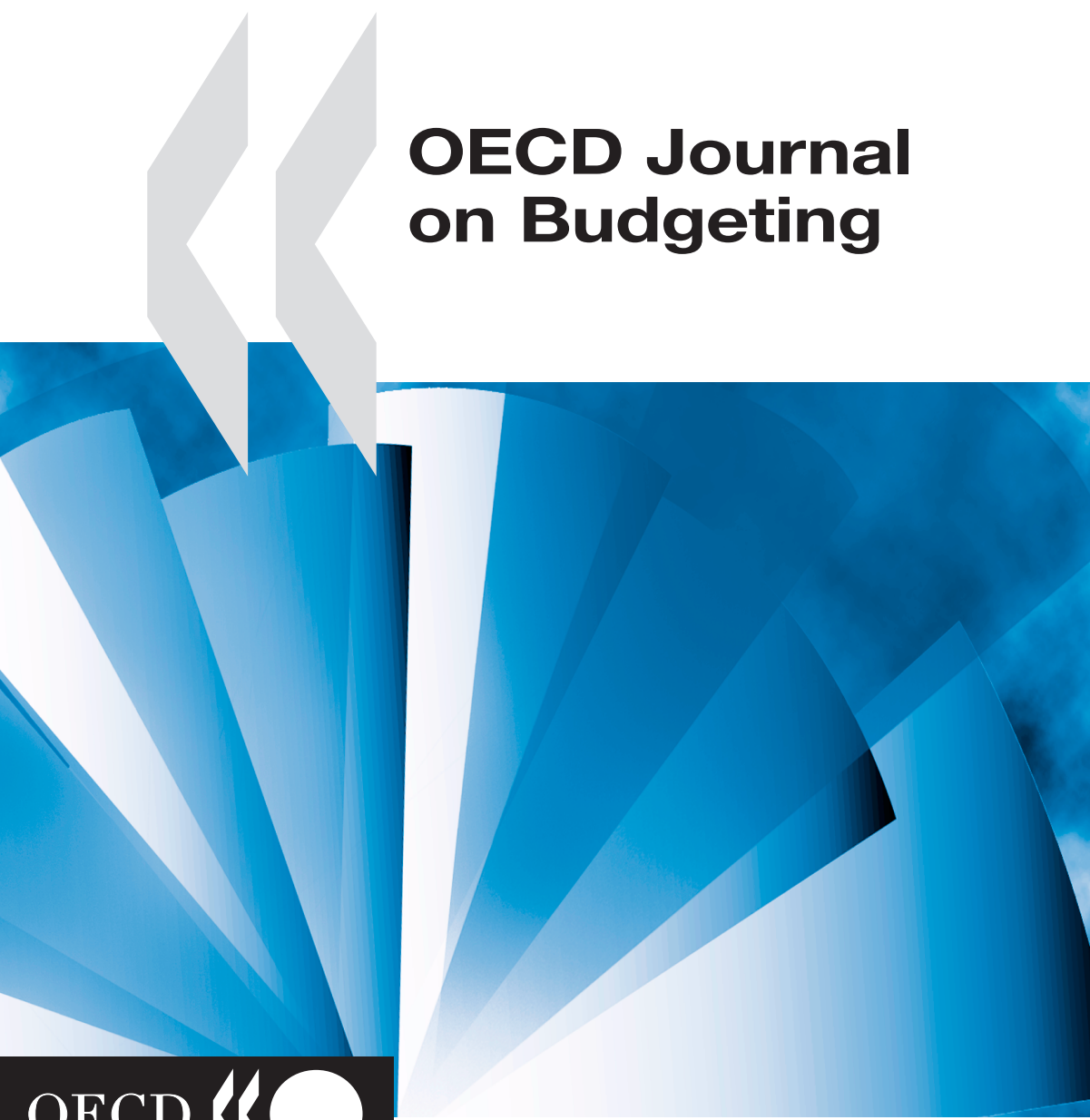




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Foreword

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

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Budgeting in Croatia

by

Dirk-Jan Kraan, Daniel Bergvall, Iris Müller and Joachim Wehner*

Since 2000, three consecutive governments in Croatia have focused their policies on modernising the public administration and reforming the budget process. This article examines the budget process in Croatia in the light of its two unique characteristics: a very detailed account structure, and a large number of extra-budgetary funds and quasi-fiscal activities of public enterprises. The steps in the annual budget process are described, including the roles of specific actors (budget users, line ministries, the Central Government Treasury), and the limited role of Parliament in the formulation of budget policy. Regarding budget execution, procedures are in place for cash and debt management within the government units, and a central role is played by the Financial Agency that handles all government transactions. Recent decentralisation has resulted in increased responsibility for sub-national governments in service delivery, with repercussions on procurement. Financial relations between levels of government include procedures for tax sharing, equalisation, and grants. Audit and accountability activities are carried out on a modified accrual basis; external audit is done by the State Audit Office but internal audit capacity is currently being developed.

- * Dirk-Jan Kraan and Daniel Bergvall are Project Managers in the Budgeting and Public Expenditures Division of the Public Governance and Territorial Development Directorate, OECD. Iris Müller is an Economist from German Technical Cooperation (GTZ). Joachim Wehner is Lecturer in Public Policy at the London School of Economics. The financial support of GTZ is gratefully acknowledged.

Preface

This review of the Croatian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials of the OECD. The Budget Project aims to initiate and foster regional networks of senior budget officials outside the OECD area. This review served as a basis for the examination of the Croatian budget system at the second meeting of the network of Senior Budget Officials of Central, Eastern and South Eastern Europe (SBO CESEE), held on 16-17 February 2006 in Ljubljana. German Technical Cooperation (GTZ) is gratefully acknowledged for its contribution to the review and for its financial support.

A mission comprising Dr. Dirk-Jan Kraan (OECD Secretariat), Mr. Daniel Bergvall (OECD Secretariat), Mrs. Iris Müller (GTZ) and Mr. Joachim Wehner (London School of Economics) visited Zagreb in September 2005 to carry out the review. During its visit the mission met with Mr. Niko Raič, Assistant Minister for Budget Preparation, Mrs. Ivana Maletić, Assistant Minister for Budget Execution, and senior officials from various departments of the Ministry of Finance, and Mr. Željko Tufekčić, Assistant Minister, and other officials of the Ministry of the Sea, Transport and Development. The mission also met with Mr. Dino Bulešić, President of the Finance and Central Budget Committee of Sabor, the Croatian Parliament, with Mr. Jozo Serdarušić, Deputy Director for the State Audit Office, and with Mrs. Prof. Katarina Ott, Director of the Institute of Public Finance.

The mission would like to express its gratitude and appreciation for the cordial reception by the Croatian authorities and the frankness and openness that characterised the discussion with all Croatian officials.

Finally, the mission would like to thank Mrs. Ivana Jakir-Bajo, Head of the Budget Analysis and Capital Investment Evaluation Department, for the excellent organisation of the meetings and her unsparing help during the mission's stay in Zagreb, as well as Mrs. Ivana Vargasević and Mrs. Ana Michieli for their assistance to the mission and their efforts to collect documents and information that could be useful for the mission's aim.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

1. Introduction

1.1. General characteristics

Croatia is one of the countries that have evolved from the dissolution of the former Yugoslavia. It gained its independence in 1990, but subsequently went through a tumultuous period of external and internal war in which the government, led by President Tuđman, gave relatively little attention to the reform of internal public governance. After the end of the Tuđman era the Constitution of 1990, as amended in 1992, was amended again in 2000 and 2001. The amendments of 2000 obliged the president to resign from membership in a political party after election and made the government answerable solely to Parliament and no longer to the President of the Republic. In view of this feature Croatia can now be considered as a parliamentary republic, rather than as a presidential or semi-presidential republic.

Since 2000 three consecutive governments have focused their policies on the modernisation of public administration and reform of the budget process with a view to joining the European Union as soon as possible. A first step in this process was the signing of the Stabilisation and Association Agreement with the EU in October 2001. In February 2003 Croatia applied to join the European Union and indicated its intention to join the second wave of EU enlargement foreseen for the accession of Romania and Bulgaria in 2007. After some delay caused by the concern of EU members about the lack of co-operation of Croatia with the International Criminal Tribunal for the former Yugoslavia in the Hague, the EU has recently decided that in view of changed Croatian policies towards the Tribunal, accession negotiations with Croatia could start.

Compared to the other countries of the former Yugoslavia, Croatia takes an intermediate position in regard to the progress of its reform process. Whereas Slovenia has focused since the first day of independence on the transition process, Croatia has made substantial progress only since the end of the 1990s. Other countries of the former Yugoslavia are in an even less favourable situation. However, given the relative late start of the focused reform efforts in Croatia, much has been achieved. The Constitution has been adjusted, administrative law has been reformed, sub-national government has been re-organised, and human resource management has been put on a modern footing with the new Law on Civil Servants and Public Employees. As far as the budget process is concerned the new Budget Act of 2003 (the organic budget law) has laid the foundation for a transparent and effective budget process. At the Ministry of Finance, young and competent staff have been recruited, who understand the priorities and

seem to be determined to sustain and accelerate the reform process. At the political level, there is presently no large difference of opinion between the major political parties, or between the government and the opposition, about the major direction of budgetary policy, although views on priorities within agreed constraints may mildly diverge. Under these circumstances, major further steps forward should be possible in the coming years.

With about 4.5 million inhabitants, Croatia is a relatively small European country. Although it has two layers of sub-national governments (counties and municipalities), sub-national expenditure is relatively low (5.6% of GDP in 2004). However, consolidated general government expenditures are relatively large (51.4% of GDP in 2004). This is far above the EU 15 average, surpassed only by the Nordic countries (Denmark, Finland, Norway and Sweden).

The same is true for the revenue side. Total revenues of consolidated general government in Croatia were at 46.5% of GDP (2004), resulting in a general government deficit of 4.9% (2004). However, like many transition countries in central, eastern and south-eastern Europe, Croatia has had strong economic growth in recent years. The slowdown that many EU countries have experienced from 2001 to 2004 has hardly affected the growth performance in Croatia. Spurred by strong internal demand, made possible by easy access to bank credit (91% of loans are provided by banks that are owned by foreign banking groups), and a booming tourism sector, GDP growth has been well above the EU 15 average since 2000 (see Table 1). Strong growth has contributed to increasing revenues, the more so because in view of the high deficit, Croatia has postponed some planned tax reduction programmes that might have spurred the growth performance even further, but would have been inconsistent with the consolidation effort in the public sector.

Table 1. Growth in real GDP 1999-2008

Per cent change on previous period

	1999	2000	2001	2002	2003	2004	2005 ^a	2006 ^a	2007 ^a	2008 ^a
EU 15	3.0	3.8	1.9	1.1	1.1	2.3	1.4	2.0	2.2	n.a.
Croatia	-0.9	2.9	4.4	5.2	4.3	3.8	3.9	4.0	4.4	4.3

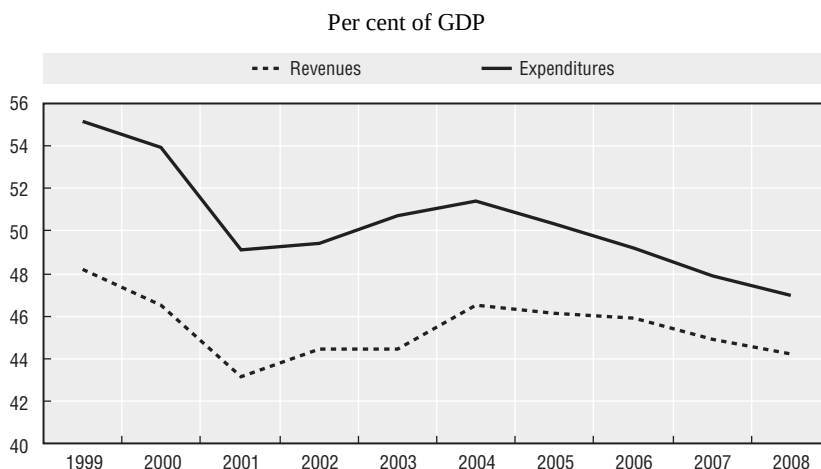
a. Forecast.

Sources: EU 15: Eurostat; Croatia 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; Croatia 2003-08: *Pre-accession Economic Programme (PEP) 2006-2008*.

The large general government sector and the high deficit in Croatia are to a large extent a heritage of the past. Since 2000, subsequent governments

have tried to steer the macro-budgetary indicators in the direction of the EU averages. Figure 1 shows the development of consolidated general government revenues and expenditures since 2000 and the planning numbers until 2008 to which the Croatian government has committed itself.

Figure 1. General government expenditures and revenues 1999-2008
(excluding quasi-fiscal activities of public enterprises)



Note: 2005-07: forecast.

Sources: 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; 2003-08: *Pre-accession Economic Programme (PEP) 2006-2008*.

Table 2 shows the resulting general government deficit, excluding one-off capital revenues from privatisation in comparison with the EU 15 average.

Table 2. General government deficits 1999-2007
(excluding quasi-fiscal activities of public enterprises)

Per cent of GDP

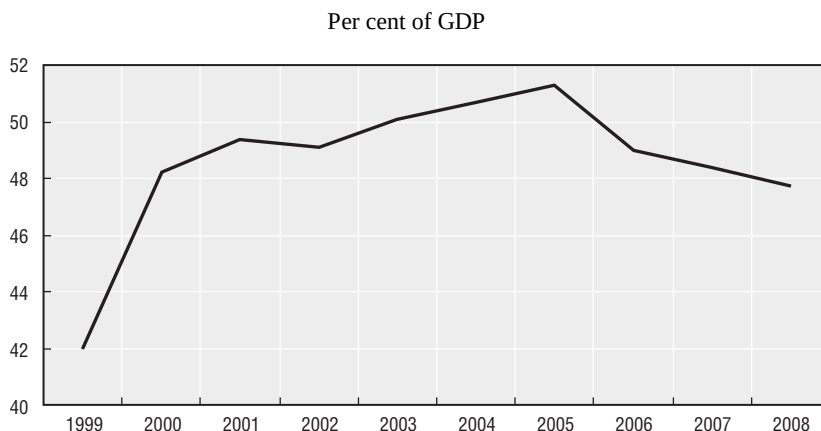
	1999	2000	2001	2002	2003	2004 ^a	2005 ^a	2006 ^a	2007 ^a
EU 15	-0.7	1.0	-1.2	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.
Croatia	-7.0	-7.4	-6.0	-5.0	-6.3	-4.9	-4.2	-3.2	-2.8

a. Forecast.

Sources: EU 15: Eurostat; Croatia 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; Croatia 2003-07: *Pre-accession Economic Programme (PEP) 2006-2008*.

General government debt in Croatia in 2004 was at 44.8% of GDP, well below the ceiling of 60% imposed upon the euro countries by the Stability and Growth Pact, while public debt was at 50.7% of GDP. Public debt represents general government debt, *i.e.* the consolidated debt of central government (around 85% of general government debt), the extra-budgetary funds, and the local governments, augmented for the amount of guarantees. However, as can be seen from Figure 2, public debt has been growing in recent years at a rather fast rate. Partly this is due to a gradual improvement of registration, especially concerning debt of extra-budgetary funds, public enterprises and local government, as well as guarantees. Registration of guarantees (in 2004 about 12% of public debt) is still not perfect but, especially since the second half of 2003, the quality of the statistics has substantially improved.¹

Figure 2. Public debt 1999-2008



Note: 2005-08: forecast.

Source: *Pre-accession Economic Programme (PEP) 2006-2008*.

1.2. The transition process in Croatia

OECD budget reviews look at the budget process. This comprises the budget institutions (the rules of decision making) and the way they function. Until the end of the 1990s the budget institutions and fiscal policies of Croatia fell short of the standards adhered to in OECD countries. Since the year 2000, however, subsequent cabinets have pursued with great energy

and perseverance fiscal and institutional policies directed at reform and modernisation and speedy accession to the EU.

These efforts were supported by the IMF, the EU and the World Bank. Croatia has twice concluded stand-by arrangements with the IMF, namely in February 2003 and in August 2004, not so much because of acute debt or balance of payments problems, but more for precautionary reasons and to signal its commitment to sound fiscal and structural policies.² Croatia has also committed itself to gradual adjustment of its fiscal and structural policies as part of the pre-accession economic programme agreed with the EU (Government of the Republic of Croatia, 2004a). Finally, the World Bank has long-standing relations with Croatia. In 2001 the World Bank approved a structural adjustment loan of USD 202 million and in 2005 a country financial accountability assessment of Croatia was published as basis for a potential programmatic adjustment loan (World Bank, 2005). The country financial accountability assessment focused on budgeting, treasury and cash management, accounting and financial reporting, internal control and internal audit, external audit and legislative oversight, financial accountability arrangements for sub-national government, and capacity development. Currently there are eleven World Bank active projects in Croatia totaling USD 447.6 million. The projects focus on infrastructure, railway management, the health system, the judicial system, the pension system, property administration (the cadastre) and energy policy.

The commitments made by Croatia in contracts with the IMF, the World Bank and the EU cover not only fiscal policies and structural financial-economic policies in general but also budget institutions, and are often the point of departure of the findings in this review.

1.3. Fiscal policy and institutional reform in the recent past

In order to put the findings of this review in perspective it is useful to provide some data at the outset about institutional and fiscal policy in the recent past.

In 2003 fiscal policy had not achieved its general government deficit reduction target (excluding quasi-fiscal activities of public enterprises) of 4.5% of GDP (IMF, 2004a). This was partly due to a sharp reversal of fiscal policy in the run up to the November 2003 parliamentary elections (see Figure 1). Additional spending led to an overrun of the general government deficit target of about 1% of GDP in 2003 (of which a half percentage point was for additional road construction). Moreover, the state-owned Croatian Bank for Reconstruction and Development (HBOR) provided additional loans for housing reconstruction, and the chronically money-losing state-owned Croatian Railways was directed to borrow additional funds under

government guarantee for both operating and capital expenses. If these quasi-fiscal activities are taken into account, the general government deficit in 2003 amounted to 6.3% of GDP.

Fiscal consolidation became a central objective of fiscal policy in the budget and supplementary budget³ for 2004. The most important considerations in this respect were the necessity to close the gap between saving and investment in the domestic economy (leading to the deterioration of the balance of payments and rapidly increasing foreign debt) and the authorities' wish to bring the general government deficit within the boundary of 3% of GDP, which is imposed as a ceiling upon the euro zone countries. In particular the government wanted to bring back the general government deficit (excluding quasi-fiscal activities) to -4.5% of GDP in 2004 and to -3.7% of GDP in 2005 while simultaneously eliminating the general government payment arrears. The aim for 2004 was to be achieved through an increase in revenues (one-off dividend payments from public enterprises and receipts from the sale of GSM licenses, increase in excise rates on cars and tobacco) and to a lesser extent reduction in investment expenditures (especially in the motorway and road agencies).

In the 2004 supplementary budget it was announced that for 2005 and the longer term the government wanted to enhance tax collection (in part through establishment of the financial police), limit borrowing by local government, and take measures to control health spending. In the institutional sphere the government wanted to bring all financing of the extra-budgetary funds of Croatian Railways and of the Croatian Bank for Reconstruction and Development (mainly loans for housing reconstruction) on budget. In addition the authorities intended to control contingent liabilities by keeping the nominal stock of guarantees from increasing during 2004-05. Finally, the authorities intended to formulate a medium-term fiscal plan as part of the 2005 budget in which an annual general government deficit reduction of 0.5% of GDP would be announced until the deficit would be below the 3% ceiling. The process of harmonisation with EU legislation would require substantial adjustments in spending priorities in the medium term.

