification of performance, as one moves along the continuum from unconditional grants to highly detailed conditional grants.

Two factors that impact on the degree of performance specification in a particular case are the ability the government has to influence performance through the power of the purse, and through any ownership relationship it has with the agency. However, any owner funding the supply of outputs from an entity has a vital interest in *ex ante* incentive alignment, rather than sole reliance on the instruments available to owners to enforce accountability. The government's objective is to maximise the advantages of delegation of control, net of agency costs, through a combination of *ex ante* incentive alignment and *ex post* governance. Therefore, design criteria should address the following question: what is the best mix of

ex ante performance specification and use of *ex post* instruments for a particular institutional setting, and for a specific type of activity or output?

Principal/agent theory provides a number of principles for efficient *ex ante* design of the funding relationship. These include clarity of roles and responsibilities, clear specification of the outputs and/or outcomes to be delivered, delegation of authority over inputs, and effective monitoring of performance. Significant gains are achievable through the careful application of these principles. In their absence there is a serious risk of poor performance.

However, there are important constraints on the use of a simple principal/agent framework in the public sector. Designing the funding relationship in a pure principal/agent framework can cut across the statutory independence of some state agencies, and can infringe on important principles, often enshrined in constitutions, of the separation of powers, of the duties of public servants, and of the roles and responsibilities of sub-national governments.

There are also a number of costs and risks in designing appropriate performance measures. These are in addition to negotiating costs and the need to establish systems to capture and report the physical and financial information required for monitoring. Additional costs and risks include inappropriately restricting the freedom to manage, damage to trust and the quality of the relationship, and the inducement of dysfunctional behaviour. Strategic decisions over the type of performance contracting regime must take into account possible interactions with other, non-contractual approaches to reducing agency costs, such as socialisation and professional leadership.

Table 3 summarises the general factors driving the appropriate degree of specification of expected performance for conditional grants.

The choice of the precise degree and form of performance specification requires particular care. There are risks both from having too detailed or too simple a specification. There is no escaping the need for careful case-by-case analysis in every instance. This analysis should focus on:

- the nature of the goods or services being supplied;

Table 3. **Factors driving the degree of performance specification**

	Less prescriptive	More prescriptive
Difficulty of performance measurement	High	Low
Degree of statutory or constitutional independence	High	Low
Need for adaptability	High	Low
Reliance on culture/professionalism	High	Medium
Contestability	Low	Medium

- the type of institution and its relationship with the executive and other branches of government; and
- the broader cultural and legal environment in which the relationship takes place.

Used with care, performance contracting should be seen as a very important lever for improving the performance of the public sector. It is by no means, however, a silver bullet.

Notes

1. *Governance in Transition: Public Management Reforms in OECD Countries*, OECD, 1995. The quotation is from the "Conclusions of the OECD Public Management Committee", p. 7.
2. Apart from performance contracting, there is a broader range of approaches aimed at improving performance management, including benchmarking, contestability, contracting out, and mechanisms for increasing consumer voice. See OECD, (1997a).
3. This utilitarian view of contract can be contrasted with a view that sees upholding the freedom of contract as a primary task of a legal system, as part of a broader function of protecting the freedom of the individual and safeguarding his/her power. See Zweigert and Kotz, (1998), pp. 325-327.
4. See Williamson, (1985).
5. Macneil, I.R., "The Many Futures of Contracts", *Southern California Law Review*, 47, May 1974, pp. 691-816, cited in Williamson, (1985).
6. Such efforts, or safeguards, might include severance or penalty payments for early termination; the creation of specialised contract governance structures such as independent arbitration; or the creation of reciprocal business transactions so that each party is reliant to some degree on a continuing good relationship with the other (in the language of transaction cost economics, the creation of mutual hostages). More generally, Williamson describes contracts as involving choices over the three elements of technology (that is the extent of use of specific assets), safeguards/governance structures, and price. These three elements are fully interactive and determined simultaneously. "It is important to study contracting in its entirety. Both the *ex ante* terms and the manner in which the contracts are thereafter executed vary with the investment characteristics and the associated governance structures within which transactions are embedded." See Williamson, *ibid.*, pp. 34-35.
7. Ouchi (1980, p. 130) has defined transactions costs as "any activity which is engaged in to satisfy each party to an exchange that the value given and received is in accord with his or her expectations." In considering issues of the design of contracting and institutional choice in the public sector, transaction costs should include all the costs incurred by the political system in negotiating, monitoring and enforcing the arrangements concerned. See Dixit, (1996), for a discussion of transaction-costs politics, and see also footnote 22.
8. Although from the perspective of each individual contracting party, it is only the costs they bear, and the gains they can appropriate that determine their actions.
9. The transaction costs of long-term contracting are seen as: *a*) the cost of anticipating all possible eventualities; *b*) the cost of agreeing how to deal with them; *c*) the cost of specifying the contract in a way that can be enforced; and *d*) the cost of enforcement (where this occurs). Because of these costs it is efficient to leave many possible even-