Policy implementation in 2004 was broadly in line with the (supplementary) budget with the exception of the general government deficit and the reduction of the general government arrears. The 2004 general government deficit (excluding quasi-fiscal activities of public enterprises) was reduced to 4.9% of GDP instead of 4.5% of GDP due to slippage in tax collection and a shortfall of some one-off revenues (particularly dividends from the telecom company). Total expenditure was on target. The reduction of the general government arrears fell short of the target, mainly because of an increase in arrears in the health sector (payments to hospitals). This

increase may have been due to better registration and was symptomatic of more fundamental problems in the finances of the health sector. At the end of 2004 the total outstanding stock of arrears stood at 0.7% of GDP.

The 2005 budget was accompanied by a multi-annual macroeconomic and fiscal framework. The framework was put up in accordance with a pre-accession economic programme prepared for EU accession. The general government deficit target for 2005 was adjusted to 3.7% of GDP (due to the slippage in 2004) and was set at 3.2% of GDP for 2006 and 2.9% of GDP in 2007. The presidential elections in early 2005 and local elections in May 2005 weakened the government's focus on economic policies, but since then policies have been back on track with a less ambitious fiscal target but a significantly strengthened structural agenda. The original deficit target of 2005 had to be abandoned because of a shortfall in tax collections, expenditure overruns in entitlement programmes, and the postponement of the change in the indexation formula for public pensions that had already been incorporated in the original 2005 budget to compensate for additional spending on EU harmonisation programmes.

In July 2005 Parliament approved a supplementary budget with a revised deficit of 4.2% of GDP, additional one-off measures at the revenue side (dividends of public enterprises), and an increase in the ceiling for debt guarantees (needed for the restructuring of the state-owned shipyards). The revised budget contained additional structural measures: a new Civil Service Law; introduction of co-payments in the health sector as a first step to comprehensive health reform; curbing housing subsidies, employment subsidies and state aid to industry; promulgation of the delayed change in pension indexation; introduction of a 10% VAT rate on all tourist accommodation (thus eliminating the present 0% rate). The government also announced its intention to strengthen financial discipline in the broader public sector by better control of guarantees and restructuring Croatian Railways. Despite legal delays, the privatisation process will be pursued until all remaining government holdings in the Privatisation Fund are sold. The World Bank's programmatic adjustment loan will support this process. Finally, the government announced its intention to settle the "pensioners' debt" during the period 2006-13. This debt originated from a 1998 decision of the Supreme Court ruling that the state was liable for unpaid pension indexation entitlements during the period 1993-98. The pensioners' debt was estimated at 6.2% of GDP in 2005.

On many of the institutional issues addressed by the Croatian Government in the last few years, progress has been made in 2005 and especially during the preparation of the budget 2006. However, as the present report makes clear, there is still much to do, and the transition process in Croatia is by no means completed.

2. Budget formulation

2.1. Key characteristics of the Croatian budget process

It should be mentioned at the outset that the Croatian budget has two features, which differentiate it from most OECD countries:

- First the Croatian budget has a very detailed account structure, but still maintains some flexibility through a provision in the Budget Act that allows reallocation during budget execution and a legislative device called the Law on Budget Execution.
- In Croatia there are a large number of extra-budgetary funds and quasi-fiscal activities of public enterprises which are mostly reported in general government accounts in accordance with IMF standards, but which are not fully integrated in the decision-making process on budget formulation.

2.2. Detailed account structure

The budget classification of Croatia is very detailed. It contains approximately 7 000 line items which are determined by economic, organisational and programmatic dimensions. In recent years there has been a tendency towards more emphasis on programmatic considerations, but this has so far not led to a reduction of economic and organisational distinctions.

Although the budget is decided on a very detailed level, the government is given large authority over reallocation of expenditures during the execution phase of the budget. Rules regarding reallocation of expenditures are laid down in the Budget Act (Article 38) and the annual Law on Budget Execution. The passing of a special Law on Budget Execution is not usual in OECD countries, but also occurs in Slovenia (OECD, 2004).

Rules for reallocating expenditures do not differ between the reasons for reallocation, like forecast errors, changed macroeconomic conditions and new spending priorities, but instead apply to the size of the reallocation. Three different types of reallocation can be identified:

- Reallocation of less than 5% of a line item estimate;
- Reallocation of more than 5% of a line item estimate, but still within total government expenditure; and
- Reallocation that increases or decreases total budget expenditure.

The first two types of reallocation can be made without the approval of Parliament. If a budget user wants to reallocate an amount that is less than 5% of a line item estimate, it can do so after the approval of the minister of finance. Reallocation of more than 5%, but still within the budget total can be reallocated with the permission of the government. Reallocation that increases or decreases the budget total can only be made by supplementary budget. However, repayment of public debt and interest payments on public debt can be made in amounts exceeding the approved budget items without any permission. Furthermore, funds may not be reallocated between revenue/expenditure accounts and financial accounts⁴ except with authorisation in the Law on Budget Execution. This law also sets the term within which Parliament has to be notified of reallocation (in 2005, within 15 days).

There has been reluctance in Parliament to reduce the number of line items in the budget. Parliamentarians like to see “their” items included in the budget, even if they are for small amounts and obscure the perspective on the purpose of broader categories of spending. This can be seen as contradictory, as the government at the same time has large autonomy in reallocating expenditures during budget execution. The Ministry of Finance is aware of the desirability of reducing the number of line items and moving towards a more programmatic budget classification focused around programme objectives, but so far little has been achieved in this respect. Presently it is recognised in the Ministry of Finance that progress in this direction can only be made by a general change of attitude, starting in the line departments. Only if line departments start providing reliable information on performance and results, not necessarily in the budget but in any case in plans and evaluations of line ministries, can Parliament gain the confidence that is a precondition for a substantial reduction of line items.

2.3. Extra-budgetary funds and quasi-fiscal activities of public enterprises

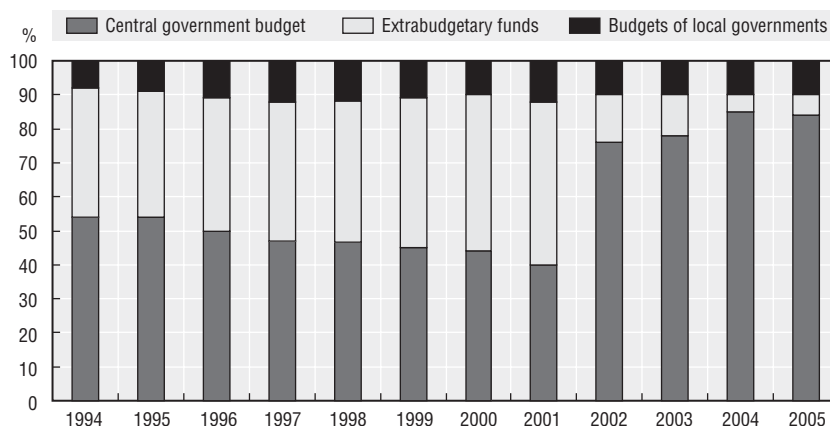
The universality and unity of the budget has been a major issue and area of reform in Croatia in recent years. The principle of universality requires that all revenues and expenditures under the control of the central government are authorised by the government and Parliament. The principle of unity requires that all revenues and expenditures are authorised in the same document so that all trade-offs can be considered during executive and legislative budget formulation.

In the past these principles were compromised by extensive use of extra-budgetary funds and quasi-fiscal activities of public enterprises. Extra-budgetary funds can undermine budgetary discipline if only the net

payments from the central government budgets to these funds are reported in the budget (rather than the gross payments and revenues of the funds themselves, including the earmarked revenues and fees that flow directly into the funds rather than into the central government treasury). Furthermore, budgetary discipline is undermined if extra-budgetary funds can engage in borrowing and lending or can provide guarantees without regular appropriation controls. Quasi-fiscal activities undermine budgetary discipline if public enterprises can sell below market price because they receive special favours such as tax exemptions, regulatory protection, soft loans, or guarantees without regular appropriation controls.

In recent years Croatia has made considerable progress in the integration of extra-budgetary funds into the budget (see Figure 3). Some of the funds are brought under the Treasury Single Account and are brought within the budget prioritisation process.⁵ Two other major extra-budgetary funds, namely the Development and Employment Fund (for redevelopment of war-affected regions) and the Regional Development Fund which were established in 2002 and took over a number of tasks that were previously funded from the state budget, were integrated again in the budget as of 2003 (not as budgetary funds but as parts of the state budget). Other funds however remain outside the Treasury Single Account system and the budget decision-making process⁶ although their budget estimates are included in the budget (not for authorisation but for information purposes) and their realisations in financial reports.

Figure 3. Expenditures of the general government budget 1994-2005



Note: 2005: forecast.

Source: Bajo (2005).

More than half of the expenditures of extra-budgetary funds in 2003 were made by the motorway fund (see Table 3). This fund covers only one-quarter of its expenditures by earmarked taxation on cars and gasoline and is mainly funded by net transfers from the state budget.

Croatia has a large sector of public enterprises compared to economies of similar size. This too is a heritage of the past. For instance, the Croatian Privatisation Fund manages a portfolio of more than 1 100 companies outside the financial and utility sectors. There are no clear rules for profit transfers from the public enterprises to the state budget. Dividends are currently determined by the enterprise and the Privatisation Fund. Dividends are retained by the Privatisation Fund as its own revenues and only returned to the state budget as part of a surplus of the Privatisation Fund at the end of the year. The Privatisation Fund itself is an extra-budgetary fund. Its revenues and expenditures are not subject to the appropriation controls of the budget process. Another public enterprise is Croatian Railways, which suffers large losses due to restrictive price regulation, but is protected by extensive soft loans and guarantees.

Table 3. General government expenditures and extra-budgetary funds in 2003

Per cent of GDP

State budget	41.0
Extra-budgetary funds	6.4^a
Pension Fund	1.0
Health Insurance Fund	0.5
Employment Fund	0.1
Croatian Waters	0.9
Croatian Motorways	2.9
Croatian Roads	0.8
State Agency for Deposit Insurance and Bank Rehabilitation	0.1
Croatian Privatisation Fund	0.2
Regional and local government	5.4
General government	52.8

a: Rounded figures.

Source: IMF (2004b).

In the financial sector, the state owns (apart from the central Croatian National Bank) two small commercial banks (Postansk Bank and Croatia Bank) as well as the large Croatian Bank for Reconstruction and Development (HBOR). The HBOR was established in 1992 with a starting capital of HRK 3.7 billion (Croatian kuna) to finance housing reconstruction and development in war-affected areas. Its role is extensive and comprises housing loans, business start-ups, infrastructure development and export finance. Many HBOR activities are covered by government guarantees.

Quasi-fiscal facilities enjoyed by the publicly owned banks include soft loans and guarantees, tax exemptions⁷ and regulatory protection.⁸

There is no clear division of tasks concerning the oversight of the extensive public enterprise sector. The roles of the line ministries, the Ministry of Finance and the Privatisation Fund are not clearly defined.⁹ It is important that the rules in this respect are clarified and that budget users are made accountable for the financial management of the public enterprises under their supervision and for the speedy elimination of quasi-fiscal activities.

2.4. Annual budget process

In Croatia the annual procedure for budget formulation was established in the Budget Act of 2003. It prescribes and regulates among other things: the time schedule and procedures for the preparation of the economic forecasts; and the subjects to be treated in budget guidelines and in the financial plans and development programmes of the line ministries and the budget users.

Budget users are divided into three levels. First-level budget users are ministries (13) and public law agencies (37). Second-level budget users are sub-units within ministries or agencies (31 units), and third-level budget users are lower-level budget beneficiaries such as schools, theatres, courts, etc. (approximately 720 units).

The fiscal year in Croatia coincides with the calendar year. The main steps in the process are indicated in Table 4 and described below.

Annual budget formulation starts with the release of the spring economic forecasts by the Ministry of Finance. The macroeconomic forecasts are prepared increasingly with the use of a consistent framework and a range of sectoral and macroeconomic data, including data from other European countries, which are of vital importance to Croatia's economic development. The forecasts also take account of the impacts of the governmental programmes (indirect effects). The Macroeconomic Analysis and Forecast Bureau is responsible for the macroeconomic forecasts. With support from the United States (Agency for International Development, USAID) it has established a macroeconomic model. The forecasts are established in co-operation with the Croatian National Bank. In the Macroeconomic Analysis and Forecast Bureau, nine economists are employed in three sections, one in the macroeconomic forecast section, one in the public debt issues section, and seven in the fiscal section; the latter is responsible for the projections of revenues and expenditures. The

macroeconomic forecast section seems to be understaffed and, with only one official who is able to use the macroeconomic model, rather fragile.

Table 4. Budget formulation

Due dates	Activities	Legal basis
End April	Medium-term economic and fiscal outlook prepared by the Ministry of Finance and presented to the government.	Article 18 (2)
15 May	Government enacts budget guidelines.	Article 18 (4)
End May	On the basis of the guidelines, the Ministry of Finance issues instructions to budget users and extra-budgetary users of the state budget, and to local and regional self-government units, for the development of budget proposals.	Article 20 (1,3)
End June	Budget users deliver their financial plan proposals to the responsible ministry.	Article 22 (2)
July-October	The Ministry of Finance reviews the proposals and reconciles them with the estimated revenues and receipts. Detailed negotiations between the Ministry of Finance and the line ministries.	Article 30 (1,3)
15 October	The Ministry of Finance prepares the draft state budget including the draft consolidated budget and delivers it to the government.	Article 30 (2)
End October	Government deliberation and decision on final budget proposal, on the basis of proposals from the Ministry of Finance and line ministries.	Administrative
15 November	The government or the local executive authority delivers the budget proposal and the consolidated budget to the Sabor (Parliament) or to the local representative council for adoption.	Article 30 (5)
End December	The Sabor or the local representative council passes the budget. The approved budget is published in the <i>Narodne Novine</i> (National Official Gazette).	Article 32 (1,3)

On the basis of macroeconomic projections, the Ministry of Finance develops the draft guidelines for economic and fiscal policies for a three-year period starting with the budget year. These guidelines have to be submitted to the government by the end of April. According to Article 18 of the Budget Act, these guidelines should include:

- Prerequisites for social and economic development in the budget year and the following two years;
- Basic indicators of fiscal and economic policy;

- An estimate of realisations of revenues and expenditures of all first-level budget users in the current year (prior to the upcoming budget year) and the previous year;
- A broad proposal for the financial plans for the upcoming budget year, the following budget year and the following two years at the level of first-level budget users;
- Projected changes in the state assets and assets of local and regional self-government units, and the debt of the local and regional self-government;
- A global overview of the assumed state budget obligations that have to be paid in the following years;
- A development plan including investment programmes in the medium and long term.

The guidelines are drafted under the responsibility of the minister of finance and should be adopted by the government by 15 May.

In the Central Government Treasury, the Budget Preparation Sector is divided into three departments: budget analysis (staff of four); budget preparation (staff of eight); and local governments (staff of four). All units are understaffed in comparison to the official staffing level. The government seems to have significant problems recruiting and maintaining qualified staff, who tend to move on to better paid jobs in the private sector. This is a serious problem and will continue to be so if nothing is done. An overall strategy in this field is urgent, as maintaining qualified junior and senior staff is important to keep up the momentum of reform.

On the basis of the adopted guidelines, the Ministry of Finance draws up instructions for the development of the state budget proposal and sends them to the first and second-level budget users and users of extra-budgetary funds by the end of May. These instructions should include the basic economic assumptions from the guidelines and budget targets for the upcoming budget year and the following two years. Furthermore the instructions should include the time limits for the budget formulation process.

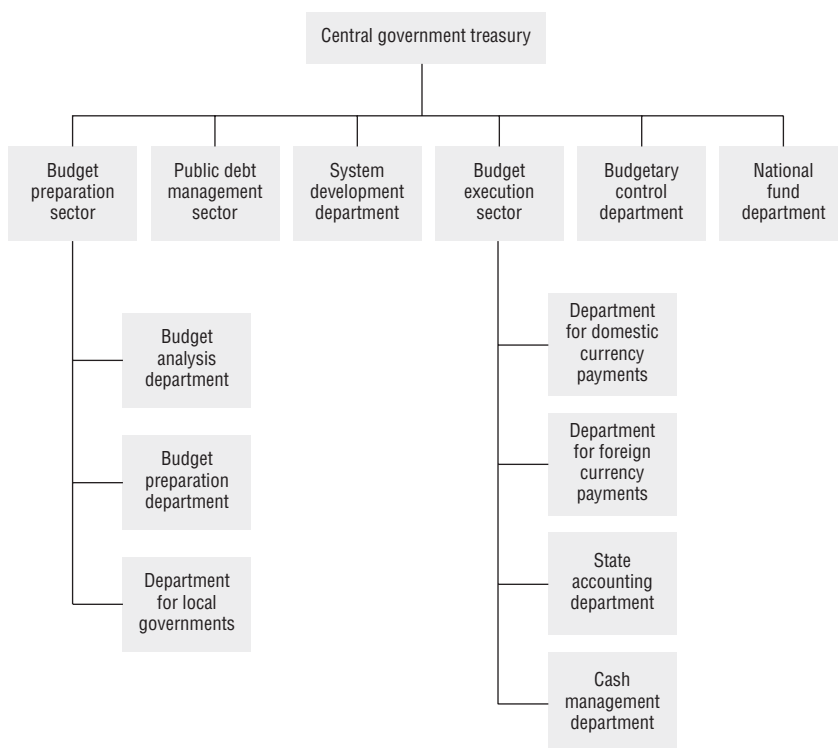
The budget users have to develop their financial plan on the basis of the instructions and send them to the Ministry of Finance by the end of June. According to Article 21 of the Budget Act, the financial plans must include:

- Revenue estimates by types;

- Expenditure estimates for the three-year period, classified according to the budget classification prescribed in the Budget Act and ensuing instructions of the Ministry of Finance;
- An explanation of the financial plan;
- Development plans of investment programmes in the medium and long term;
- Procurement plans;
- The planned number of staff for the three-year period in accordance with law and by-laws.

Figure 4. Organisation of the Central Government Treasury

All sub-units not mentioned



According to Article 22 of the Budget Act, the explanations of the financial plans should include:

- A statement of reasons for programmes in a particular area;
- Legal and other backgrounds of programmes;
- The targets of the programmes and the underlying policy strategies, harmonised with the development plans;
- The indicators on which the estimates are based;
- A report on the results achieved in the programmes in the previous year;
- Other statements of reasons (explanations) and documentation.

The harmonised financial and development plans of the first-level budget users have to be transmitted to the Ministry of Finance by the end of June. Between July and October the Ministry of Finance negotiates the financial plans with the line ministries and revises them according to the conclusions. If during the negotiations a disagreement occurs between the Ministry of Finance and a budget user, the minister of finance prepares a statement for the prime minister who makes a final decision.

By 15 October the minister of finance prepares the draft state budget including the draft budget of consolidated central government and submits it to the cabinet. The cabinet makes final decisions. Given the fact that disagreements between the minister of finance and line ministers have already been arbitrated by the prime minister during the summer, it seems that line ministers have little chance of gaining additional funds at this stage, unless they can claim that entirely new developments have occurred.

Croatia does not have an explicit fiscal rule for the total or current deficit. Instead, it relies on an expenditure and revenue strategy that aims to keep the deficit within acceptable boundaries. For a few years this strategy has also been explicitly placed in a multi-annual fiscal framework that aims to reduce the consolidated general government deficit below the 3% margin that is enshrined in the Stability and Growth Pact of the euro zone countries. This is a common practice in many OECD countries as well. However, what is still largely lacking in Croatia is a clear top-down steering of the budget process aimed at the enforcement of the multi-annual strategy. The budget is drawn up from year to year without much consideration of the multi-annual framework adopted in the previous year. Even if Croatia is perhaps not yet at the stage where it can use unalterable multi-year expenditure ceilings such as prevail in the Netherlands, Sweden and the United Kingdom, it could at least pay more attention to the explanation internally and externally of the annual changes in the multi-annual fiscal framework. The Ministry of Finance could for instance explain more clearly in the budget guidelines and in the budget submitted to the Sabor how the expenditure ceilings for the

budget year and the two following years are related to the expenditure ceilings that were announced in the previous budget and the reasons for the changes.

The budget for 2005 contained for the first year the multi-year line item estimates prescribed in the Budget Act. The role of these estimates is so far not very clear. Presumably they are based on current policy (including policies decided but not yet implemented) rather than current law.¹⁰ However, a real multi-annual budget process can only succeed if the multi-year estimates are taken very seriously. They should be updated from month to month at the line item level and be monitored continuously by the Budget Preparation Sector of the Ministry of Finance.

Box 1. Budget formulation in the line ministries

The budget cycle of line ministries starts by the end of May, when the Ministry of Finance issues instructions to line ministries and budget users for the development of the state budget proposal. The line ministries also prepare additional information for the budget users. Both the information from the Ministry of Finance and the additional information from line ministries shall be transmitted to budget users. The budget process within the line ministries is a bottom-up process.

When budget users deliver their financial plans and development plans to the responsible ministries, bilateral discussions start within the ministries. Financial plans of second and third-level budget users situated under the ministry have to be discussed and agreed with the representatives of these budget users. Afterwards, the proposals should be sent to the ministers and state secretaries and then to the Ministry of Finance.

Since policy changes and saving measures often take a long lead period before they are reflected in budget estimates, it is important that all policy discussion in the government (and not only budget policies) is supported by accurate information on multi-annual consequences and the required changes in multi-annual estimates. In many OECD countries this requirement is put in practice by an obligatory form about multi-annual budgetary consequences that should be attached to all policy proposals submitted to the government and without which a proposal cannot be considered.

In general, budgetary discipline during budget formulation could be further strengthened. In this respect it is important to make a clear distinction between the multi-annual expenditure totals of first-level budget

users and line item estimates. Expenditure totals should be enforced rigorously from year to year during budget formulation as well as during budget execution. Unexpected developments, including overspending on entitlement programmes, or new spending priorities should be accommodated by reallocation within the totals or saving measures. Line item budgetary and multi-annual estimates can be flexible but totals of first-level budget users should be as inflexible as possible. The enforcement of the totals is a crucial task of the minister of finance and the prime minister. In this respect further progress should be made in the coming years.

It is important that the budget documents explain carefully from year to year how the budgetary and multi-annual line item estimates relate to the multi-annual estimates of the previous year. In particular it is important that information is given about the reasons for the changes. Do they originate in new forecasts about entitlement spending on the basis of existing legislation or in policy changes? If the latter, how are the policy changes accommodated within the multi-annual fiscal framework? Which saving measures have been decided to make room for new spending priorities? Presently this information is largely lacking, which makes it difficult for Parliament and civil society to assess the budget proposals of the government.

In order to strengthen budgetary discipline it is also important that extra-budgetary funds are fully brought under the regular appropriations controls, either by integrating them in departmental budgets or by integrating them as separate funds in the budget. In a first stage this would not necessarily imply that their expenditures and revenues are brought under the Treasury Single Account system as this might involve technical complications that could take some time to resolve. It would imply however that the revenues and expenditures of extra-budgetary funds are reported on a gross basis in the budget documents and can be subject to trade-offs during budget deliberations on the same footing as other revenues and expenditures in the state budget.

Like in many OECD countries, the Croatian Parliament approves the budget on a cash basis, but in the explanatory budget documents the government presents a consolidated central government budget balance on a commitment basis (in accordance with the Government Finance Statistics of the IMF; IMF, 1986 and 2001) and a consolidated general government budget balance on a commitment basis. However, in the budget documents (as opposed to the retrospective financial reports, see section 5 below) there is not yet a fully transparent explanation of how the budget balance on a commitment basis is derived from the budget balance on a cash basis, nor how the consolidated general government balance is derived from the consolidated central government balance. In the latter respect it is

particularly not transparent how extra-budgetary funds, quasi-fiscal activities of public enterprises and cumulative changes in the stock of arrears are taken into account. However, in the absence of such information, it is difficult for Parliament to assess the general budgetary strategy in the context of the medium-term fiscal framework.

In Croatia no attempt has yet been made to estimate tax expenditures and to present them in a separate survey in the budget documents. This is not an easy exercise. Nevertheless many OECD countries have started reporting tax expenditures in the budget documents in order to facilitate a more rational use of this instrument and to allow trade-offs with other expenditures (Kraan, 2004).

Box 2. The Institute of Public Finance

The University of Zagreb founded the Institute of Public Finance, a research institution specialising in public finance, in 1970. It employs ten researchers, one librarian, two editors and two administrative staff.

Today's Institute of Public Finance is a public non-profit institution that undertakes research into all aspects of public sector economics, *e.g.* public sector expenditure and revenue, fiscal policy, budget policies, public debt, and the role of the state in the economy. In addition to economic research, the Institute specialises in publishing work related to public sector economics.

The Institute of Public Finance has regular contacts with numerous foreign institutions and associations.

In general the transparency of the budget documents in Croatia has increased considerably in recent years, but it is important that further steps be taken. This will further stimulate the debate about budgetary priorities, not only in Parliament but also in the press and civil society. In this respect a very useful role has been fulfilled in recent years by the Institute of Public Finance, which is an independent Croatian think tank and research institute that has focused on budgetary policy and has published many important studies.

2.5. Conclusion

The Croatian budget has a very detailed account structure with approximately 7 000 line items, but still maintains some flexibility through a provision in the Budget Act that allows reallocation during budget execution and a legislative device called the Law on Budget Execution. There has been

reluctance in Parliament to reduce the number of line items in the budget. The Ministry of Finance is aware of the desirability of reducing the number of accounts and of moving towards a budget classification focused around programme objectives, but progress in this direction can only be made by a general change of attitude, starting in the line departments. Only if line departments start providing reliable information on performance and results can Parliament gain the confidence that is a precondition for a substantial reduction of line items.

In Croatia there are a relatively large number of extra-budgetary funds. In recent years there has been considerable progress in the integration of extra-budgetary funds into the budget. However, a number of funds remain outside the Treasury Single Account system and the regular appropriations controls of the budget process. It is important that these funds are also integrated in the budget. If it takes some time to bring these funds under the Treasury Single Account because of technical complications, a first step could be to include the revenues and expenditures in the budget on a gross basis so that they become subject to the regular appropriations controls and so that trade-offs with other revenues and expenditures can be considered during budget deliberations.

Croatia has a large number of public enterprises, many of which engage in quasi-fiscal activities. There is no clear division of tasks concerning the oversight of public enterprises between the line ministries, the Ministry of Finance and the Privatisation Fund. It is important that the rules in this respect are clarified and that budget users are made accountable for the financial management of the public enterprises under their supervision and for the speedy elimination of quasi-fiscal activities.

The government seems to have significant problems in recruiting and maintaining qualified staff. This is a serious problem and will continue to be so if nothing is done. An overall strategy is urgent as maintaining qualified staff is important to keep up the momentum of the reform process.

Croatia does not have an explicit fiscal rule but instead relies on a medium-term expenditure and revenue strategy that aims to keep the deficit within acceptable boundaries. This is common practice in many OECD countries as well. However, what is still largely lacking in Croatia is a clear top-down steering of the budget process aimed at enforcement of the multi-annual strategy. It would be useful for the Ministry of Finance to explain more clearly in budget guidelines and in the budget documents submitted to Parliament how the expenditure ceilings for the budget year and the two following years are related to the expenditure ceilings that were announced in the previous budget and the reasons for the changes.

The budget for 2005 contained for the first time the multi-year estimates at the line item level prescribed in the Budget Act. The role of these estimates is so far not very clear. A real multi-annual budget process can only succeed if the multi-year estimates are taken very seriously. They should be updated from month to month at the line item level and be monitored continuously by the Budget Preparation Sector of the Ministry of Finance.

For the sake of budgetary discipline it is important to make a clear distinction between the multi-annual expenditure totals of first-level budget users (ministries and independent public law agencies) and line item estimates. The latter should be flexible in order to accommodate unexpected developments, including overspending on entitlements, and new spending priorities. The former should be as inflexible as possible. The enforcement of the totals is a crucial task of the minister of finance and the prime minister. In this respect further progress should be made in the coming years.

It is important that the budget documents explain carefully from year to year how the budgetary and multi-annual line item estimates relate to the multi-annual estimates of the previous year. Presently this information is largely lacking which makes it difficult for Parliament and civil society to assess the budget proposals of the government.

As in many OECD countries, Parliament approves the budget on a cash basis but in the explanatory documents the government presents a consolidated central government balance and a consolidated general government balance on a commitment basis. However in the budget documents, as opposed to the retrospective financial reports, there is not yet a fully transparent explanation of how the balance on a commitment basis is related to the cash balance nor how the consolidated general government balance is related to the consolidated central government balance. In the absence of such information it is difficult for Parliament to assess the general budgetary strategy in the context of the medium-term fiscal framework.

In Croatia no attempt has yet been made to estimate tax expenditures. Reporting on tax expenditures is important in order to facilitate a more rational use of this instrument and to allow trade-offs with other expenditures.

3. Parliamentary approval

Box 3. The Croatian Parliament (Sabor)

A multi-party Parliament (Hrvatski Sabor) was constituted after the democratic elections in May 1990. Croatia initially had a bicameral Parliament consisting of the Chamber of Deputies with legislative authority, and the Chamber of Counties with an advisory role and the right to lodge so-called suspension vetoes. The constitutional amendments of 2000 abolished the Chamber of Counties and transformed the semi-presidential system into a parliamentary system of government. According to the Constitution, the Croatian Parliament is to have a minimum of 100 and a maximum of 160 members. The electoral system is based on proportional representation. Members are elected from party lists by popular vote to serve four-year terms. Croatians residing abroad and the autochthonous national minorities have special constituencies that ensure their representation.

Sources: Inter-Parliamentary Union (www.ipu.org); Croatian Parliament.

3.1. Legal framework

The Constitution, the Budget Act of 2003 (the organic budget law), and the parliamentary Standing Orders legally define the budgetary role of the Croatian Parliament. The Constitution obliges the government to propose a state budget (Article 112), which has to be approved by Parliament in order to become effective (Article 80). Failure to adopt the budget within 120 days from the date when it was proposed can result in the dissolution of Parliament (Article 103). This has not happened since the Constitution was adopted in 1990.

The powers of Parliament to amend the budget are circumscribed by the Budget Act (Article 31), according to which any amendments and supplements to the proposed budget may not alter the deficit. During the parliamentary debate on the budget proposal, an amendment proposing an increase in expenditure may only be accepted if it is financed by a commensurate cut of another item of expenditure, but not from budgetary reserves or additional borrowing. Similar constraints on parliamentary amendments exist in several other countries in the region, for example Romania (Ruffner *et al.*, 2005) and Slovenia (Kraan and Wehner, 2005).

The Budget Act also regulates the broad time parameters for the parliamentary process. The government has to table the budget proposal for the coming year by 15 November of the current year (Article 30). Parliament in turn is to enact the budget before the beginning of the fiscal

year to which it relates (Article 32). If the budget is not approved in time, Parliament has to make a decision on provisional financing (Article 35). This is limited to a period of up to three months and a maximum of one-quarter of realised total income during the previous fiscal year. During a period of provisional financing, no new programmes may be created and budget users may not increase their number of staff or assume any new financial obligations. There have been six provisional budgets since 1990, due to delays in preparing the draft budget.

While the Budget Act sets out the main steps of budget formulation within the executive branch, it does not prescribe an opportunity for Parliament to discuss the budget strategy before the budget guidelines are adopted. To encourage debate on budget aggregates, the *OECD Best Practices for Budget Transparency* recommend the publication of a pre-budget report (OECD, 2002a). Early parliamentary deliberation on the budget totals may provide greater guidance for the legislative phase of the budget process. On the other hand it may be argued that in the Croatian case there is less reason for such a process than in some other countries, because of the constitutional limitation that Parliament cannot alter the budget in a way that would increase the deficit.

3.2. The Finance and Central Budget Committee

The parliamentary Standing Orders provide for the establishment of the Finance and Central Budget Committee as a working body of Parliament (Article 56) and give the committee a range of responsibilities (Article 65). These include the public finance system, the central government budget and accounts, audit reports, the tax system and tax policy, as well as various other duties relating for instance to the banking sector, foreign transactions, and the monetary system. An amendment to the Standing Orders in 2002 further extended the areas of responsibility of the committee to the structure, authority and operating methods of the State Audit Office (SAO) and the Financial Agency (FINA). The committee's jurisdiction is thus very comprehensive and encompasses all aspects of public financial decision making. On the other hand, such a broad mandate also constrains the amount of time that the committee can devote to any one of its particular responsibilities.

The composition of the committee reflects corporatist ideas and is unusual compared with OECD member countries. The Standing Orders prescribe that the Finance and Central Budget Committee has a chairperson, a deputy chairperson and 11 members who are parliamentarians (Article 66). Six additional members are also appointed: one each from among higher-level trade union representatives, the employers' association and the

Croatian Chamber of Commerce, and three representatives of scientific and professional institutions. While these six additional members may attend committee meetings, they have no voting rights. The provisions for other parliamentary committees are similar. For example, the Judiciary Committee has six additional members who are appointed from among public officials, scholars and relevant professionals. These arrangements give interest groups a formal consultative role in the decision-making process.

A secretary supports the Finance and Central Budget Committee and the committee may also employ consultants. Given the extensive areas of responsibility of the committee, this limited access to supporting staff does not allow for detailed budgetary analysis in aid of parliamentary scrutiny. Members of Parliament also have access to the services of a parliamentary library and a small information and documentation unit, but neither of these have analytical capacity. The formation of legislative expertise is also hampered by membership turnover. Moreover, the Croatian Parliament has 24 committees, and parliamentarians may serve on more than one committee simultaneously. As a result, ensuring attendance can be problematic. These factors impede the effectiveness of the Finance and Central Budget Committee (Bratić, 2004, p. 16).

3.3. Parliamentary process

As noted above, the Budget Act prescribes the tabling of the budget by mid-November, one and a half months before the beginning of the fiscal year. Compared with international standards and practices, the timing of the parliamentary budget process in Croatia is very tight. A recent survey of OECD and non-OECD countries shows that in more than two-thirds of the 41 countries surveyed the legislature receives the budget at least two months or more prior to the beginning of the fiscal year (OECD and World Bank, 2003, question 2.7.b). The OECD recommends a minimum of three months prior to the beginning of the fiscal year for the tabling of the budget in the legislature (OECD, 2002a).

The central government budget and the financial plans of extra-budgetary users are submitted to the president of Parliament, together with the budget execution bill. The president of Parliament then refers the draft budget for comment to the Finance and Central Budget Committee as well as other working bodies for consideration. Debate in the committees serves the formulation of amendment proposals that are contained in reports submitted to the president. Individual Members of Parliament, committees, party groups, and the government may propose amendments.

The plenary session considers the budget by sections and by amendments. The debate in the plenary appears to have an important

publicity function for individual parliamentarians, but its impact on budget policy is extremely limited. These debates attract attention in the press and are broadcast on television. Members of Parliament sometimes propose hundreds of amendments, but the Finance and Central Budget Committee views many of them as “unrealistic”. The Standing Orders prescribe that a vote on the submitted amendments and the budget as a whole may not be held prior to the expiry of three days after the debate (Article 175). This gives the government a chance to respond to the proposed amendments. Although a large number of amendment proposals are generated, very few of them are actually adopted. The Finance and Central Budget Committee reports that during the debate on the 2005 budget, 400 amendments were proposed. Out of this total, only nine were ultimately adopted.

During the course of the financial year, Parliament also receives information on the execution of the central government budget. The Budget Act requires the government to prepare a semi-annual statement on budget execution and to submit it to Parliament no later than 5 August of the current budget year (Article 125). The Finance and Central Budget Committee does not view reallocations and revisions during budget execution as an issue of concern, which suggests that the monitoring of budget implementation by Parliament is not strongly developed. Moreover, in the absence of adequately trained support staff, in-depth monitoring of budget execution would most likely overburden the Finance and Central Budget Committee. In addition to limited in-year monitoring, Parliament also considers the execution of the budget following the end of the fiscal year. This aspect is considered separately in section 5 below, on audit and accountability.

3.4. Conclusion

The Croatian Parliament plays a minor role in the formulation of budget policy. The timing of the budget process is very constrained compared with international practice, and this gives parliamentarians little chance for detailed engagement and analysis of the budget. The curtailment of parliamentary amendment powers helps to ensure that amendments are not detrimental to fiscal discipline, which can be seen as an important safeguard, but in any case very few amendments are actually passed.

To strengthen parliamentary scrutiny, some of the following options might be considered:

- An increase in resources available to the Finance and Central Budget Committee would allow it to maintain an appropriate number of analytical staff in support of its budgetary functions. Such support is particularly important when parliamentarians have

overlapping committee assignments and hence limited time to scrutinise budgetary details.

- A working group of parliamentarians and Ministry of Finance officials could be established in order to review the usefulness of budget documentation, and to form a common understanding of the desirable level of detail contained therein. A reduction of items in the budget is a necessary step in order to strengthen the performance orientation of the budget process. Ultimately, parliamentarians would benefit from increased accountability for results, even if they have to forfeit micromanagement of small items.
- Currently, Parliament appears to pay very limited attention to implementation issues, which is a gap in oversight. The credibility of the budget could be enhanced if there were an increased focus on deviations from budgeted amounts during the fiscal year.

4. Budget execution

4.1. The organisation of budget execution

The basic principles of budget execution are laid down in the Budget Act and the annual Law on Budget Execution.¹¹ The Law on Budget Execution is passed at the same time as the budget, and many rules regarding budget execution are found in this law and not in the Budget Act.

During the budget year, the Budget Execution Department of the Budget Execution Sector approves budget users' expenditures and orders payments from the Treasury Single Account (TSA), while the Budget Preparation Sector monitors actual development of budget users' expenditures (see Figure 4 above).