tualities out of the contract, and to re-negotiate once it is known what specific circumstances have in fact materialised. Through this economising on transactions costs, many contracts will be incomplete in important respects. See Hart and Moore, (1998). Alternative or additional explanations for incomplete contracts are the potential for performance specification to distort behaviour through an undesirable focus on the measurable but not necessarily the most important dimensions of performance (see Holmstrom and Milgrom, 1992); and through the possibility that, where it is not possible to specify all aspects of performance, it may be optimal to leave out some elements even where they are capable of specification (see Bernheim and Whinston, 1998).

10. Reputation effects are seen in the transaction cost literature as creating pressures for self-enforcement of contracts by the two parties to the contract, as opposed to resorting to third party enforcement.
11. Quoted in Boston (1994), p. 17.
12. In an arbitration situation it is easier for the arbitrator to obtain all the relevant information from both parties, than in an adversarial court setting where the parties use information more strategically.
13. The literature on incomplete contracts makes an important distinction between performance that is observable only by the parties to the contract, and performance that can also be verified by a third party. The parties to the contract may both know whether either has shirked, but unless that can be verified by a third party it will be difficult to contract over this dimension of performance.
14. Grossman and Hart see the contracting versus integration decision as involving a comparison of the costs of contracting for all the specific rights desired over the assets concerned, compared with purchasing the residual decision rights (that is, ownership). See Grossman and Hart, (1986).
15. Where specific assets are significant, vertical integration may be even more of an advantage in the public sector than in the private sector. This is because, in the private sector the specific assets may be in the context of the supply of an intermediate product to a producer who is selling in a competitive market. Competition in the final goods market can impose discipline on the intermediate goods supply relationship, as both parties "sink or swim together". (This point is due to Peter Gorringer).
16. Between the "pure forms" of market exchange and hierarchy the transaction cost literature also identifies hybrid forms that exhibit some of the features of both, for example franchising. In a public sector setting, networks between individual organisations are an important feature – for example, horizontal networks between agencies involved in policy analysis and advice on specific areas of government policy.
17. Williamson, (1993), p. 15.
18. See Ouchi, (1980), p. 132.
19. See Ouchi, (1980), who suggests two factors determine the desirable basis of organisational control: the degree of goal congruence, and the degree of performance ambiguity. Where goal congruence and performance ambiguity are moderately high, bureaucracy is the preferred institution (rather than market relations). When goal congruence is high and performance ambiguity high, a "clan" is the efficient form of organisation. Ouchi defines a clan organisation as one where socialisation is the principal mechanism of control.