The Budget Execution Sector is the main body responsible for budget execution. It consists of a Department for Domestic Currency Payments; a Department for Foreign Currency Payments, a State Accounting Department and a Cash Management Department (see Figure 4). The Department for Domestic Currency Payments consists of the Unit for Domestic Currency Payment and the Unit for Legal/Financial Affairs. The State Accounting Department is responsible for the Treasury ledger, determining accounting standards and recording of transactions. The Cash Management Department is responsible for establishing a cash flow plan in order to make sure that short-term borrowing and investments of cash deficits/surpluses are managed effectively and efficiently.

The Department for Domestic Currency Payments has a staff of 13 and is mainly in contact with the 51 first-level budget users. Generally, there is more contact between the Department for Domestic Currency Payments and a large budget user than a small one. Examples of large budget users are the Health Insurance Fund and the Pension Fund.

The main information system for the Ministry of Finance is an SAP¹² government financial management system that is used for budget preparation, state accounting, budget execution and management of funds. Budget users have their own accounting systems. Only first and second-level budget users have direct access to SAP. Transactions and other information for third-level budget users have to be forwarded to first or second-level budget users to be compiled and entered into SAP. According to the Ministry of Finance, the system has certain drawbacks that are presently being addressed. One example is that the SAP system is not yet entirely integrated with other systems that are used by the Ministry of Finance and budget users. Information from budget users' accounting systems cannot automatically be transferred to SAP; instead transactions have to be manually entered into several systems. Also the system is not fully compatible with the needs for good cash management, as obligations and liabilities can only be entered in the month that payments have to be made. Furthermore, several other systems, for example the ones used by the Public Debt Management Sector, are not compatible with SAP. The SAP system is under development in order to improve these aspects.

Included in the Croatian budget is a reserve that the government can use for unforeseen expenditures. The size of the budgetary reserve is determined by the budget and, according to Article 45 of the Budget Act, cannot exceed 0.5% of budget revenues (including taxes but excluding receipts such as user charges and fees). Although the government can use the reserve discretionally, it has to report use of the reserve to the Sabor (the Croatian Parliament).

4.2. Cash and debt management

For effective and efficient implementation of the budget, the central government must make sure that cash and liquidity are managed so that liabilities can be met, revenues are collected in a timely manner, and cash balances do not stand idle.

Cash management is the responsibility of the Cash Management Department of the Budget Execution Sector. Several reforms have improved the Treasury's ability to manage cash and liquidity in recent years (see Figure 4). The most important steps have been the creation of a Treasury Single Account (TSA) for the national currency (kuna) in 2001 in the

Croatian National Bank¹³ and the recent inclusion of some extra-budgetary funds into the TSA. With the inclusion of most extra-budgetary funds, around 95% of the central government payments now go through the TSA. Budget users are allowed (often compelled) to have an account in the Postanski Bank (state-owned bank) for transaction purposes. At present there are 292 budget user accounts in the postal bank. Budget users can hold a balance on these accounts, but the balance is monitored by the Ministry of Finance and the balance can at any moment be withdrawn from the accounts to the TSA if deemed necessary. The situation is a bit different for accounts in foreign currency: although a TSA for foreign currency exists, budget users still have foreign currency accounts in private banks.

Box 4. Systems of cash management

There are basically three models of cash management in central governments.

In the decentralised model (in place in Croatia before the introduction of the Treasury Single Account), all budget users have their own account with the commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budget users make payment orders by drawing on their own accounts.

In the centralised model (now mainly in place in Croatia) budget users are not allowed to have their own accounts with the commercial banks. There is only a single account (with sub-accounts) usually kept at the Croatian National Bank, which is under the Treasury. Since the Treasury is not allowed to borrow from the Croatian National Bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budget users have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget users are allowed to have their own bank accounts with a single commercial bank, but the positive balances on these accounts are daily transferred to the Treasury account with the central bank and daily supplied with cash advances. The contract with the commercial bank is auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget users make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term borrowing at the Treasury.

Table 5. Reforms of the Croatian cash management system 2001-03

Change	Year	Objective
Reform of the kuna payment system.	2001	Execution of payment clearing in the banks.
Ban on government borrowing in the Croatian National Bank.	2001	Financing from primary emission made impossible.
Control of national budget liabilities.	2001	Improvement of fiscal discipline and orderly execution of the budget.
TSA – kuna.	2001	Centralisation of budget cash flows and deposits at the Treasury and the Croatian National Bank.
TSA – foreign currency.	2003	Centralisation of foreign currency deposits of the government at the Treasury.
Improvement of foreign currency payments clearing in government accounts.	2003	Improvement of foreign currency payments clearing in the Croatian National Bank.

Source: Bajo (2005).

The budget execution process starts when the Sabor approves the budget for the next fiscal year. After approval, the Budget preparation sector defines allocations for all three levels of budget users on an annual basis, in accordance with amounts decided in the budget (Table 6). In the next step, first and second-level budget users divide the allocations over the twelve months of the budget year and submit an annual cash plan divided by month on the basis of estimation of payment due date. The annual cash plans are entered in the SAP system by the relevant local treasury (the treasuries of the first and second-level budget users are commonly called local treasuries).

The cash plans are reviewed and approved by the Budget Preparation Sector and delivered to the Budget Execution Sector where maximum cash amounts are allocated. Budget user's local treasuries enter their cash plans in SAP, if necessary after revision, in accordance with the allocated maximum cash amounts. Local treasuries update and adjust the cash plans of budget users during the budget year. The monthly plans are approved each time by the Budget Preparation Sector.

During the budget year the Cash Management Department makes monthly allotments to make sure that expenditures are within limits of available cash resources. Budget users enter payment requests in SAP and the Department for Domestic Currency Payments pays invoices according to their maturity date and salaries when they are due. Actual collection of

revenues and payment of expenditures are handled by the Financial Agency (FINA).

Table 6. Stages of the budget execution process

Action	Responsible for entering the information in the SAP system
1. Allocation of funds to all levels of budget users	Budget Preparation Sector
2. Annual cash plans, divided by month	Local treasury
3. Allocation of maximum cash amounts	Department for Domestic Currency Payments
4. Revised cash plans	Local treasury
5. Monthly allotments	Cash Management Department
6. Reservations	Local treasury
7. Payment requests	Local treasury
8. Payments	Department for Domestic Currency Payments

Invoices or payment requests are sent to local treasuries from suppliers or from the lower level of budget users (see Figure 5). Information on wages for government staff is taken directly from staff data. Local treasuries collect the information and send bulk payment requests to the Central Government Treasury (Budget Execution Sector) and to FINA. When the Budget Execution Sector accepts the payments, it orders FINA to make the actual payments. The cash is transferred by FINA from the TSA either directly to suppliers (or employees' bank accounts) through TSA sub-accounts, or via budget users' transaction accounts in the Croatian Postansk Bank.

Cash flow projections are made on a monthly, weekly and daily basis. The revenue and cash position is the sum of daily balances in kuna and foreign currencies (in the TSA, the Croatian Postansk Bank and commercial banks). Cash flow projections are based on the most actual cash plans of budget users, the revenue forecast from the Macroeconomic Analysis and Forecast Bureau of the Ministry of Finance, and cash plans for interest, repayments of public debt and payments on guaranteed debt default from the Public Debt Management Sector.

For efficient cash management it is important that liabilities are entered into SAP as soon as possible, but at present the system still has weaknesses in this respect. Since SAP is ill-suited to handle obligations that are due in future months, the present SAP system only works as a cash transaction system, not a tool for cash management. An assistance project funded by the

EU is being introduced with the aim of linking budget users' accounting systems with SAP and making it possible to enter obligations when incurred into the SAP system.

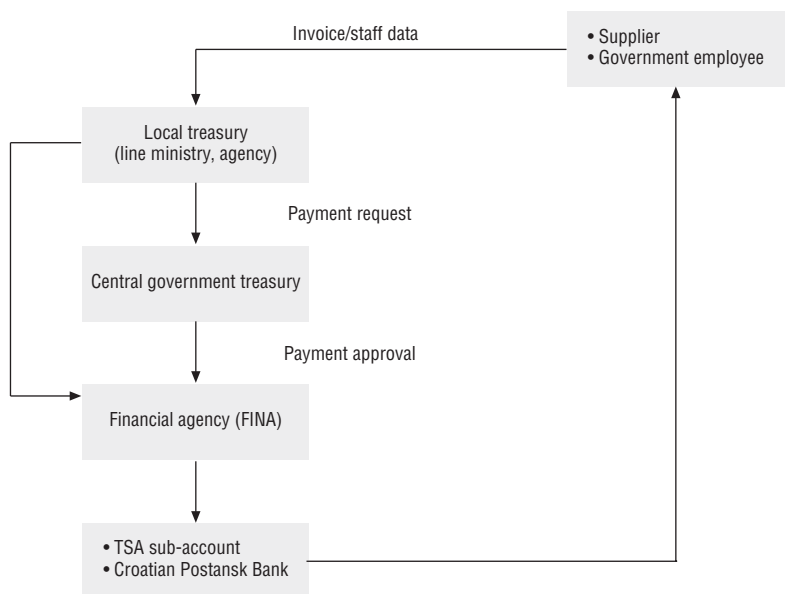
Box 5. The Financial Agency (FINA)

A rather unique feature of the Croatian financial management system is the Financial Agency, which is a heritage from the former Yugoslavia where the Social Accounting Service was the institution responsible for execution of all public transactions. In 1993 this institution was renamed the Institute for Payment Transactions (ZAP) and in 2001 reformed and renamed FINA.

FINA has a central role in the Croatian financial system, including the large public enterprise sector, and presently also for the private sector. It is formally a central government agency; its board is appointed by the government and is financed by fees that the government pays for services that it provides. FINA handles a wide range of functions for the government. All government transactions to and from the TSA go through FINA, both on the revenue and on the expenditure side. Taxes are collected by FINA and, depending on tax shares, transferred to different levels of government. On the expenditure side, payment orders are sent to FINA which then executes, upon approval from the Budget Execution Sector, the actual payments from the TSA to receivers. The same applies to wages for government employees and other transfers. Payment orders are sent to FINA which then draws money from the TSA to pay recipients. FINA records a detailed set of data on revenues and expenditures and reports to the Ministry of Finance through the SAP information system. The information is generally seen as reliable and of high quality.

Presently, FINA also plays an important role in the private sector. Around 80% of its revenues come from services that it performs for the private sector (primarily banks). It has around 180 branches and acts as a bank, a postal transfer system, and a clearing house for banks.

There have been discussions about incorporating at least the part of FINA that operates on behalf of the government into the Ministry of Finance, but nothing has been done so far. In Slovenia, a similar institution existed that has partially been included in the Ministry of Finance and partially contracted out to the commercial banking sector. An important reason that complicates the merger of FINA into the Ministry of Finance is that wages are much higher in FINA compared to the Ministry of Finance. Also, the fact that the system is working quite well has contributed to the hands-off policy.

Figure 5. From invoice to payment

Cash management with detailed preventive control by the Ministry of Finance is a practice that many OECD countries have abandoned. In fact the Budget Execution Sector exerts a double control, first through the allocation of annual maximum cash amounts, and second through the allotment of monthly cash ceilings. The need for preventive cash control is a consequence of the lack of budgetary discipline. If the budget cannot be relied on as a mechanism of control because of insufficient monitoring and updating, control is relocated to the cash management process. The first priority for the reform of the budget process is therefore the strengthening of budgetary discipline. For that purpose it is necessary that the budget itself, including the multi-year estimates, rather than the annual cash plan is continually updated during budget execution¹⁴ and that the Budget Preparation Sector takes a more active monitoring role during the execution stage. The monitoring and updating of the budget and the multi-year estimates not only takes account of the accuracy of the estimates in the light of the progressing spending process (payments and obligations incurred) but have a much wider scope. In particular the process of monitoring and updating takes care of new spending priorities and planned reallocations including their multi-annual consequences.

The updating of the budget ought to become a monthly subject of discussion between the Budget Preparation Department and the local treasuries. Unreliable updating ought to be signalled to the minister of finance and overspending ought to be sanctioned by the government. Presently the Budget Preparation Sector with a staff of 12 (apart from the Department for Local Governments) is clearly not capable of handling this task. To the extent that the budget itself becomes a reliable tool of control during budget execution, the preventive controls by the Budget Execution Sector can be reduced and eventually abolished.

Debt management is the responsibility of the Public Debt Management Sector. Different departments within the Public Debt Management Sector are involved in all areas of short and long-term debt management including drafting debt strategy on a three-year horizon, risk management, analysing the debt portfolio and keeping accounts of debt. Several departments that are supposed to be operational are not functional today. Instead their tasks are handled by other departments.

Within the Public Debt Management Sector there is also a department responsible for state guarantees. This department keeps a record of central government guarantees, evaluates state guarantees, and evaluates requests for new state guarantees.¹⁵ As is the case for the departments responsible for central government debt, this department is not at present fully staffed.

There is a lack of transparency with respect to the use of guarantees. According to the IMF, guarantees are systematically used to circumvent budgetary discipline (IMF, 2004b). The annual Law on Budget Execution sets a ceiling on the value of new guarantees the central government may issue in the budget year. Each guarantee must be approved by the minister of finance on the basis of criteria set out in the Law on Budget Execution. The annual budget contains a line item to meet the estimated cash costs of making payments under called guarantees. It is not clear how this line item has been estimated. There is no information in the budget documents about risk analysis of total outstanding guarantees nor on past calls (IMF, 2004b). Moreover, there is no clear policy regarding the use of guarantees as an alternative to direct expenditures or state loans in the light of default risk and interest costs.

The data system of the Public Debt Management Sector is not interfaced with SAP, reducing the scope for using the SAP system as an overall financial management tool.

4.3. Service delivery

The state administration consists of the central bodies of state administration and the decentralised offices of state administration. The central bodies of state administration are the ministries, central administrative offices, and administrative organisations (independent public law agencies). There are 13 ministries, four central administrative offices, and eight administrative organisations (OECD, 2004). The decentralised offices of state organisation organise and oversee central government duties in the counties. There are 20 offices of this type, one in each of the counties. Apart from the central government, there are 570 sub-national units, namely 20 counties, 123 cities, 426 municipalities, and the capital Zagreb. Due to recent decentralisation, the areas of responsibility for the sub-national governments have increased significantly.

OECD countries that have traditionally separated the policy development and policy execution organisations (the Nordic countries) or that in recent years have moved in that direction (the Netherlands, the United Kingdom) have generally attempted to realise two benefits from this split:

- More freedom for executive agencies concerning the production process and the input mix in order to enhance efficiency;
- Better information about cost prices of outputs.

Both benefits are dependent on accurate output information and a close monitoring of outputs by the central ministries. Both benefits are not fully realised in the Croatian central and decentralised agencies. First, budgets of agencies generally remain largely on a detailed input basis which impedes the autonomy of agencies concerning the production process and the input mix. Second, outputs are not well defined, and monitoring procedures on outputs in the central ministries are feeble. Under these conditions the separation can even have adverse effects. Insofar as agencies have more autonomy than ministerial line offices, they can use that autonomy to hide their resources from oversight. This risk is especially acute in independent public law agencies which may even enjoy legal protection. It is therefore important that Croatia takes further steps to define outputs and improve and institutionalise its oversight procedures for central and decentralised agencies. In a next stage agencies could be given more autonomy, and more executive branches could be split off from the central ministries.

Croatia has recently modernised its procurement procedures in accordance with EU legislation and has started the implementation of those procedures.

Box 6. Procurement

In Croatia the procedure for publishing tenders for public procurement was promoted to a legislative norm in 1997 with the Law on Procurement of Goods, Services and Works (Official Gazette No. 142/97). This law was replaced in 2001 by the Public Procurement Act (Official Gazette No. 117/01) which aimed at harmonisation with EU procurement legislation and introduced the Public Procurement Office within the Ministry of Finance as an advisory body for procurement. The State Commission for Supervision of Public Procurement Procedures (set up in late 2003) handles complaints regarding procurement. Appeals can be submitted for tenders under these procurement procedures. The State Commission is a specialised instance of semi-judicial type, independent and only responsible to the Sabor (Parliament). Decisions of the State Commission are final. The procurement law applies to all levels of government.

The threshold for procurement is HRK 200 000 (before tax). (The exchange rate of the kuna is around EUR 0.138.) According to the law, tenders between HRK 6 000 000 and HRK 12 000 000 must be subject to international competition.

Introducing this legislation was a significant change, and it altered contract practices between the public and the private sector in Croatia. It has been an important step towards improving the way public funds are being used and has improved trust in government and decreased corruption.

At the moment, the Croatian authorities are revising the procurement law to bring it in line with recent development in EU legislation.

Due to recent decentralisation, the sub-national part of the general government has increased, but the central government still accounts for more than 80% of the general government expenditures. The distribution of functions between the central and sub-national parts of government is complex. Decentralisation of functions has not been the same in all parts of Croatia and has started with sub-national units that have been judged fit to take over the provision of services from the central government.

Reform of the administration is an important part of the Croatian efforts towards integration with the EU. Several recent laws aim at the strengthening of the central government's capacity to manage and control the public sector¹⁶ and other initiatives are in the pipeline. This work includes modernisation of legislation regarding the civil service, improving the organisational structure of the government, a clearer separation of the permanent civil service and political appointments, and improving the educational facilities for the civil service.

4.4. Conclusion

The Croatian cash management system is characterised by heavy preventive control by the Ministry of Finance. The need for preventive cash control is a consequence of the lack of budgetary discipline during budget execution. If the budget cannot be relied on as a mechanism of control, control is relocated to the cash management process. The first priority for the reform of the budget execution process is therefore the strengthening of budgetary discipline. For that purpose it is necessary that the budget itself, including the multi-year estimates, is continually updated and monitored during budget execution and that the Budget Preparation Sector takes a more active role during the execution stage. To the extent that the budget itself becomes a reliable tool of control during budget execution, the preventive controls by the Budget Execution Department and the Cash Management Department can be reduced and eventually abolished.

The Budget Preparation Sector, with a staff of 12 (apart from the Department for Local Governments), is clearly understaffed and needs to be expanded to enhance the budget as the primary instrument of budgetary control.

At present, debt management is not up to date, mainly because of lack of staff and problems relating to merging information systems. Also, a clear policy regarding guarantees should be developed to reduce the fiscal risk for the government. Improving the information systems and giving the Public Debt Management Sector the full responsibility for all central government debt would improve the possibilities for an effective management of debt.

The benefits of separation of policy implementation and execution are not fully realised in the Croatian central and decentralised agencies. It is important that Croatia takes further steps to define outputs and improve and institutionalise its oversight procedures on central and decentralised agencies. In a next stage agencies could be given more autonomy, and more executive branches could be split off from the central ministries.

Croatia has taken important steps to bring its procurement procedures into accordance with EU legislation and has started the implementation of those procedures.

5. Audit and accountability

5.1. End-of-year reporting

Croatia used cash-based accounting until 2001, but in 2002 moved to a modified accrual basis (the budget remains on a cash basis). For the

modified accrual accounts, expenses are registered at the time a commitment is made and revenue records are based on financial income in the reporting period. The Budget Act of 2003 (Article 121) and the Decree on Budget Accounting require the end-of-year financial statements to be presented on a modified accrual basis. The long-term objective of the government is to move to full accrual accounting. Ministry of Finance officials note that the move to modified accruals has brought benefits, in particular an improvement in the control of arrears accumulated by budget users. But the transition has not been without difficulties, partly due to a lack of prerequisite accounting skills amongst some budget users. Moreover, the accounting system is fragmented. Budget users frequently operate different systems for different types of expenditures, which makes the preparation of financial statements cumbersome and vulnerable to errors. The State Audit Office (SAO) notes that the number of errors in the submitted accounts has decreased over the past three years, although it still picks up and reports individual cases where expenses are recorded on a cash basis.