20. These points are taken from Williamson, (1986), p. 87.
21. See Williamson, (1985), p. 41.
22. Under Australian law, the national government and its component parts – the legislature, executive and judiciary, cannot enter into legal arrangements other than those arrangements permitted by the national constitution or constitutional convention and cannot litigate against each other. It is therefore not possible for agencies of the executive government, such as departments of state and certain unincorporated statutory authorities (*e.g.* Centrelink) to litigate against each other; although they may litigate against other legal entities either on behalf of the national government or in the case of statutory authorities, in their own right. See Worthington, (1999),.
23. This may or may not significantly distance the minister from their operations. In many countries the delegation of service delivery functions to devolved institutions is part of an attempt to place ministerial control at greater arms-length. A distinction is often made between strategic objectives, for which the minister remains responsible, and operational matters which are the responsibility of the institution itself. This association of greater delegated authority and a reduction in ministerial responsibility may represent a political equilibrium, making the commitment to non-interference in day-to-day operational matters more credible. On the other hand, there have been concerns about a reduction in ministerial accountability through the transference of activities from departments to agencies more removed from ministers. Ministerial involvement in the UK prison service in recent years illustrates the tension between the desire to delegate authority and the ability of the political system to commit to the delegation over time. This is an example of the need to take a broader view of transaction costs in institutional design in the public sector, to ensure institutional arrangements are politically robust (see footnote 7).
24. Enforceable contracts are sometimes implicitly advocated even where they are not legally possible. For example, Hood (1991, p. 9) has noted that implicit in some criticisms of the new public management is the argument that it lacks substance, and that what is needed are some real teeth – “for example, in making contracts between ministers and chief executives legally binding”.
25. This section is based on collaborative work between the author and Mai Chen, Partner, Chen and Palmer, public law specialists.
26. In some legal systems consideration is also a requirement.
27. See “An Introduction to Comparative Law”, by K. Zweigert and H. Kötz, Third Edition, Clarendon Press, Oxford, 1998, Section C, Contract, pp. 323-526.
28. In some countries their statutory duty may be subject to judicial enforcement.
29. There may also be instances where it is unclear whether the government is in fact the owner of an entity from which it is purchasing services, which makes clarity at the outset over what is being purchased even more important.
30. See for instance Moe, (1984, pp. 765-766): “Democratic politics is easily viewed in principal/agent terms... [as] a chain of principal-agent relationships, from citizen to politician to bureaucratic superior to bureaucratic subordinate and on down the hierarchy of government to the lowest level of bureaucrats who actually deliver services directly to citizens...”.
31. Moral hazard refers to the tendency of an agent, after the contract is entered into, to shirk or otherwise not fully seek to promote the principal's interests. Adverse selection

refers to the inability of a principal to determine, before the contract is entered into, which among several possible agents is most likely to promote the principal's interests; and, given this imperfect information, the tendency for candidates with less than average motivation or qualifications to apply.

32. Consequences may, for example, be in the form of the performance assessment of the agency head; the withholding of payment or budget transfers, the loss of some decisions rights or the imposition of financial penalties, if certain specified conditions are not met; or the use of performance information as an input in the budget process to assess the agency's budget for the following year.
33. Accountability will usually be in terms of the specification of certain inputs and the delivery of specified outputs (expressed in both physical and financial terms), and, where appropriate, the achievement of certain outcomes – together with various ratios of inputs, outputs and outcomes aimed at assessing efficiency and effectiveness. For some outputs where quality is hard to assess (for example policy advice) performance standards may be based on specification of the processes to be used in producing the outputs, as a proxy for output quality. Use of consumer satisfaction indicators based on client surveys can also be useful as an indicator of output quality, taking advantage of the information widely dispersed amongst actual recipients of the services. This can be done in a centralised manner (for example the French *Charte des Services publics*, the US *National Performance Review*, and the UK *Citizens' Charter*) or in a decentralised manner (for example on the initiative of individual service delivery agencies).
34. See Alchian and Demsetz, (1972) for a discussion of the role of residual claims in creating incentives for performance monitoring in the private sector.
35. As Moe, (1984, p. 769) has noted, this can mean that politicians in general have a more difficult time controlling the bureaucracy. It can also mean that, rather than acting solely in the interests of their nominal principal, bureaucrats have an interest in ensuring broad-based political support for their agency to head off potential threats to its survival.
36. Vertical imbalance is typical because efficiency in expenditure is generally seen as requiring a high degree of decentralisation, whereas efficiency in taxation is generally seen as requiring a relatively high degree of centralisation.
37. See OECD, (1997b), p. 53.
38. See Ouichi, (1980), p. 137.
39. See Wallis and Dollery, (1997).
40. See Mintzberg, (1995), p. 81. Mintzberg identifies five key elements of a normative model: selection by values and attitudes, rather than just credentials; socialisation in public service ethics; guidance by principles and visions, rather than plans and targets; responsibility and inspiration rather than empowerment; and performance judged by experienced people.
41. See World Bank, (1997, Chapter 5) for a discussion of the challenge for developing countries of developing the state's capacity to implement a contractual approach to public sector management.
42. There are a variety of terms used to describe different funding relationships. In this paper, the word "funding" will be used as a catch-all, covering all types of relationship. "Grant" covers both an unconditional grant (or, the same thing, a gift), and a conditional grant, which is a funding relationship involving the specification of conditions the recip-

ient is expected to meet, but which does not have contractual force. "Subsidy" is a type of funding where the funder is making only a partial contribution towards the costs of an activity. The funder is not necessarily determining who will supply the goods or services, or even exactly what the goods or services to be supplied are, as these are being determined by the purchase choices of others. For example a subsidy to private schools is driven by the choice of parents over where to send their children.

43. This insight is due to Mai Chen. The comment might be made that a grant is qualitatively different from a contract, from a legal perspective, because there is no legal obligation to fulfil the conditions of the grant in order to receive or retain the funds. In practice however, where the government owns the supplier, there is an effective obligation to meet the conditions, especially but not only where these conditions are set down as part of the statutory duties of the agency.
44. One possible exception is a transfer to a lower level of government, where accountability for the use of the monies is effected through reporting by the recipient government to the governance institutions at that level. Government transfer payments – such as social welfare benefits – are generally unconditional, in the sense of not limiting what the recipients can spend the money on. However, such benefits are transfer payments, and are not used to fund the supply of goods or services, and so fall outside the scope of this discussion.
45. There may also be situations where the government has quasi-ownership rights and/or obligations because of the degree of dependence of an NGO on government funding, and/or the degree of dependence of government on a monopoly NGO supplier of a politically sensitive service. These issues are worthy of in-depth exploration in their own right, but are beyond the scope of this paper. A related issue is that, where the government funding is more in the nature of a partial subsidy, and the rights of a purchaser are being exercised by another entity, it may be difficult to specify just what outputs the government is funding. Even in these situations, however, it may be possible to contract around a more limited set of conditions. For example, a government subsidy to private schools might be conditional on the schools meeting minimum requirements with respect to the curriculum they teach.
46. See Wilson, (1989), p. 370.
47. There is also an important time dimension to this. The appropriate performance specification is likely to change over time as circumstances change. For example, focusing on a simple performance measure can be a powerful way to bring about radical organisational change, even where that measure is acknowledged to be too narrow a measure of performance in steady state – see Petrie, (1998). More generally, Carter, (1991, pp. 98-99) has described common regularities in the pattern of use of performance indicators in organisations: first, perfunctory compliance in response to outside pressure to introduce performance measurement; then organisational resistance and attempts to discredit; then refinements, and acceptance of the view that performance indicators are useful.
48. See Carter, (1991), for a discussion of the design of performance measures.
49. These are based on Milgrom and Roberts, (1992), pp. 219-228.
50. See Wilson, (1989), Chapter 9, pp. 154-175.

51. Mintzberg, (1996, p. 79) has noted: "How many times do we have to come back to this one until we finally give up? Many activities are in the public sector precisely because of measurement problems: If everything was so crystal clear and every benefit so easily attributable, these activities would have been in the private sector long ago."
52. Of course any one organisation may conduct more than one of these types of activities.
53. An example is the State Owned Enterprises Act in New Zealand, Section 7 of which provides that, where a state-owned enterprise is asked by the government to supply services on a non-commercial basis, this is to be on the basis of a legally enforceable contract. The one instance where this currently occurs is the funding through Vote Justice of the purchase of the services of NZ Post in maintaining the electoral rolls for Parliamentary elections.
54. The credibility effect could come from the fact that government would be giving the enterprise the ability to enforce the agreement in court against the government, while government would be highly unlikely itself to enforce the agreement given its ownership rights.
55. OECD, (1997*b*), p. 64.

Bibliography

- ALCHIAN, A., and DEMSETZ, H. (1972),
“Production, Information Costs, and Economic Organisation”, *American Economic Review*,
Volume 62, December, pp. 777-795.
- BERNHEIM, B., and WHINSON, M. (1998),
“Incomplete Contracts and Strategic Ambiguity”, *American Economic Review*, pp. 902-932.
- BOSTON, J. (1994),
“Purchasing Policy Advice”, *Governance*, 7:1, January, pp. 1-30.
- BOSTON, J. (ed.) (1995),
The State Under Contract, Bridget Williams Books Limited, Wellington.
- BUCHANAN, J., and TULLOCK, G. (1962),
The Calculus of Consent, University of Michigan Press, Ann Arbor.
- CARTER, N. (1991),
“Learning to Measure Performance: The Use of Indicators in Organizations”, *Public Administration*, Volume 69, Spring, pp. 85-101.
- DIXIT, A., (1996),
“The Making of Economic Policy: A Transaction-Cost Politics Perspective”, *Munich Lectures in Economics*, Cambridge, Massachusetts, MIT Press.
- GROSSMAN, S., and HART, O. (1986),
“The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration”,
Journal of Political Economy, 94:4, pp. 691-719.
- HART, O., and MOORE, J. (1998),
“Foundations of Incomplete Contracts”, LSE/STICERD Discussion Paper No. TE/98/358,
September.
- HOLMES, M., and SHAND, D. (1995),
“Management Reform: Some Practitioner Perspectives on the Past Ten Years”, *Governance*,
8:4, October, pp. 551-578.
- HOLMSTROM, B., and MILGROM, P. (1992),
“Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design”, *Journal of Law, Economics and Organization*, 7, Special Issue, pp. 24-52.
- HOOD, C. (1991),
“A Public Management For All Seasons?”, *Public Administration*, Spring, Volume 69, pp. 3-19.
- MILGROM, P., and ROBERTS, J. (1992),
Economics, Organization and Management, Prentice Hall, Englewood Cliffs, New Jersey.
- MINTZBERG, H. (1996),
“Managing Government; Governing Management”, *Harvard Business Review*, May-June.