The accounting reform also brought forward the date for the submission of accounts by one month. Financial statements for a budget year are now to be submitted to the Ministry of Finance and the SAO by 31 January of the current year for the previous year. Meeting this new deadline proved difficult for some budget users, and there have been several requests for extension of the deadline. This included a number of high-spending budget users, such as the Ministry of Finance, the Ministry of Agriculture, Forestry and Water Management, the Croatian Institute for Pension Insurance, and the Ministry of Science, Education and Sports. The SAO has warned that the deadline is too tight and has recommended an extension. Although the Ministry of Finance itself has encountered difficulties in meeting the deadline, the latter has so far not been revised.

End-of-year budget reporting to Parliament remains mainly on a cash basis. The Budget Act does not clearly distinguish between the different end-of-year reports. The act outlines the process for the compilation of a report on budget execution, which is referred to as the “annual statement of budget accounts” (Articles 124-128). Budget users under a ministry have until the end of February following the end of the fiscal year to submit budget accounts to the relevant line ministry. Each line ministry is then charged with reviewing, harmonising, and consolidating these data and submitting them to the Ministry of Finance by the end of March. The Ministry of Finance, in turn, is charged with preparing the consolidated statement of budget accounts and submitting it to the government by the beginning of May. The annual statement of budget accounts has to be transmitted to the SAO as well as to Parliament for approval by June, but there have been difficulties in meeting the deadline.

End-of-year reporting on quasi-fiscal activities is not comprehensive. Although quasi-fiscal activities are not part of the budget process, since 2003 efforts have been made to provide more information on these types of expenditures in end-of-year reports. For 2003 an expenditure total of HRK 2.5 billion (1.3% of GDP) was reported on a selection of quasi-fiscal expenditures consisting mainly of guarantees provided to Croatian Motorways, Croatian Roads and HBOR, equity acquisition by the Croatian Privatisation Fund and cumulative changes in arrears (Government of the Republic of Croatia, 2004c). Quasi-fiscal expenditures of HBOR were reported to amount to 0.4% of GDP in 2004, and were projected to remain at this level in 2005 (IMF, 2005). Until now, quasi-fiscal activities other than HBOR operations and arrears are not systematically reflected in end-of-year reports.

5.2. External audit

The SAO is Croatia's supreme audit institution and was founded in 1993. The fundamental legal framework for the operation of the SAO is the State Audit Act. The act establishes the SAO as "directly responsible" to Parliament (Article 10). The office is headed by the Auditor General who is appointed by Parliament for a renewable term of eight years.¹⁷ The SAO has to carry out annual financial audits of the state budget, extra-budgetary funds at the national level, and budgets of local and regional self-government units. Audits of the financial statements of central government, local and regional government units, public enterprises, and companies with government majority shareholdings are performed in accordance with an annual programme.

The SAO has about 270 employees, of which 230 are certified state auditors and most have backgrounds in economics or law. The SAO has a central office, in the capital Zagreb, which is structured into several departments with responsibility for development and methods, legal affairs, human resources, European Union funds, the state budget, local government budgets, and state-owned enterprises. This is complemented with a network of 20 regional branches that are under the control of the central office. The SAO is funded from the state budget, and its allocation is approved as part of the regular budget process.

The State Audit Act (Article 3) prescribes that the SAO's annual audit programme has to be passed by Parliament. It is unusual for a legislature to have such strong formal powers over the planned audit activities of the supreme audit institution. In member countries of the OECD, the dominant practice is that audit institutions have statutory independence in determining their audit programme, although they may consult with relevant legislative

committees (United Kingdom National Audit Office, 2001; OECD, 2002b). The International Organisation of Supreme Audit Institutions (INTOSAI) explicitly highlights the need for autonomy in the determination of the audit programme.¹⁸ Substantive interference may lead to the politicisation of the work of a supreme auditor and undermine her/his impartiality. In practice, it appears that the Croatian Parliament does not exercise its formal powers to influence the annual audit programme of the SAO, but such a convention offers less protection against parliamentary interference than statutory safeguards.¹⁹

The definition of audit in the State Audit Act is broad and covers financial as well as performance audit (Article 2). Until the end of 2004, a substantial part of audit capacity was absorbed by audits of privatisation activities in the 1990s.²⁰ With this work concluded, more time and resources can be directed towards regular annual audit activities. The development of capacity for performance audit is very recent, and is taken forward in a twinning project with the National Audit Office (NAO) of the United Kingdom. At present, 26 SAO staff members receive training in performance auditing as part of the twinning project. Relevant manuals from the NAO and INTOSAI have been translated to prepare for the execution of performance audits. No substantial performance audit work has been carried out to date, but four such audits are planned for next year. These include the audit of a national park that will be carried out in co-operation with the Court of Audit of the Republic of Slovenia.

The SAO estimates that it produces about 600 reports per year, which are summarised in its annual report. The State Audit Act requires the SAO to submit an annual report on executed audits and its own work to Parliament no later than five months following the expiry of the date for submission of annual financial statements (Article 11). In practice, there have been delays, in particular following the accounting reform in 2002, when many budget users struggled to ensure the timely submission of accounts. As a result, the annual report of the SAO on the 2002 accounts was presented more than 12 months after the end of that fiscal year. The next annual report was more timely (see Table 7).

5.3. *Parliamentary audit*

Following the finalisation of an annual report of the SAO, the Auditor General presents a summary of audit findings to the plenary, and Parliament has an opportunity to question the Auditor General. The Croatian Parliament does not have a specialised audit committee. The Finance and Central Budget Committee is a main recipient of audit reports, as well as the

Domestic Policy and National Security Committee. Other committees may consider relevant findings as appropriate.

Table 7. The timeliness of audit reporting 1994-2003

Audit report for fiscal year	Date submitted to Parliament
1994	13 December 1995
1995	11 November 1996
1996	4 November 1997
1997	9 November 1998
1998	9 November 1999
1999	11 November 2000
2000	24 October 2001
2001	23 October 2002
2002	16 January 2004
2003	29 October 2004

Source: State Audit Office.

The Finance and Central Budget Committee noted that audit scrutiny takes up less of its time compared with the discussion of the draft budget. Of the several hundred individual audit reports that are generated each year, most relate to the local government level, and very few of these reports are reviewed in depth. Although the Auditor General and representatives from the audited government bodies are invited to relevant committee sessions, the detailed interrogation of witnesses with regard to individual audits is rare. Typically, audit reports are discussed in conjunction with other items on a committee's agenda.

Parliament considers the government's annual statement on the execution of the budget, following a process that is formally similar to its approval of the draft budget. Parliament approves a report on budget execution containing conclusions that may be used to direct government to take action on certain issues. The effectiveness of this mechanism is unclear. Parliament has never refused approval of budget execution, and there is no regular follow-up mechanism to check whether any issues raised by Parliament were actually addressed by the government. Also, this process is not integrated with a review of audit findings by the Auditor General.

5.4. Development of internal audit

Croatia is in the process of establishing capacity for internal audit. The Budget Act provides a legal basis for internal audit of budget users, which is also a requirement for accession to the European Union.²¹ According to the act, internal audit units are to establish “independently and objectively” whether budget users accomplish their functions, point out instances of irregularities or non-compliance with legal provisions, and propose remedial actions (Article 137). The specific responsibilities of the internal auditor include assessing the quality of internal control and accounting, and examining transactions (Article 138). She/he is to present a written report to the head of the government unit (budget user) at least semi-annually, as well as a separate report on any irregularities that are uncovered. A rulebook and a manual for internal audit have been developed, and the government adopted a development strategy for public internal financial control, including internal audit, in May 2005.²²

Since internal audit is a recently introduced concept, these arrangements are not yet operational, but line ministries have embarked on the process of creating internal audit capacity. One of the largest budget users reported that an internal audit unit had been set up that consists of five people. This is one of the biggest internal audit units among the different spending ministries. Staff members of this unit were receiving appropriate training, but no actual audit activities had been carried out up to that date. At the time of this review, central government had a total of 12 certified internal auditors and 55 candidates who were in the process of completing the qualification. Therefore, it is still too early to draw any conclusions about the effectiveness of these new structures.

5.5. Conclusion

Croatia’s audit and accountability arrangements have undergone significant change over recent years. These include efforts to move to accrual accounting and to achieve timely production of financial statements, the building of capacity for performance audit in the SAO, and the institutionalisation of an internal audit function. These developments are positive, but will take time to become established.

It is important to remain realistic about the pace of reform, and to allow for and proactively manage initial teething problems. The following issues deserve further consideration:

- The timeliness of accounting and audit could be improved. The deadline for the submission of financial statements to the SAO may be overly ambitious, in particular in the context of recent accounting

reforms. An extension of the deadline, as suggested by the SAO, appears reasonable and may make the process more realistic and credible. However, it should be a medium-term goal to bring the delivery of audit reporting forward.

- End-of-year reporting is currently disjointed. While Parliament considers the statement on budget execution, this process appears to be largely formalistic and is not firmly linked to a discussion of audit findings relating to the financial statements. These two processes should be integrated, as audit findings can significantly contribute to understanding problematic issues in budget implementation.
- The SAO has insufficient statutory independence in deciding its annual audit programme. The requirement for parliamentary approval of the audit programme should be removed, or at a minimum substituted with a requirement for a non-binding consultation. While the current provision may not so far have been problematic in practice, it is out of line with international standards. It is crucial for the credibility of external audit that the statutory framework safeguards against eventualities where political interference may be attempted.
- It appears desirable to strengthen Parliament's institutional capacity for ex post oversight. Given the fact that a relatively modest number of parliamentarians already have to serve on a large number of committees, the creation of a separate Public Accounts Committee may not be a viable solution. As a compromise, Parliament may consider setting up a sub-committee on audit under the Finance and Central Budget Committee and recruiting support staff to monitor audit reporting.

6. Financial relations between levels of government

6.1. Decentralisation

In Croatia, the sub-national government level is divided into two parts, regions (counties) and local government (cities and municipalities). There are 570 sub-national units divided into 20 counties, 123 cities, 426 municipalities, and the capital Zagreb. Zagreb has a special status and is considered both a county and a city (not included in the previous figures and usually counted as the 21st county). The size of sub-national units varies considerably. Zagreb is the most populous county and at the same time geographically the smallest (779 000 inhabitants, 641 km²). The least

inhabited county is Ličko-senjska with 54 000 inhabitants covering an area of more than 5 000 km².

Croatia is a unitary state and sub-national responsibilities are defined by law, not in the Constitution. Counties are responsible for activities of regional importance, such as education, health care, urban planning, economic development, traffic and transport infrastructure, and establishing a network of educational, health, social and cultural institutions. Cities and municipalities are responsible for local activities whose purpose is to accommodate the immediate needs of citizens in their geographical area. In particular, these activities involve housing and community amenities, urban planning, municipal services, child and social care, primary health care, child care and primary education, culture, physical education, sports, consumer protection, protection and promotion of natural environment, fire fighting, and civilian protection. Cities and municipalities can take over functions from counties, if they have enough economic capacity.

Croatia has started an ambitious policy of decentralisation in the last few years. A programme initiated in 2001 began to transfer the responsibility for education, health care, welfare, and fire fighting to sub-national governments. Although sub-national expenditure is still small compared to the central government, the decentralisation process increased revenue and expenditures for sub-national governments significantly (see Table 8). Decentralisation has been gradual and functions are being decentralised only if sub-national governments have the ability to perform the services properly.

Table 8. The budgets of the sub-national sector 1999-2003

Per cent of general government budget and share of GDP

	1999	2000	2001	2002	2003
Share of general government budget					
Revenue	11.2	12.6	12.9	15.1	16.1
Expenditure	11.1	11.8	12.6	14.3	15.2
Per cent of GDP					
Revenue	5.9	6.2	6.0	7.0	7.5
Expenditure	6.1	6.4	6.2	7.0	7.5
General government expenditure	54.8	54.0	49.1	48.8	49.4

Source: Bajo and Bronić (2005).

Local government revenue comes mainly from taxes and to a smaller extent from grants. Tax revenue is mainly from tax-sharing arrangements, where the central government sets the tax rates and the shares that go to different layers of government. Sub-national governments also receive a significant amount of non-tax revenues, mainly in the form of user charges

for utilities.²³ Most current expenditures are consumption expenditures, but a significant part is also subsidies and other transfers.

With the introduction in 2002 of the Rules on Budget Accounting and Chart of Accounts, the accounts of sub-national governments have to be based on modified accruals for both budgeting and accounting purposes, with revenues on a cash basis and expenditures when obligations are incurred.

Table 9. Sub-national government revenue and expenditure 1997-2003

Billion Croatian kuna (the exchange rate is around EUR 0.138)

	1997	1998	1999	2000	2001	2002	2003
Revenue	7.6	8.7	8.4	9.4	10.0	13.2	15.3
Taxes	4.0	4.8	4.6	5.0	5.3	7.1	8.4
of which sub-national surtax on income						0.7	0.8
Grants	0.6	0.8	0.6	0.7	1.0	1.2	1.5
Other	3.0	3.0	3.1	3.7	3.7	4.2	4.6
Expenditure	7.4	8.7	8.7	9.7	10.3	11.7	14.4
Current expenditure	4.9	5.8	6.1	6.8	8.2	9.4	10.9
Capital expenditure	2.5	2.9	2.6	2.9	2.0	2.4	3.5
Net lending	0.2	-0.1	-0.3	-0.3	-0.3	1.5	0.9

Source: Bajo and Jakir-Bajo (2006).

Sub-national borrowing is limited by the Budget Act (article 105). Prior agreement from the central government is needed for borrowing. Government consent is given if the local unit's annual obligations do not exceed 20% of its revenue of the previous year. The amount of the total annual obligation shall include the amount of annuities on new and existing loans, the debt service (interest and amortisation) on newly issued and existing securities, and the expected calls of new and existing guarantees.

6.2. Tax sharing

Shared taxes are the taxes on income, profit and real estate transactions. County and local levels have tax bases of their own, but the tax rates are to a large extent set or restricted by the central government. Since 2002, municipalities and cities can introduce surtax on personal income. This tax has increased revenues significantly since its introduction and is now an important source of revenue for cities and municipalities.

The Croatian tax-sharing system is complicated. The tax that goes to a specific sub-national government is based on taxes actually collected in its constituency. The general shares going to different levels of government are presented in Table 10 but there are exemptions. For example, regarding

personal income, Zagreb receives a different share than the rest of the country, and the tax-sharing system also includes regional policy to improve the revenue for poorer sub-national governments. Furthermore, depending on the degree of decentralisation, additional tax shares are given to sub-national governments. Parts of the taxes go to the Equalisation Fund. The Equalisation Fund is used to transfer additional resources to sub-national governments that have assumed responsibility for decentralised functions when the revenue from the increased tax share cannot fully finance the activity.

The tax share put aside to finance decentralisation of elementary and secondary education, health care, social welfare and fire fighting totals 10.4%. The size of the transferred tax share depends on the responsibilities that the sub-national level has assumed. If a sub-national government only takes over the responsibility for some of the functions, only the percentages associated with those functions are transferred. Tax shares for responsibilities that are not transferred are kept by the central government.

Table 10. Tax sharing between levels of government in Croatia

Percentage points

Tax on	State budget	Counties	Municipalities/ cities	Equalisation Fund ^a	Decentralised functions ^b
Personal income	24.6	10	34	21	10.4
Personal income, Zagreb	21.6	–	47	21	10.4
Profit	70	10	20	–	–
Real estate sales	40	–	60	–	–

a. The Equalisation Fund is a fund from which resources are transferred to poorer sub-national governments.

b. Transferred functions are elementary education (2.9%), secondary education (2.0%), health care (2.5%), social welfare (2.0%) and fire-fighting (1%). The revenue from these shares remains in the sub-national governments that have assumed responsibility for the function.

Source: Croatian Ministry of Finance.

Since 2001, cities and municipalities can add surtax on personal income in their jurisdiction.²⁴ As with the general personal income tax, the surtax is payable in the jurisdiction where the citizen resides. The surtax has a maximum rate set by the central government of 10% for municipalities, 12% for cities up to 30 000 citizens, and 15% for cities with more than 30 000 citizens. For Zagreb the maximum surtax is set at 30%. The revenue from this surtax is still relatively small compared to total tax revenue, but is increasing. In 2003, 198 cities and municipalities had introduced this surtax.

6.3. Equalisation

The Croatian tax-sharing system includes equalisation of revenue capacity, cost structure and regional policy. This works in two ways, through a special tax-sharing arrangement for areas of special national concern (ASNC) and through the Equalisation Fund.

Areas of special national concern are divided into five groups. Groups one and two consist of areas occupied and damaged during the war. Group three contains areas which lag behind in terms of development. The last two groups are hilly/mountainous regions and islands. About 275 cities/municipalities are regarded as ASNC. For the ASNCs, the central government can transfer its entire own tax share so that these local units can receive 90% of the tax on profits and up to 90 % of the tax on personal income – *i.e.* everything except what goes to the counties (see Table 11).

Table 11. Tax sharing for areas of special national concern (ASNC)

Percentage points

Tax on	State budget	Counties	Municipalities/ cities	Equalisation Fund	Decentralised functions
Personal income tax	0	10	90	0	0
Profit	0	10	90	0	0

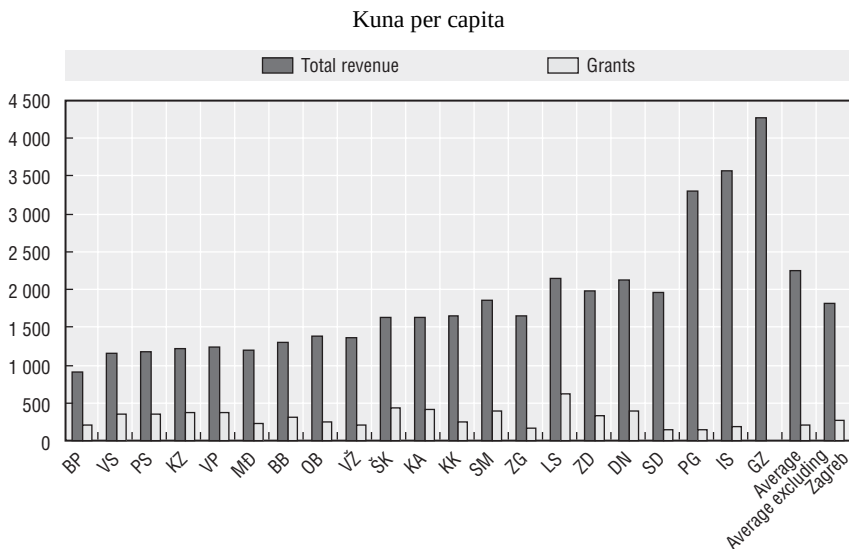
The Equalisation Fund was created to help sub-national governments that cannot provide decentralised functions at a national minimum level from their regular tax share. The Equalisation Fund receives a 21% tax share on personal income tax from areas not belonging to the ASNC group. In addition to the Law on the Financing of Local and Regional Self-governing Units, a decree is passed every year that determines necessary minimum resources for the decentralised functions. This minimum resource is decided by the relevant line ministry together with the Ministry of Finance and set in the Law on Budget Execution. The difference between the minimum resource and the regular tax share is compensated through the Equalisation Fund. On an aggregate level, almost 50% of the cost for the decentralised functions is financed by the regular tax share; the rest is financed through the Equalisation Fund. The funds allocated to the decentralised functions (both tax shares and Equalisation Fund contributions) are earmarked to their specific purpose. The government is aware that this may hamper the efficiency of service provision and intends to move away from earmarking.