- MOE, T.,
"The New Economics of Organization", *American Journal of Political Science*, Volume 28,
pp. 739-775.
- NORTH, D. (1990),
Institutions, Institutional Change and Economic Performance, Cambridge University
Press.
- OECD (1995),
Governance in Transition: Public Management Reforms in OECD Countries, Paris.
- OECD (1997a),
In Search of Results, Paris.
- OECD (1997b),
Managing Across Levels of Government, Paris.
- OECD (1997),
Issues and Developments in Public Management, Paris.
- OUICHI, W. (1980),
"Markets, Bureaucracies and Clans", *Administrative Science Quarterly*, Volume 25, March,
pp. 129-141.
- PETRIE, M. (1998),
Organisational Transformation: The Income Support Experience, Department of Social Welfare,
Wellington.
- PREMFORS, R. (1998),
"Reshaping The Democratic State: Swedish Experiences In A Comparative Perspective",
Public Administration, Volume 76, Spring, pp. 141-159.
- SCHICK, A. (1996),
"The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change", A
Report for the State Services Commission and The Treasury, New Zealand, August.
- SCHICK, A. (1998),
"Why Most Developing Countries Should Not Try New Zealand's Reforms", *World Bank
Research Observer*, Volume 13, No. 1.
- SEN, A. (1987),
On Ethics and Economics, Basil Blackwell, Oxford.
- WALLIS, J., and DOLLERY, B. (1997),
"An Evaluation of Leadership as a Response to Agency Failure in the Public Sector",
Public Administration, 75:2, Summer, pp. 247-265.
- WILLIAMSON, O. (1985),
The Economic Institutions of Capitalism, New York, Free Press.
- WILLIAMSON, O. (1986),
Economic Organisation: Firms, Markets and Policy Control, The Harvester Press Publishing
Group, Sussex.
- WILLIAMSON, O. (1993),
The Economic Analysis of Institutions and Organisations – In General and with Respect
to Country Studies", *OECD Economics Department Working Papers*, No. 133.
- WILSON, J.Q. (1989),
Bureaucracy: What Government Agencies Do and Why They Do It, Basic Books, New York.

- World Bank (1997),
World Development Report 1997: The State in a Changing World, Oxford University
Press, New York.
- ZWEIGERT, K., and KOTZ, H. (1998),
An Introduction to Comparative Law, Third Edition, Clarendon Press, Oxford.

The OECD Budgeting Database

Note by the Editors

The following series of tables contain information on parliamentary budget procedures in OECD Member countries. They were compiled from information submitted by Member countries to the OECD Secretariat. Note that per cent totals at the bottom of each table may not add up to 100% due to rounding, and in a few circumstances when multiple answers are allowed.

ROLE OF THE LEGISLATURE – 1

Are there any restrictions on the right of the legislature to modify
the budget proposed by the government?

(See also question 3)

	Yes	No
Australia		X
Austria		X
Belgium		
Canada	X	
Czech Republic		X
Denmark		X
Finland		X
France	X	
Germany		X
Greece	X	
Hungary		X
Iceland		X
Ireland	X	
Italy		X
Japan		X
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands		X
New Zealand	X	
Norway		X
Poland	X	
Portugal		X
Slovak Republic		
Spain	X	
Sweden		X
Switzerland	X	
Turkey		X
United Kingdom	X	
United States		X
Total	11	16
Per cent of total	41%	59%

ROLE OF THE LEGISLATURE – 2

If applicable, what form do these restrictions take?

	May not make any changes. Legislature can only approve or reject the budget in whole	May not increase or propose new expenditures, i.e. legislature can only decrease funding levels	May reallocate and increase funding levels, but only if it reduces others or approves new revenue sources, i.e. no net change in total deficit/surplus	Government must approve any changes proposed by legislature
Belgium				
Canada		X		
France		X		
Greece	X			
Ireland	X			
Korea				X ^a
Luxembourg				
Mexico			X ^b	
New Zealand				X ^c
Poland			X ^d	
Slovak Republic				
Spain			X	
Switzerland			X ^e	
United Kingdom		X		
Total	2	3	4	2
Per cent of total	18%	27%	36%	18%

a) Korea – The legislature needs the government's agreement in order to initiate any new expenditure or to increase any expenditure proposed by the government.

b) Mexico – It can reallocate, create or increase expenditure as long as it established new sources to finance them whenever such modification would alter the balance of the budget.

c) New Zealand – The finance minister may exercise a "financial veto" over any proposed change to votes that would have more than a minor impact.

d) Poland – It can reallocate, create or increase expenditure as long as it established new sources to finance them whenever such modification would alter the balance of the budget.

e) Switzerland – The legislature must observe the balanced budget amendment to the constitution which stipulates a maximum level of permitted deficit.

ROLE OF THE LEGISLATURE – 3

If applicable, what is the respective role of each house of the legislature in approving the budget?

	Upper House has no role	Lower House is pre-eminent. It can override any vote of Upper House	Both Houses enjoy similar stature
Australia			X ^{b, c}
Austria	X		
Belgium			
Canada			X ^b
Czech Republic	X		
France		X	
Germany		X	
Ireland		X	
Italy			X
Japan		X	
Luxembourg			
Mexico		X ^a	
The Netherlands			X ^c
Poland		X	
Slovak Republic			
Spain		X	
Switzerland			X
United Kingdom		X	
United States			X ^d
Total	2	8	6
Per cent of total	13%	50%	38%

a) The Upper House must approve taxation measures; it has no direct role in approving expenditure measures.

b) The Upper House may not introduce expenditure or taxation measures.

c) The Upper House can only accept or reject the entire budget; it cannot make any amendments.

d) Tax legislation must originate in the Lower House, but can be amended by both Houses.

ROLE OF THE LEGISLATURE – 4

Notwithstanding any legal restrictions on the legislator's ability to modify the budget,
 is a vote on the budget considered a vote of confidence in the government,
i.e. the government would resign if any changes are approved to its budget proposal?

	Yes	No
Australia	X ^a	
Austria		X
Belgium		
Canada	X ^a	
Czech Republic		X
Denmark		X
Finland		X
France		X
Germany		X
Greece		X
Hungary		X
Iceland		X
Ireland		X
Italy		X
Japan		X
Korea		X
Luxembourg		
Mexico		X
The Netherlands		X
New Zealand	X	
Norway		X
Poland		X
Portugal		X
Slovak Republic		
Spain		X
Sweden		X
Switzerland		X
Turkey		X
United Kingdom	X ^a	
United States		X
Total	4	22
Per cent of total	15%	85%

a) Applies to Lower House only.

ROLE OF THE LEGISLATURE – 5

In practice, does the legislature generally approve the budget as presented by the government?

	With no changes	With minor changes only	With significant changes
Australia	X		
Austria		X	
Belgium			
Canada	X		
Czech Republic			X
Denmark			X
Finland		X	
France		X	
Germany		X	
Greece	X		
Hungary			X
Iceland		X	
Ireland		X	
Italy		X	
Japan	X		
Korea		X	
Luxembourg			
Mexico		X	
The Netherlands		X	
New Zealand	X		
Norway		X	
Poland		X	
Portugal		X	
Slovak Republic			
Spain		X	
Sweden		X	
Switzerland		X	
Turkey		X	
United Kingdom	X		
United States			X
Total	6	17	4
Per cent of total	22%	63%	15%

ROLE OF THE LEGISLATURE – 6

Does the legislature have any opportunity to formally debate overall budget policy prior to the introduction of the government's budget?

	Yes And vote taken on budget policy	Yes But no vote taken on budget policy	No
Australia			X
Austria			X
Belgium			
Canada		X	
Czech Republic			X
Denmark			X
Finland	X		
France		X	
Germany			X
Greece			X
Hungary	X		
Iceland			X
Ireland			X
Italy	X		
Japan			X
Korea			X
Luxembourg			
Mexico			X
The Netherlands			X
New Zealand		X	
Norway		X	
Poland			X
Portugal	X		
Slovak Republic			
Spain			X
Sweden	X		
Switzerland			X
Turkey			X
United Kingdom		X	
United States			X
Total	5	5	17
Per cent of total	19%	19%	63%

ROLE OF THE LEGISLATURE – 7

Does the legislature first vote on the total amount of revenue and expenditure in the budget before it votes on specific appropriations?