6.4. Grants

The Croatian government also uses grants to finance sub-national governments. The criteria for the distribution of grants (current and capital) are defined in the annual Law on Budget Execution. Grants are mainly given to counties which subsequently pass on parts of the grants to cities and municipalities. Grants are mainly of a general purpose character and directed towards areas of ASNC (both counties and cities/municipalities). Examples of criteria used to distribute grants are size of population, revenue per capita, and expenditure for capital assets.

Although the general purpose grants seem to be motivated partly by equalisation purposes, the data do not confirm that. As Bajo and Bronić show (Figure 6), grants per capita are distributed quite evenly among counties, independent of total revenue per capita (apart from Zagreb which receives no grants).

Figure 6. Local government (counties) total revenue and grants in 2001



Note: GZ is Zagreb; the other acronyms indicate the other counties of Croatia.

Source: Bajo and Bronić (2005).

6.5. Conclusion

In Croatia, revenue from tax-sharing arrangements is the most important source of income for sub-national governments. Sub-national governments in Croatia have relatively large own revenues, but little own taxes.

Equalisation of fiscal capacity and service capacity is realised in Croatia with various instruments: tax-sharing, the Equalisation Fund, and grants. The system is rather complex. An important criterion for these various instruments is if a sub-national government belongs to the areas of special national concern. The criteria for belonging to this group are not entirely transparent, which opens the way for lobbying and *ad hoc* political deals. This may reduce the fairness of the system. In general the equalisation aims could be realised by a simpler and more transparent system.

The general purpose grant has an equalisation purpose but the actual distribution of the grant seems not to reflect this purpose.

Tax shares and Equalisation Fund transfers are to a large extent earmarked. This may hamper the efficiency of service provision. It is important that the government's reform plans in this respect are implemented soon.

Notes

1. The Debt Management Division of the Ministry of Finance is formally responsible for the registration of guarantees. However, its registers were not complete before 2003. In the second half of 2003 the registration of guarantees in the Public Debt Management Sector was improved. Nevertheless, in 2004 the official record in the Ministry of Finance still showed differences with the registration maintained by the Croatian National Bank (CNB) which is based on data originating with the banks (IMF, 2004a).
2. In connection with the stand-by arrangement of 2004, the IMF has published staff reports on Croatian fiscal and structural policies in 2004 and 2005 (IMF, 2004a and 2005). Furthermore, in 2004 the IMF conducted a fiscal transparency review of Croatia (IMF, 2004b).
3. Approved by Parliament on 15 July 2004.
4. For instance moving privatisation receipts (which are means to finance the deficit) to non-tax revenues.

5. In 2001 and 2002 the Croatian Institute of Pension Insurance and the major portion of the expenditures and revenues of the Croatian Institute of Health Insurance and the Croatian Employment Office were included in the state treasury system.
6. Namely Croatian Waters, Croatian Motorways, Croatian Roads, State Agency for Deposit Insurance and Bank Rehabilitation, and the Croatian Privatisation Fund.
7. For instance, the HBOR is exempt from tax.
8. For instance, certain budget users are compelled to hold accounts with the Postansk Bank.
9. For example, for an enterprise in the Privatisation Fund portfolio, it is not clear whether the line ministry or the Fund has the final responsibility for the decision on a loan guarantee before it goes to the Ministry of Finance for approval (IMF, 2004b).
10. The United States uses multi-year estimates based on current law, but this is largely due to the dominant position of the US Congress in the budget process. The Congress cannot be confronted with policy decisions from the executive branch that are not yet enacted in law.
11. Official Gazette no. 96/03 and Official Gazette no. 171/04 for the Law on Budget Execution for 2005.
12. SAP stands for System, Application and Product and is a management system produced by a company of the same name (SAP).
13. The Croatian National Bank is independent according to Article 53 of the Constitution. It is not involved in quasi-fiscal activities (IMF, 2004b), and since 2001 it is prohibited from providing credit to the government (Article 36 of the Law of the Croatian National Bank).
14. Usually updated budgets are presented only once or twice to Parliament during the execution year (supplementary budgets). However, within the executive branch, updating should be a permanent activity.
15. An exception is guarantees to international financial institutions, which are handled by the Department for International Financial Institutions and European Integration (within the Ministry of Finance).
16. Two examples are the Act on the Organisation and Competences of Ministers and State Administrative Organisations (2003, with amendments in 2004) and the revoking of the Regulation on the Principles of Internal Organisation of State Administrative Bodies. Revoking the last regulation removed some regulations regarding quotas and numbers of public civil servants in internal organisational units,

contributing to a more effective organisation of central government bodies.

17. So far, a single person has occupied this office since its creation. Parliament appointed the first Auditor General in 1994, and her mandate was renewed in 2002.
18. Section 13.1 of INTOSAI's *Lima Declaration of Guidelines on Auditing Precepts* states: "Supreme Audit Institutions shall audit in accordance with a self-determined programme." See www.intosai.org.
19. In comparison, Slovenia has chosen an interesting compromise between parliamentary involvement and audit independence. The Court of Audit of the Republic of Slovenia is required to consider at least five proposals for audits from the National Assembly (Kraan and Wehner, 2005, p. 93).
20. SIGMA (OECD, 2002b) estimated in 2002 that up to half the audit activity was absorbed by privatisation audits.
21. Hence the development of internal audit capacity is also an issue for other accession candidates. The situation in Romania, for instance, is considered in Ruffner *et al.*, 2005, pp. 42-43.
22. These documents are available at http://pifc.mfin.hr/home_en.htm ["Development of Public International Financial Control (PIFC) in the Republic of Croatia"].
23. The legal framework regulating sub-national governments' financing can be found in the following documents: the Budget Act, the Law on the Financing of Local and Regional Self-governing Units, the Law on Budget Execution, the Decree on the Mode of Calculation of Equalisation Grants for Decentralised Functions, the Rules on Budget Accounting and Chart of Accounts, and the Rules on Financial Reporting in Budget Accounting. In addition to this, sub-national governments have to follow other laws and rules that regulate various areas of public spending.
24. Before 2001, only cities, including Zagreb, were allowed to introduce surtax on personal income.

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Budgeting in Georgia

by

Dirk-Jan Kraan and Daniel Bergvall*

Following the Rose Revolution of November 2003, the government of Georgia has undertaken large reform initiatives in the area of fiscal policy. These efforts have focused on taxation, tax administration, and the budget process, including cash and debt management. A new budget system law became effective in January 2004, establishing a comprehensive framework for the functions and responsibilities of the Ministry of Finance and the spending agencies via a two-stage prioritisation process guided by the annual “Basic Data and Directions” document. A medium-term expenditure framework was introduced in the budget formulation for 2006, in line with the strategic development plan established by the Ministry of Finance in 2004. Budget execution is characterised by flexibility in spending, control of the cash flow, the use of regional treasuries for the quarterly appropriations to all budget users, and arrangements for service delivery at the central level partly in regular ministerial departments and partly in public law entities. The sub-national government sector is small but could grow through the continuing process of decentralisation. The article concludes with a discussion of accounting policies and procedures, the role of the Chamber of Control for external audit, and the need to develop internal control.

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Preface

This review of the Georgian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials of the OECD. The Budget Project aims to initiate and foster regional networks of Senior Budget Officials outside the OECD area. This review served as a basis for the examination of the Georgian budget system at the second meeting of the network of Senior Budget Officials of Central, Eastern and South Eastern Europe (SBO CESEE), held 16-17 February 2006 in Ljubljana. German Technical Cooperation (GTZ) is gratefully acknowledged for its contribution to the review and for its financial support.

The review was carried out in two stages. An initial draft of the review was written by Mr. Michael Ruffner (then at the OECD Secretariat) with the support of Mrs. Anke Scholz (from German Technical Cooperation, GTZ) in connection with a project appraisal mission of GTZ to Tbilisi in late 2004. That mission met with Mr. Roman Gotsiridze, President of the Parliamentary Budget Committee, Mr. Zurab Nogaideli, the Minister of Finance at that time, Mr. Lasha Gotsiridze, first Deputy Minister, Mr. Grigol Gobejishvili, Director of the Budget Department, and their staff.

The final draft was written on the basis of a second visit to Tbilisi, which took place in December 2005. During this visit the mission consisted of Dr. Dirk-Jan Kraan and Mr. Daniel Bergvall (both from the OECD Secretariat). The mission met with Mr. David Khosruashvili, Head of the Budget Department, Mr. Nino Tchelishvili, Deputy Head of the Treasury Service, Mr. Ioseb Skhirtladze, Head of the Foreign Relations Department, Mr. Jacob Meskhia, First Deputy Chairman of the Chamber of Control of Georgia, and their staff.

Both missions would like to thank the Georgian authorities for the frank and open exchange of information. Special thanks go to Mr. Goga Mekvabishvili of the International Department of the Ministry of Finance who co-ordinated the first visit, and to Mr. Hennie Maters, Economic Advisor to the Ministry of Finance, who co-ordinated the second visit. Both put together excellent programmes and provided the missions with many relevant documents as well as practical assistance during their stay in Tbilisi. In addition to the Ministry of Finance and the Chamber of Control, the missions would like to thank the many other government employees, advisors and civil society members who took time out of their busy schedules to meet with them. Finally, special thanks go to Mr. Juergen Schilling, Head of the Georgia GTZ office, for his help and advice to the first mission, and to Mr. Jason Orlando, Resident Budget Advisor of the United States Treasury, for his help and advice to the second mission.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

1. Introduction

To understand the Georgian system one must first understand the context. In November 2003 Georgia went through the peaceful Rose Revolution which unseated an unpopular and largely corrupt government. As with all popular revolutions, there is a united tolerant populace in Georgia with grand ambitions and great hope buffeted against large structural problems.

The populist mandate of the revolution focuses on territorial unification, healing wounds from civil strife, and improvement of living conditions. Two years after the revolution, the Georgian government system is still in the process of total transition, as every facet of society, the economy and government is in flux. Government structures are changing, personnel are being reduced, officials and government employees are being replaced, and new programmes are being created.

Shortly after the Rose Revolution an important constitutional change was enacted (February 2004). This led to a shift in the relations between the major state organs. On the one hand, the position of the president vis-à-vis Parliament was strengthened by broader defined competences, including the right to dissolve Parliament. On the other hand, Georgia moved to a cabinet system of government, which gave Parliament the right to withhold confidence and bring down the cabinet, barring dissolution.

The present government of Georgia is pursuing profound institutional reforms directed at the creation of a market economy and an efficient government. It has embarked on a programme of large-scale privatisation, decreased regulations, and significantly lower tax rates. In the public sphere corruption was a major problem. The government has effected a radical dismissal of government employees that will also achieve the goal of substantial downsizing of the civil service. The new senior management and political control is made up of young, energetic but relatively inexperienced officials. While some functions, like the Chamber of Control, came to a halt during the transition, most of the reformed organisations are now functioning. The inexperience and the weak capacity of the civil service is a main challenge for the planned reforms.

OECD budget reviews look at the budget institutions or the rules of the budget process and the way they function. Since some institutions have been introduced only quite recently, such as the Budget System Law of Georgia

of December 2004 (originally approved in 1996), there is not much experience about the way they are functioning. In such a case assessment necessarily has to be based on comparison with institutional features in other countries and on the accumulated experience in that respect (international best practice). Of course this is also the method used by international organisations such as the IMF and the World Bank when offering their advice to countries in a state of transition. The present review conforms to that approach.

It should also be kept in mind that institutions do not entirely determine policies. This is true of the rules of constitutional law as well as of budget institutions. All these rules are typically of a procedural nature in the sense that they allow different policies based on the political visions of the government and the Parliament of the day. On the other hand institutional rules may also bar or restrict certain policies and in general confine the room for budgetary policy within certain boundaries.

OECD budget reviews look at budget institutions from the perspective of how well they contribute to the fulfilment of the functions of the budget, namely the control of aggregate spending, taxation and borrowing, the efficient allocation of resources, the cost-efficient management of spending programmes, and the democratic authorisation of, and accountability for, taxation, spending and borrowing. For the latter purpose, transparency or clarity about the content of the budget is an important criterion of assessment. Parliament, media and civil society can only participate in the debate about budgetary policies and outcomes if institutional rules guarantee transparency.¹

1.1. General characteristics

With 4.3 million inhabitants, Georgia is a relatively small European country. Consolidated general government expenditure, at 19% of GDP in 2005, is relatively small. This is due to the transition status of the Georgian economy and in particular to the underdeveloped system of social security. Social security expenditures in 2004 amount to 4.4% of GDP, which is very low in a European perspective (comparative figures are: France, 17.7%; Germany, 19.2%; the Netherlands, 12.3%; Sweden, 18.0%; the United Kingdom, 13.4%).

During its first two years in office, the Saakashvili administration and its consecutive ministers of finance have achieved remarkable results in the field of economic and fiscal policy. GDP growth has been strong, a large-scale privatisation effort has gained momentum, a zero tolerance attitude towards corruption has taken root, and impressive gains in tax revenues have been achieved.

Table 1. Real gross domestic product 2002-09

Per cent change on previous period

	2002	2003	2004	2005 ^a	2006 ^a	2007 ^a	2008 ^a	2009 ^a
EU 15	1.1	1.1	2.3	1.4	2.0	2.2	n.a.	n.a.
Georgia	5.5	11.1	6.2	8.2	7.5	7.0	6.0	5.5

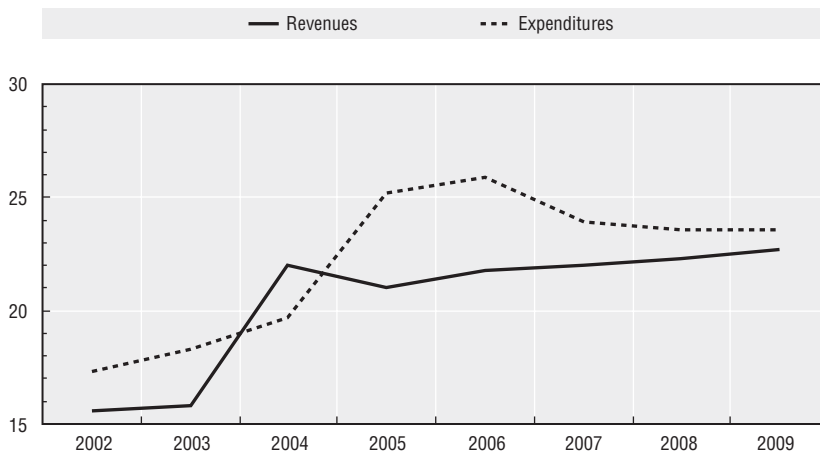
a. Forecast.

Sources: Eurostat; Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

In both 2004 and 2005 large expenditure increases were made possible by revenue increases and privatisation receipts. In 2005 autonomous revenue growth was partly compensated by a general tax reform aimed at rate reduction and broadening of tax bases. In 2005 these increases induced a budget deficit of 4.2% of GDP (privatisation receipts do not count as revenues according to Government Finance Statistics accounting standards but are a means of deficit financing).

Figure 1. General government expenditures and revenues 2002-09

Per cent of GDP



Note: 2005-09: forecast.

Source: Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

The present macroeconomic and fiscal forecast, established in close co-operation with the IMF, foresees a gradual reduction of the budget deficit in the medium term. Privatisation receipts can increasingly be used for debt

reduction, which will allow room for additional expenditures to the extent that debt service decreases.

Table 2. General government deficits 2002-09

Per cent of GDP

	2002	2003	2004	2005 ^a	2006 ^a	2007 ^a	2008 ^a	2009 ^a
EU 15	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.	n.a.	n.a.
Georgia	-1.7	-2.6	2.3	-4.2	-4.2	-1.9	-1.3	-0.9

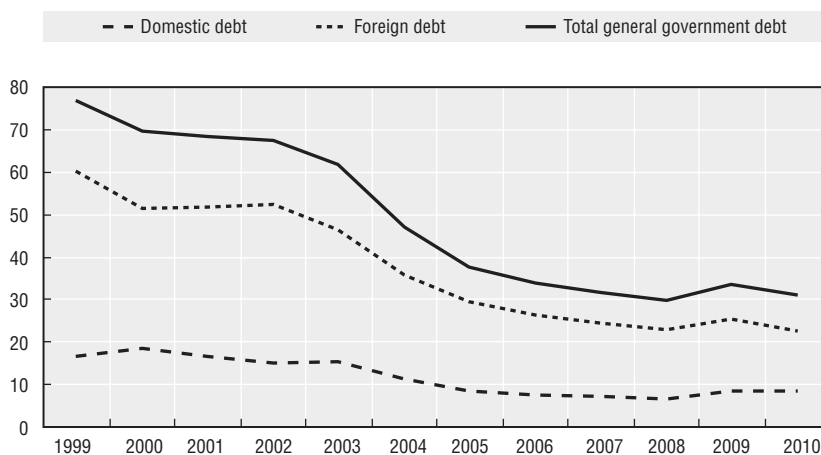
a. Forecast.

Sources: Eurostat; Georgian Government, *Basic Data and Directions 2006-2009*, 2005.

In Georgia foreign debt makes up the largest share of public debt. Foreign debt was strongly reduced in 2004 and 2005 as a consequence of a debt restructuring agreement with Paris Club countries reached in July 2004 and follow-up bilateral agreements. Arrears on domestic debt service have been cleared in the last few years and indebtedness has accordingly been reduced.

Figure 2. General government debt 1999-2010

Per cent of GDP



Note: 2005-10: forecast.

Sources: Georgian authorities; IMF, 2005b.

1.2. The transition process in Georgia

The government has undertaken large reform initiatives in the area of fiscal policy. These reform efforts have focused on taxation, tax administration, and the budget process, including cash and debt management.

These efforts have been supported by the IMF, the World Bank, the EU, the United States, and other bilateral donors. Aid to Georgia was coordinated by a consultative group that met for the first time in Brussels in June 2004. At that time it pledged USD 1.1 billion of which two-thirds is in grants. Major donors are the World Bank (USD 235 million), the United States (USD 360 million) and the EU (USD 160 million).

In June 2004 Georgia concluded a three-year arrangement, Poverty Reduction and Growth Facility (PRGF²), with the IMF in the amount of USD 141.6 million.³ This arrangement involved a wide array of quantitative and indicative targets and corresponding performance criteria in the areas of tax revenues, fiscal deficit, domestic expenditure arrears, credit of the banking sector to the general government, external debt, accumulation of external arrears, reserve money, and average monthly cash collections from the electricity and gas sectors. It also involved a number of qualitative targets and corresponding structural performance criteria and benchmarks in the areas of tax reform, tax collection practices, settlement of electricity sector legacy debts⁴, Treasury reform, supervision of public enterprises, collection of fees from electricity users, reform of the private auditing sector, anti-money laundering legislation, auditing of public enterprises, reform of the Budget System Law, auditing of the stock of state arrears, revision of foreign trade tariffs, and a stop on state guarantees on domestic loans.⁵ The IMF has stationed an IMF Resident Advisor in Tbilisi.