	Yes	No
Australia		X
Austria		X
Belgium		
Canada	X	
Czech Republic	X	
Denmark		X
Finland		X
France	X	
Germany		X
Greece		X
Hungary		X
Iceland		X
Ireland		X
Italy	X	
Japan		X
Korea		X
Luxembourg		
Mexico	X	
The Netherlands		X
New Zealand		X
Norway	X	
Poland	X	
Portugal	X	
Slovak Republic		
Spain	X	
Sweden	X	
Switzerland		X
Turkey		X
United Kingdom		X
United States	X	
Total	11	16
Per cent of total	41%	59%

ROLE OF THE LEGISLATURE – 8

In how many separate appropriation laws does the legislature approve expenditures?

	In one law	If more than one, then how many
Australia		X (2)
Austria		
Belgium	X	
Canada		X (4 or 5)
Czech Republic	X	
Denmark	X	
Finland	X	
France	X	
Germany	X	
Greece	X	
Hungary	X	
Iceland	X	
Ireland	X	
Italy	X	
Japan		X (3)
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands		X (23)
New Zealand	X	
Norway	X	
Poland	X	
Portugal	X	
Slovak Republic		
Spain	X	
Sweden	X	
Switzerland	X	
Turkey	X	
United Kingdom	X	
United States		X (13)
Total	21	6
Per cent of total	78%	22%

ROLE OF THE LEGISLATURE – 9

What best describes the committee structure for dealing with the budget?

	A single budget committee deals with all budget-related matters. Sectoral committees may make recommendations, but budget committee does not have to follow them	A single budget committee deals with budget aggregates. Sectoral committees deal with appropriations for each respective sector	No budget committee in place. Sectoral committees deal with appropriations for each respective sector
Australia			X
Austria	X		
Belgium			
Canada		X	
Czech Republic		X	
Denmark	X		
Finland	X		
France	X ^a		
Germany	X		
Greece	X		
Hungary		X	
Iceland	X		
Ireland			X
Italy		X	
Japan	X		
Korea	X ^b		
Luxembourg			
Mexico	X ^a		
The Netherlands			X ^c
New Zealand		X	
Norway		X	
Poland		X	
Portugal	X ^d		
Slovak Republic			
Spain	X		
Sweden		X	
Switzerland	X		
Turkey	X		
United Kingdom		X	
United States		X ^e	
Total	14	10	3
Per cent of total	52%	37%	11%

- a) Members of the respective sectoral committees join the budget committee when appropriates relating to their sectors are being discussed.
- b) The budget bill shall first be referred to the competent standing committees which shall report the results to their examination to the speaker. The speaker shall then refer the budget bill to the special budget and settlement committee.
- c) A special budget committee is in place, but it only offers technical assistance to the sectoral committees as they discuss their respective parts of the budget.
- d) There are discussion at the level of sectoral committees (concerning expenditures of their specific areas) prior to discussion and deliberations of the budget committee.
- e) Budget committees of both Houses deal with budget aggregates. Appropriation committees, consisting of 13 sectorally based sub-committees consider annual spending legislation. Substantive sectoral committees are responsible for legislation creating entitlement (transfer) and other mandatory programmes.

ROLE OF THE LEGISLATURE – 10

Do ministers typically appear before committees to answer questions?

	Yes	No
Australia	X	
Austria	X	
Belgium		
Canada	X	
Czech Republic	X	
Denmark	X	
Finland	X	
France	X	
Germany	X	
Greece	X	
Hungary		X
Iceland		X
Ireland	X	
Italy	X	
Japan	X	
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands	X	
New Zealand	X	
Norway		X
Poland	X	
Portugal	X	
Slovak Republic		
Spain		X
Sweden		X
Switzerland	X	
Turkey	X	
United Kingdom	X	
United States	X	
Total	22	5
Per cent of total	81%	19%

ROLE OF THE LEGISLATURE – 11

Do officials (civil servants) typically appear before committees
to answer questions?