The World Bank, including the International Finance Corporation (IFC) and the International Development Aid (IDA) Board, is supporting structural reform programmes in a wide range of areas. Georgia has received in total USD 773 million in IDA loans for 37 operations and USD 117 million in investment aid from the IFC for eight projects. IDA loans come in a variety of forms. A reform support credit (RSC) approved in June 2005 supports improvements in the areas of governance and anti-corruption, public finance management, and energy sector bottlenecks. To deepen the assistance initiated with the RSC over the medium term, the first poverty reduction support credit (PRSC) is under preparation. It focuses on public administration reform, energy sector reform, education and training, social protection, and private sector development. Other IDA support has come in the form of project support and analytical and advisory assistance across a broad spectrum: education, health, social protection, energy, roads, water

and sanitation, agriculture, irrigation and drainage, forestry, environment, biodiversity, enterprise development, municipal development, judicial reform, and cultural heritage. A country procurement assessment report was prepared in 2002 and a country financial accountability assessment in 2003. IFC projects include equity and credit provision to local and international companies, including British Petroleum and other sponsors for the construction of the Baku-Supsa Early Oil Pipeline and the Baku-Tbilisi-Ceyhan Pipeline, and various banks specialising in micro-finance. In the housing finance sector, the IFC has provided credit lines to various banks for mortgage lending. Other investments have been in electricity distribution, mineral water, and glass bottle production. The IFC Private Enterprise Partnership is implementing a technical assistance project to develop financial leasing, strengthen corporate governance practices, and assess the business environment for small and medium-sized enterprises. The IDA Board recently approved a USD 24 million RSC, a USD 20 million secondary and local roads project, and a USD 3.6 million electricity market support project. The World Bank continues its discussion with the government on a more comprehensive medium-term reform strategy that would be supported by a series of PRSCs and technical assistance operations such as the public sector management reform programme.

The EU is funding multiple technical assistance projects under several programmes (Tacis, TEMPUS, Policy Advice, etc.), in addition to budget support (Food Security Programme and Macroeconomic Assistance). These technical assistance projects support reform initiatives in various line ministries. In the Ministry of Finance, the EU has supported macroeconomic modeling, the preparation of the new Customs Code, capacity building in the Tax Department (including the inspectorates at central and regional levels), and an initiative aimed at increased public awareness of taxpayers' rights and obligations and dissemination of information about technical aspects of Georgian tax law and the applicable procedures.

The United States government has set up a fiscal reform project in Georgia (through the Agency for International Development, USAID). This project supports reform initiatives in various line ministries and in the Ministry of Finance (especially in the area of information technology development). The US Treasury provides technical assistance to the reform of the budget process and debt management, and has maintained a resident budget advisor in the Ministry of Finance since 1996. The US Treasury presence also includes a resident advisor to provide policy and technical advice in the areas of fiscal policy, monetary policy, and foreign exchange policy to the Ministry of Finance and the National Bank of Georgia (the central bank). The US Treasury also provides technical assistance to the Tax

Department (in the Ministry of Finance) in the areas of audit, tax collection, and taxpayer registration.

The commitments made by Georgia in contracts with the IMF, the World Bank, the EU and the United States cover not only fiscal and structural financial-economic policies but also the reform of budget institutions. These commitments are often the point of departure of the findings in this review.

1.3. Fiscal policy and institutional reform in 2004 and 2005

In order to put the findings of this review in perspective, it is useful to provide some data at the outset about institutional and fiscal policy in the recent past.

Fiscal performance in 2004 was impressive. Tax revenue grew by 50% (nominally) compared to the previous year (from 14.1% of GDP to 18.3% GDP). This was mainly due to a strong drive to curb tax evasion and to improve tax and customs administration. There has also been a one-off surge in non-tax revenue, stemming from clearance of arrears in fee collection and monies collected from former government officials suspected of corruption. The higher than envisaged growth of government revenues allowed two supplementary increases of spending appropriations, including the clearance of the largest part of domestic wage and spending arrears ahead of schedule. The fiscal balance on a commitment basis, exclusive of quasi-fiscal activities of public enterprises, was improved from –2.5% of GDP in 2003 to 2.3% of GDP (surplus) in 2004. (However, the fiscal balance on a cash basis was –0.3% of GDP, the difference reflecting the net change in expenditure arrears.) Domestic arrears were reduced from 4.7% of GDP in 2003 to 2.1% of GDP in 2004. A debt restructuring agreement, reached in July 2004, consolidated roughly USD 211 million due on debts contracted before 1 November 1999, including USD 161 million from Paris Club member countries. This amount consists of arrears due as at 31 May 2004 as well as maturities falling due from 1 June 2004 up to 31 December 2006. The agreement leads to rescheduling of the maturities and 50% of the arrears and will reduce the debt service to Paris Club creditors from USD 169 million to USD 36 million (which consists mainly of interest on rescheduled amounts and payments on arrears) during the period of the IMF-supported PRGF programme (until 2007). The agreement has also led to the reduction of foreign debt from 43.9% of GDP in 2003 to 34% of GDP in 2004.

Fiscal performance has continued to be strong in 2005. Tax collection increased by 21.9% (nominally) compared to 2004 (from 18.2% of GDP to 19% of GDP). This was due to continuing strong economic growth (8.2 % in

real GDP 2005), further improvements of tax and customs administration, a comprehensive tax reform implemented as of January 2005, and large privatisation receipts. This strong performance enabled the government to secure passage of two supplementary budgets in April and May 2005, authorising a large increase in appropriations that would be financed mainly by privatisation receipts.⁶ The 2005 budget was further increased through amendments in October and December. Additional expenditures are mainly on defense (as part of Georgia's bid to join NATO) and on rehabilitation of roads and the dilapidated energy sector. The four supplementary budgets have raised the 2005 budget deficit to 3.6% of GDP on a commitment basis (4.8% on a cash basis, the difference reflecting the net change in expenditure arrears). The government has emphasised that two-thirds of the additional outlays will be spent on imported goods and services, limiting the effects on inflation. The government also stressed that continuing accumulation of government deposits at the central bank from privatisation is not politically feasible against the backdrop of pervasive social needs and other priorities. Foreign indebtedness has been reduced from 34.0% of GDP in 2004 to 28.5% of GDP in 2005, partly as a consequence of follow-up bilateral agreements with Paris Club creditors. The stock of domestic arrears has been revised upward by GEL 60 million (0.5% of GDP) as a result of recent audits. The government intends to fully eliminate domestic arrears by end 2006.

Important goals of structural financial-economic reforms in 2004 and 2005 were tax reform, reform of the electricity sector, privatisation, improvement of social protection, civil service reform, and reform of public expenditure management and treasury operations.

Tax reform, coming into effect as of January 2005, involved the adaptation of a new tax code, reducing the number of taxes from 21 to 8, cutting the value-added tax rate from 20% to 18% and the payroll tax (for social security and health care) from 33% to 20%, and setting a flat 12% personal income tax, replacing marginal rates between 12% and 20%. The bases of the value-added and profit taxes were broadened by eliminating certain exemptions and special regimes. The revenue loss (estimated at 3.5% of GDP) would be more than offset by increased excise tax rates on oil and tobacco products, liquor and automobiles, taxation of the electricity sector on an accruals basis, and the enhancement of the revenue administration. To encourage the legalisation of the informal economy, a one-off tax write-off was granted on undeclared tax obligations incurred by end 2003, and regularisation of undeclared property was authorised against payment of a one-time levy of 1 % of the value of the property. Under the terms of Georgia's accession to the World Trade Organisation, the number of import tariff bands has been reduced from 21 to 16 as of January 2005. Draft legislation leading to further reduction of the number of tariff bands and

reducing the maximum import tariff rate (currently 30%) is under preparation and will become effective in early 2006. In 2004 and 2005 the government completely overhauled the tax and customs administration, securing impressive gains. Measures included: (1) establishment of an excise tax inspectorate, to bolster collections, and a financial police; (2) reduction of the number of inland tax and regional offices, accompanied by staff retrenchments; (3) integration of the road tax administration and the tax organs of the Adjara region into the national tax department; and (4) re-registration of taxpayers (by March 2005, 60 000 taxpayers had been registered).

Energy sector reforms (electricity and gas) sought to reduce the sector's quasi-fiscal losses (due to subsidised prices, lack of metering, and large-scale electricity theft) and provide reliable power supplies (avoidance of chronic power cuts in winter). In the electricity sector, a review of the tariff methodology will eventually permit introduction of an updated tariff structure at cost recovery levels by mid 2006. A report on the revision of the rate structure is under preparation with the help of the World Bank. Average monthly cash collection rates in the electricity sector improved from 52.4% in 2003 to 64.8% in 2005. Quasi-fiscal losses declined from an estimated 4.9% of GDP in 2003 to 3.4% of GDP in 2005 (from 3.8% of GDP to 2.5% of GDP in the electricity sector and from 1.0% of GDP to 0.9% of GDP in the gas sector). This steady increase in collection rates is mainly due to ongoing extension of metering by the main electricity distribution company in Tbilisi. Non-payment for the use of electricity outside Tbilisi remains the largest source of quasi-fiscal losses.

The government started an ambitious programme of divestiture and operational improvements in state-owned enterprises. The Enterprise Management Agency, which controls 1 800 public enterprises employing 180 000 persons, will be shifting from managing companies to preparing them for privatisation or, at least, to private equity participation and performance-based management contracts conducive to early privatisation. The authorities envisage divestiture or liquidation of the bulk of the enterprises controlled by the Enterprise Management Agency during 2005–06. Most small and medium-sized enterprises would be sold as soon as possible, while the government would restructure larger companies in the energy, transport and telecommunication sector in step with enabling legislative and regulatory reforms. More than 100 full or partial privatisation contracts were reached in 2004 and early 2005. Privatisation proceeds in 2004 amounted to GEL 87 million⁷ (0.9% of GDP) and in 2005 to GEL 387 million (4.2% of GDP).⁸ Recently the government has invited bids for additional privatisations (likely to begin in 2006), including several energy companies (comprising the main provincial distribution companies),

a number of smaller hydro power plants, the large Rustavi and Madneuli metallurgical plants, and the Batumi crude oil storage complex.

In 2004 the authorities raised monthly social security pensions from GEL 14 to GEL 28 (USD 15) at an estimated cost of 0.8% of GDP. The latest data show a somewhat declining share of the population living under the poverty line (about USD 30 per month) from 55.7% in the first half of 2003 to 52.5% in the second half of 2004. This decline partly reflects the recovery in economic activity, timely payment of public sector wages and social transfers, and a significant clearance of domestic arrears. The lay-offs in the public sector in 2004 helped to create a more efficient government but they also appear to have contributed to a rise in the unemployment rate from 11% to 13%. The authorities envisaged the introduction in late 2005 of a streamlined, means-tested poverty benefit targeted at the 600 000 most needy (living under the extreme poverty line and, depending on family size and living conditions, under the poverty line) which would cost about 0.7% of GDP per year. The preparation of draft legislation for this purpose has been delayed because of technical difficulties concerning the eligibility criteria.

The authorities made an ambitious effort to downsize the civil service and to sack corrupt officials with the aim to improve governance. Public employment was reduced by 30 000 positions in 2004 (23% of the workforce), mainly in the areas of defense, internal security, and the Ministry of Finance. Salary savings have been used to improve remuneration of remaining personnel. The fiscal costs of retrenchment were negligible as a result of 2003 legislation temporarily suspending severance payments. In August 2004 the government established a Civil Service Council tasked with co-ordinating civil service reform. In October 2004 the government defined the mandate of the council and its implementing arm, the Civil Service Bureau. Further reforms were envisaged. Emphasis will be placed on creating a professional and efficient civil service, further upgrading remuneration and harmonising it across all branches of central government, and introducing norms and regulations that would ensure accountability of officials.

The new Budget System Law became effective on 1 January 2004. The new law established a comprehensive framework for the functions and responsibilities of the Ministry of Finance and the spending agencies in the budget process. The law introduced a two-stage prioritisation process: first the key directions are determined and then spending agencies present their detailed budget requests within the budget ceilings put up in the first stage. A new commitment verification mechanism for budget expenditures, existing since 2003, has brought order to the spending of public resources, stopped accumulation of arrears, and increased transparency of

expenditures. The verification mechanism was extended to extra-budgetary state funds as of September 2004.

Concerning treasury operations, in April 2004 a single revenue account was established at the National Bank of Georgia. More than 10 000 transit accounts in the bank were closed. All revenue accounts at commercial banks were closed. Budget, tax and customs legislations were amended in view of this reform. Through assistance provided by USAID among others, the computer hardware in the Treasury was upgraded while supportive software was developed by Treasury specialists. These components contributed to the successful implementation of the first stage of Treasury reform. For the second stage of reform, the closing down of all expenditure accounts is envisaged. The completion of the Treasury Single Account (TSA) uniting the single revenue account and all expenditure accounts was planned for 2005 but has not yet entirely been achieved. The establishment of the single revenue account made it possible to develop and implement mechanisms for refunding excessively paid taxes (mainly VAT), which had been an unresolved problem for many years. The new system of refunding became operational in April 2004. The Treasury Service, which operates through a central apparatus and 11 regional treasury services, was re-organised. The Accounting Methodology Administration was transferred to the Treasury Service. A new charter of treasury services, defining the structure of the Treasury Service and the functions and responsibilities of the various divisions, was implemented in October 2004.

2. Budget formulation

2.1. Institutional reform in the run up to budget formulation 2006

It should be mentioned at the outset that in the run up to the formulation of the 2006 budget some important institutional reforms have been implemented and for the first time applied. These include:

- the formulation of a medium-term expenditure framework;
- a new structure of the “Basic Data and Directions” document.

2.2. The medium-term expenditure framework

In 2004 the Ministry of Finance initiated a series of reforms. In order to sustain this reform process, the Ministry established its Strategic Development Plan covering the directions of budget management and expenditure policy, debt management, treasury systems, improvement of the investment climate, enhancement of state revenues, and institutional

strengthening. The Plan was updated in September 2005 (Georgian Government, 2005c). The introduction of the medium-term expenditure framework (MTEF) was the driving force of the reform in budget management and expenditure policy. The first MTEF was introduced in the budget formulation process for 2006 and covered the period 2006-09.

The MTEF aims to ensure targeted spending of scarce state resources in line with the government priorities, and to strengthen the link between policies and expenditure estimates over a period of four years (the budget year plus three subsequent years). There are two stages:

- Allocating resources to sectors, based upon overall macroeconomic forecasts and incorporating national and sectoral government priorities. The result of this stage is the annual Basic Data and Directions document;
- Allocating resources within sectors, based upon sectoral strategic priorities and within sectoral ceilings determined in the first stage. The result of this stage is the draft budget to be submitted to Parliament.

Although the introduction of the MTEF process was somewhat disconnected from the regular budget formulation process for 2006, in the course of 2005 both processes became fully integrated, which is of course essential for an effective MTEF. Throughout the public administration the awareness of the MTEF aims and requirements has been greatly increased, and the MTEF became associated with budget reform. This is a solid foundation for the next MTEF cycles.

A major element of the MTEF process was the preparation of documents by the ministries linking policies with expenditure estimates. This was accomplished in both stages of the budget formulation process. In the first stage, the document supported the allocation of resources to the sectors in the Basic Data and Directions document; in the second stage, the document supported the allocation of resources within the sectors in the draft budget.

In both stages the format of the document was prescribed. In each case the prescribed format, called “strategic matrix”, consisted of four columns: (1) current situation, (2) objectives/targets, (3) reform actions, and (4) budget management implications.⁹ The first column briefly assessed the existing situation in each programme area in the sector and identified key issues affecting programme performance. The second column stated changes in the delivery of programme activity that were considered as targets for the budget year and the next three years, if possible quantified by indicators. The third column identified programme reform actions to be undertaken in

the planning period. The fourth column specified the implications for funding over the planning period. The task force set up for the MTEF process, chaired by the minister of finance and composed of line ministry representatives, held a series of meetings to assist the ministries in filling in the forms. In addition, two training sessions for line ministry officials were held. Some ministries volunteered to become pilot ministries (Environment, Energy, and Foreign Affairs).

The challenges that were faced in developing the strategic matrices were considerable, particularly in ministries unfamiliar with thinking about their budgets as a tool for policy development. Strategic matrices were to be jointly developed in working groups with policy planning units and budget units, with the former taking the lead. In fact this happened only in one ministry (Agriculture). In all other cases the budget units were charged with strategic matrix development. Political guidance was mostly lacking. In spite of these difficulties, most ministries succeeded in providing the required information, if not always in accordance with set time schedules. Not surprisingly, ministries with well worked out policies, for example Foreign Affairs and Energy, found it easier to complete the matrices and to be concise in their presentation.

One of the major innovations of the MTEF process was the establishment of budget ceilings for a four-year period¹⁰ for the 42 spending agencies (some state organs¹¹, the ministries, and the plenipotentiary representatives of the president in the regions). The ceilings were presented to the cabinet according to the timetable prescribed in the Budget System Law (15 June) and subsequently inserted in the Budget Circular to the line ministries. The ceilings were supposed to be based upon the sectoral spending forecasts contained in the Basic Data and Directions document (based in turn upon the strategical matrices of the first stage) as well as updated macroeconomic and fiscal forecasts. In fact the ceiling preparation process was rather *ad hoc*. The ceilings were only loosely connected to the sector forecasts in the Basic Data and Directions document.

The subsequent internal budget preparation process within the line ministries on the basis of updated strategy matrices was somewhat overshadowed by continuing negotiations about the ceilings. The budget process in the line ministries was in many cases not well organised. Although the idea of expanding budget narratives containing explanations about policy and expenditure changes was supported by the line ministries, their major concern during the draft budget preparation stage remained the negotiation of ceilings with the Budget Department of the Ministry of Finance. Therefore the explanations sometimes had to be given at the last moment and received little attention from both the line ministries and the Ministry of Finance.

In spite of some shortcomings in the first year of its application, the MTEF is a major and important step forwards. It brings the consideration of policy and expenditure together in a multi-annual perspective. On the one hand it necessitates the timely consideration of the multi-annual budgetary consequences of new legislation and policy initiatives, and on the other hand it necessitates the timely preparation of new legislation and policy initiatives to achieve medium-term budgetary objectives. These are important improvements, thanks to which Georgia is now pressing ahead of other countries in similar circumstances and even some OECD countries.

The MTEF process is now firmly entrenched in the Georgian public administration, forming a good basis for further improvement in the coming years. The next steps to be considered include the following:

- Closer involvement of policy units in the development of the strategic matrices; more political guidance by line ministers; ownership of the development process by the line ministries;
- A closer and more transparent relationship between the sectoral expenditure forecasts in the Basic Data and Directions document and the sectoral ceilings of the Budget Circular. The sectoral expenditure forecasts would generally have to be understood as preliminary ceilings, only to be adjusted in the Budget Circular in the light of updated macroeconomic forecasts and revenue estimates;
- Earlier definitive decisions on the ceilings in order to avoid ongoing ceiling negotiations after the Budget Circular has been sent out.