	Yes	No
Australia	X	
Austria	X	
Belgium		
Canada	X	
Czech Republic	X	
Denmark		X
Finland	X	
France		X
Germany	X	
Greece		X
Hungary	X	
Iceland	X	
Ireland		X
Italy	X	
Japan		X
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands		X
New Zealand	X	
Norway		X
Poland	X	
Portugal	X	
Slovak Republic		
Spain	X	
Sweden	X	
Switzerland	X	
Turkey		X
United Kingdom	X	
United States	X	
Total	19	8
Per cent of total	70%	30%

ROLE OF THE LEGISLATURE – 12

Are representatives of interest groups (non-governmental organisations) typically invited to appear before committees?

	Yes	No
Australia		X
Austria		X
Belgium		
Canada	X	
Czech Republic		X
Denmark		X
Finland	X	
France		X
Germany		X
Greece		X
Hungary	X	
Iceland	X	
Ireland		X
Italy		X
Japan	X	
Korea		X
Luxembourg		
Mexico		X
The Netherlands		X
New Zealand	X	
Norway	X	
Poland	X	
Portugal		X
Slovak Republic		
Spain		X
Sweden		X
Switzerland		X
Turkey		X
United Kingdom	X	
United States		X
Total	9	18
Per cent of total	33%	67%

ROLE OF THE LEGISLATURE – 13

Are committee meetings generally open to the public to observe?

	Yes	No
Australia	X	
Austria		X
Belgium		
Canada	X	
Czech Republic	X	
Denmark		X
Finland		X
France	X	
Germany		X
Greece	X	
Hungary	X	
Iceland		X
Ireland	X	
Italy		X
Japan	X	
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands	X	
New Zealand	X	
Norway		X
Poland	X	
Portugal	X	
Slovak Republic		
Spain		X
Sweden		X
Switzerland		X
Turkey	X	
United Kingdom	X	
United States	X	
Total	17	10
Per cent of total	63%	37%

ROLE OF THE LEGISLATURE – 14

What is the number of professional staff serving the budget committee(s)?

	Less than 5 staff	Between 5 and 10 staff	Over 10 staff
Australia		X	
Austria	X		
Belgium			
Canada	X		
Czech Republic	X		
Denmark	X		
Finland		X	
France			X
Germany		X	
Greece		X	
Hungary		X	
Iceland	X		
Ireland			X
Italy		X	
Japan		X	
Korea			X
Luxembourg			
Mexico		X	
The Netherlands		X	
New Zealand	X		
Norway	X		
Poland		X	
Portugal		X	
Slovak Republic			
Spain	X		
Sweden		X	
Switzerland		X	
Turkey	X		
United Kingdom		X	
United States			X (245)
Total	9	14	4
Per cent of total	33%	52%	15%

ROLE OF THE LEGISLATURE – 15

Is there a specialised budget research organisation attached to the legislature to conduct analyses of the budget?

	Yes with over 5 professional staff	Yes with 25 or less professional staff	No
Australia			X
Austria			X
Belgium			
Canada			X
Czech Republic			X
Denmark			X
Finland			X
France			X
Germany			X
Greece			X
Hungary			X
Iceland			X
Ireland			X
Italy	X		
Japan	X		
Korea		X	
Luxembourg			
Mexico		X	
The Netherlands			X
New Zealand			X
Norway			X
Poland	X		
Portugal			X
Slovak Republic			
Spain			X
Sweden	X		
Switzerland			X
Turkey			X
United Kingdom			X
United States		X	
Total	4	3	20
Per cent of total	15%	11%	74%

ROLE OF THE LEGISLATURE – 16

What best describes the manner in which expenditure for statutory (entitlement) programmes is treated?

	Parliament votes on such expenditures each year like other expenditures	Permanent appropriations authority; presented to legislature for information only
Australia		X
Austria	X	
Belgium	X	
Canada		X
Czech Republic	X	
Denmark	X	
Finland	X	
France	X	
Germany	X	
Greece	X	
Hungary	X	
Iceland	X	
Ireland	X	
Italy		X
Japan	X	
Korea	X	
Luxembourg		
Mexico	X	
The Netherlands	X	
New Zealand	X	
Norway	X	
Poland	X	
Portugal	X	
Slovak Republic		
Spain	X	
Sweden	X	
Switzerland	X	
Turkey	X	
United Kingdom	X	
United States		X
Total	24	4
Per cent of total	86%	14%

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(42 2001 03 1 P) ISBN 92-64-19062-7 – No. 52383 2002