An important test will be whether the multi-annual perspective can be maintained over the years – that is to say: whether the ceilings that have now been established for the period 2007-09 can be maintained in the next budget cycles, at least in the sense that the ceilings of the previous year will be taken as the point of departure in the next budget cycle. If this does not happen, the entire reform loses much of its significance.¹² Multi-annual stability in this sense requires that a clear distinction is made between existing policies and expenditure estimates previously approved and proposed changes in policies and their budgetary consequences in both stages of the budget formulation process. This would imply that the strategic matrices used for the preparation of the Basic Data and Directions document and the draft budget would, to a larger extent than has currently been the case, be focused on changes in policies and their budgetary consequences compared to the status quo of existing policies and corresponding expenditures as previously estimated and currently updated.¹³ For this purpose it is important that the strategic matrices contain columns for the

approved budget and multi-year estimates for the current year and the next four years as well as for the changes that the line ministries propose in these numbers. Analogously, policy information should distinguish between existing policies and proposed policy changes.¹⁴ This information should also be provided in the Basic Data and Directions document (existing versus new estimates) and in the draft budget (existing versus new policies). Presently neither the Basic Data and Directions document nor the draft budget contains information about approved estimates for the current year at the sectoral and programmatic level (let alone for future years), which makes it very difficult to assess the impact of the new budget.

For a multi-annual approach it is also important to make a distinction between the maintenance of the overall expenditure ceiling and the ceilings at the sectoral levels. In order to maintain multi-annual stability, the former should be as inflexible as possible and only be allowed to change in the light of structural macroeconomic developments. It is a special responsibility of the minister of finance to see to the maintenance of the overall ceiling over the years. The ceilings at the sectoral levels, on the other hand, should be allowed to be adjusted from year to year in order to accommodate cyclical macroeconomic developments and new policy initiatives that cannot be accommodated within the sectoral ceilings.

One of the greatest challenges to successfully implementing an MTEF, and budget reform in general for that matter, is to increase the Budget Department's ownership. In 2005, the first year of MTEF reforms, the Budget Department was involved too little and too late in organising and executing the reform work. If these reforms are truly to take hold and have a lasting effect, the public administration of Georgia needs to be accountable for managing and executing the reforms, and consultants and outside advisors should work to facilitate this. For example, for the 2007 budget the Budget Department staff (*i.e.* the State Budget Division) should take the lead in revising the strategic matrices and working with the line ministries to ensure that the matrices are completed properly.

2.3. The Basic Data and Directions document

Georgia has a two-stage budget process (Article 17 of the Budget System Law). The first stage leads to the Basic Data and Directions document¹⁵ which is submitted to Parliament (Article 17, paragraph 7 of the Budget System Law). The Budget System Law also anticipates the establishment of an MTEF (Article 17, paragraph 3) and prescribes that the Basic Data and Directions document shall be based on the MTEF (Article 17, paragraph 4). This general arrangement allows the government

and Parliament to consider and discuss the general outlines of budgetary policy in advance of budget preparation at the line item level.¹⁶

Whereas in previous years the Basic Data and Directions document had been quite short (two pages for the 2005 budget), during the budget preparation for 2006 an effort was made to produce a document that could really function as a budgetary strategy paper. It contains: a macroeconomic overview; a forecast of macroeconomic indicators (GDP, inflation, balance of payments deficit, exchange rate, monetary indicators); a sustainability analysis concerning macroeconomic shocks; detailed estimates of tax, non-tax and donor grant revenue; a brief review of 2004 budget execution; and an analysis of domestic and foreign debt sustainability. It also contains the MTEF (overall and sectoral expenditure forecasts for the medium term) as well as statements of main sector aims and objectives – all in all a quite substantial document of 27 pages and eight annexes.

Both revenue forecasts and expenditure forecasts are supposed to be based on policy priorities and on past budget trends and cross-country comparisons. Expenditure forecasts should make use of the national strategy as described in the March 2005 updated *Economic Development and Poverty Reduction Program* (IMF, 2005c) – basis for the Poverty Reduction and Growth Facility mentioned above in section 1.2 – as well as the sectoral strategies as described in the strategic matrices provided by the line ministries. The Basic Data and Directions document does not make very clear whether and to what extent the updated national strategy and the sectoral strategies have caused changes to previous revenue and expenditure forecasts (in total and by sector). As to the analysis of past budget trends and cross-country comparisons, some work was done by the Budget Department, but this was not completed and hence not used in the Basic Data and Directions document.

Although the timetable for the document preparation process was followed only to a limited extent, it was a major achievement that the Basic Data and Directions document was submitted in time to the government (15 April) and Parliament (1 May).

The Financial Policy Department of the Ministry of Finance has the lead during the preparation of the Basic Data and Directions document. This department is responsible for macroeconomic and tax policies and tax estimates. The Budget Department of the ministry is responsible for the analysis of the expenditure outturns of the preceding year, and it should also play the main role in the development of the sectoral expenditure forecasts on the basis of the strategic matrices. In fact the Budget Department has only been involved to a small extent in the expenditure forecasts, and the

actual effect of the strategic matrices on the expenditure forecasts has been small.

Additional reasons for the limited impact of the strategic matrices on the expenditure forecasts were the prescribed sectoral and programmatic expenditure classification and shortcomings in the way the matrices were filled in. The initial idea was that sectors could be wider than single ministries, more or less corresponding to the functional classification of the Government Finance Statistics (GFS), and that they would encompass not only policies and expenditures of the central government but also those of sub-national governments (so that expenditures would be forecasted at the general government level). Each sector thus defined was to be subdivided into programme areas, and in each programme area the most important ministry would take the lead. Although the ministries have tried to follow up on this idea, the incompatibility of the proposed programme areas with the conventionally used organisational budget classification made the exercise exceedingly difficult and to some extent artificial.

In spite of the shortcomings during the first year of application, the new structure of the Basic Data and Directions document has been an important step forward. Macroeconomic forecasting has improved, tax revenue estimates over the medium term have been produced, and clear decisions about the total expenditure envelope for the budget year and the medium term have been taken based on the national development strategy and sectoral priorities. Further improvements in the next budget cycle would be possible in the following areas:

- A more transparent distinction between existing policies and budget estimates on the one hand and budgetary consequences of policy changes on the other hand. This applies to the impact of updated national development strategies as well as sectoral strategies.
- The Budget Department of the Ministry of Finance could take more responsibility for expenditure forecasts and ensure that national and sectoral policy changes are adequately reflected in the forecasts.
- Analysis of past expenditure trends and cross-country analysis could play a larger role in the development of the expenditure forecasts and should be conducted by the Budget Department.
- The expenditure classification of the strategic matrices could be brought in line with the regular organisational budget classification. Sectors could coincide with ministries, and programmes could be identified by the highest level of the regular organisational budget classification.

- It could be made clearer to the line ministries that the matrices are the main vehicle for their budgetary requests and that the sectoral expenditure forecasts in the Basic Data and Directions document will function as preliminary sectoral ceilings and main input to the definitive ceilings in the Budget Circular.

Box 1. The budget timetable

1 March	The Ministry of Finance begins budget preparations, the macroeconomic framework, and the Basic Data and Directions document.
15 April	The Basic Data and Directions document is sent to cabinet for agreement, then sent to Parliament.
1 June	Parliament Finance Committee issues a report on the Basic Data and Directions document.
15 June	The Ministry of Finance issues a Budget Circular, including budget ceilings per spending agency.
15 August	Line ministries submit detailed budgets to the Ministry of Finance and begin negotiations.
5 September	Cabinet finishes discussing spending disagreements.
15 September	The Ministry of Finance submits the budget bill to cabinet.
1 October	The budget bill is sent to Parliament for review, recommendations and approval.
1 January	Start of the budget year.

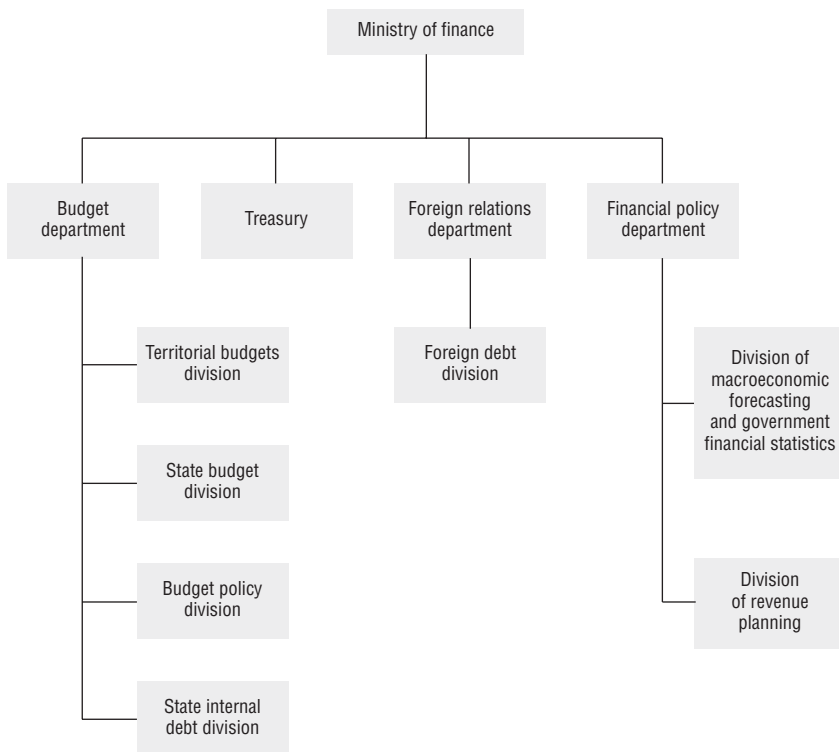
2.4. Annual budget process

The first step of the budget process is the development of macroeconomic forecasts. Before 2003 the quality of estimates was poor, especially for tax revenues, which made budgets largely unrealistic and led to high deficits and arrears for salaries and other contractual obligations. Since 2004 the situation has very much improved. Formally macroeconomic forecasting is a shared responsibility of the National Bank, the Ministry of Economic Development and the Ministry of Finance. In practice the Ministry of Finance takes the lead and compares its results with those of National Bank models. Within the ministry this task is performed by the Division of Macroeconomic Forecasting and Government Financial Statistics (see Figure 3). The division has developed a macroeconomic model, partly with donor assistance, partly by the staff itself, and expanded it over the years. The model still shows weaknesses which are due to unreliable and insufficient data as well as inherent deficiencies.¹⁷

Macroeconomic forecasts are updated in the spring to be used as input to the ceiling-setting exercise for the Budget Circular. Macroeconomic forecasts are monitored, with help and analysis from the IMF. There is little capacity outside the government – financial institutions, civil society or academia – for providing a check or other analyses of the macroeconomic forecasts.

The next step is the development of tax revenue estimates for the budget year and over the medium term. This is the task of the Division of Revenue Planning (see Figure 3). These forecasts are developed from detailed realisation data, macroeconomic forecasts, and policy impact analysis only for the budget year. Broad forecasts (tax revenues as a percentage of GDP) have been agreed upon with the IMF in the context of PRGF.

Figure 3. Organisation of the Georgian Ministry of Finance
(not all departments and subunits listed)



Box 2. The Economic Development and Poverty Reduction Programme

The EDPRP originated in 2000 when a designated secretariat in the president's administration was created to develop a strategic poverty reduction strategy. The ideas in this paper were discussed with various ministries and other stakeholders, including civil society, which led at the end of 2002 to the EDPRP document. The paper was the basis for subsequent negotiations with the IMF and the World Bank. The role of elected bodies such as Parliament and local councils was only marginal.

In order to achieve the general goal of raising the welfare of the population of Georgia, two strategic objectives were defined:

- Fast and sustainable economic development (average growth rate of real GDP at 5-8% per annum, which means two to threefold growth of real GDP by 2015 in comparison to 2001);
- Reduction of poverty (extreme poverty from 14% to 5% and poverty level from 52% to 25% until 2015).

The EDPRP was supposed to be a “live” document, subject to ongoing revision. The latest revision took place in March 2005.

The EDPRP was not a core issue in the political changes at the end of 2003. After the Rose Revolution, the lead role of further developing and implementing the EDPRP was given to the Ministry of Economic Development. The cross-governmental ownership of the strategy in the new administration has been problematic, perhaps partly because of the strong connection of the programme to former President Shevardnadze. On the other hand the involvement of the IMF and the World Bank brought a new urgency to the implementation of the programme.

Perhaps partly because of IMF involvement and partly because the past and present ministers of economic development had other priorities (privatisation, improvement of business climate), the focus of the EDPRP has shifted under the new administration from poverty reduction *per se* to general economic development. The EDPRP has now evolved into the main national economic strategy plan, with economic growth and structural reform as its main focus.

Until the budget formulation for 2006, the national economic strategy was not well integrated into the budget process. With the new structure of the Basic Data and Directions document the integration has improved, but the precise role of the national financial-economic strategy plan in the development of the medium-term expenditure framework and the sectoral expenditure forecasts remains somewhat unclear. Since the national economic strategy should lay the foundation for sector-specific reforms and be linked to the budgetary process, it is important that in the coming years the Basic Data and Directions document becomes more transparent about the impact of the updated national economic strategy upon the expenditure framework.

Macroeconomic forecasts and tax estimates are input into the medium-term expenditure framework which defines the overall expenditure ceiling and the sectoral expenditure forecasts for the budget year and the next four years. The framework is laid down in the Basic Data and Directions document. The framework is also supposed to integrate the national and sectoral policy strategies, but this integration can still be improved as indicated above.

In Georgia there is no general fiscal rule applicable (such as the Maastricht treaty limits on deficits as a percentage of GDP, or the “golden rule” in the United Kingdom), nor are there plans to create a fiscal rule. Like many OECD countries, Georgia relies instead on overall medium-term expenditure ceilings that are targeted at an acceptable deficit over the economic cycle. In this connection it should also be mentioned that expenditure ceilings, tax revenue estimates and deficit forecasts play a central role in the ongoing monitoring process in co-operation with the IMF.

By 15 April, the Basic Data and Directions document is presented to cabinet for approval. A major change from the previous regime is the formation of a cabinet and the delegation of executive power from the president to cabinet. Because the Basic Data and Directions document is transmitted to cabinet for agreement, there is a collective decision and responsibility for the estimates.

The Basic Data and Directions document is presented to Parliament for discussion. The Finance Committee of Parliament receives the document, holds hearings and discussions, and finally produces a report back to government. It is possible that Parliament as a whole discusses the document but parliamentary approval is not a requirement. Formal submission to Parliament is only for information purposes.

After Parliament’s work on the Basic Data and Directions document, the Ministry of Finance sets ceilings for each spending agency. These ceilings are presented to cabinet for approval. In view of the still underdeveloped process of sectoral expenditure forecasting in the MTEF, this has so far been the first opportunity for ministers to formally ask for changes in allocations. The line ministries negotiate bilaterally with the finance minister while the usual process of hierarchical decision making, with issues being resolved at staff, management and political levels, culminates in matters of large policy being determined by the prime minister. According to the Constitution, the president is responsible for the budget. Under current power-sharing arrangements, the president has given the prime minister the responsibility for resolving disputes. The president does on occasion chair meetings of the cabinet, and some spending issues can ultimately be decided by the president. In practice, this has only rarely happened.

Shortly after 15 June, the Ministry of Finance issues the Budget Circular which includes the budget ceilings and explains the required processes and procedures. Spending agencies must submit their draft budget (including strategic matrices at the programme level) as well as an explanatory note to the Ministry of Finance by mid August. The estimates must respect the ceilings of the Budget Circular but this has in fact not been the case in recent years. Also, in 2005 negotiations over the ceilings continued through September, which has diminished the attention for policies and expenditures at the programme level. The Budget System Law states that the draft budget should go to cabinet by 15 September.

The budget for 2006 contains good information on the economic and functional classification of expenditures. This is a considerable achievement. However, information on current estimates and multi-year estimates (as previously approved) at the programme level and line item level is still largely lacking. This makes it hard to assess the significance of the budget compared to the existing situation (policies and expenditure estimates). The budget for 2006 lacks good information about the nature and size of domestic debt. Information about the use of reserve funds could also be improved (expected use in the budget year in the light of use in prior years and the current year). A final matter that deserves attention for next year is public access to the draft budget and related materials. It is important that these materials can be easily purchased from the public printing office. It would also be a good idea to publish a “citizen’s guide to the budget” or “budget in brief” which could be made available to the press and citizens at a low price.

The president formally submits the draft budget to Parliament on 1 October. Before 2003 this requirement was never adhered to, and budgets were not submitted until after the beginning of the year¹⁸ and often not formally approved until much later. In 2004 and 2005, budget submissions have respected the deadline.

2.5. Conclusion

In spite of some shortcomings in the first year of application, the introduction of the MTEF in the Georgian budget process is a major step forwards. It brings the consideration of policies and expenditures together in a multi-annual perspective. This is an important improvement, thanks to which Georgia is now pressing ahead of other countries in similar circumstances and even some OECD countries.

The MTEF process is now firmly entrenched in the Georgian public administration, forming a good basis for further improvement in the coming years. Next steps to be considered include closer involvement of policy units

of line ministries and more political guidance during the development of policy and expenditure proposals that are inputs to the MTEF process, a closer and more transparent relationship between the sectoral expenditure forecasts in the Basic Data and Directions document and the sectoral ceilings of the Budget Circular (“preliminary ceilings” versus “definitive ceilings”), and earlier definitive decisions on the ceilings.

An important challenge for the future will be the maintenance of the multi-annual perspective over the years. This requires that the overall and sectoral ceilings of the previous year are taken at least as a point of departure for the ceilings in the next year. Multi-annual stability in this sense can be enhanced if, during the entire budget formulation process, a clearer distinction is made between existing policies and budget estimates on the one hand and changes in policies and their budgetary consequences on the other. Presently neither the Basic Data and Directions document nor the draft budget contains information about approved estimates for the current year at the sectoral and programmatic level (let alone for future years), which makes it very difficult to assess the impact of the new budget.

The overall expenditure ceiling should be as inflexible as possible and only be allowed to change in the light of structural macroeconomic developments. The ceilings at the sectoral level should be more flexible and adjustable to accommodate cyclical macroeconomic developments and new policy initiatives.

The new structure of the Basic Data and Directions document is an important improvement. Macroeconomic forecasting has improved, tax revenue estimates over the medium term have been produced, and clear decisions about the total expenditure envelope for the budget year and the medium term have been taken early in the budget cycle, based upon the national development strategy and sectoral priorities. Shortcomings in the first year of application have to be addressed in the coming years. Next steps to be considered include a clearer explanation of the impact of the national development strategy and sectoral strategies on the sectoral expenditure forecasts, a larger role of the Budget Department in the preparation of the document, a larger role for the analysis of past expenditure trends and cross-country analysis, an adjustment of the expenditure classification in accordance with the regular, organisational classification (per spending agency and programme area), and more emphasis on the policy and expenditure proposals of line ministries as the main vehicle for budgetary requests.

Macroeconomic forecasting and tax revenue estimation by the Ministry of Finance has improved substantially in recent years. It is important to develop the capacity outside government – financial institutions, civil

society, and academia – for providing a check or other analyses of the macroeconomic forecasts.

The Economic Development and Poverty Reduction Programme has recently evolved into the main national economic strategy plan, with economic growth and structural reform as its main focus. It is important that in the coming years the Basic Data and Directions document becomes more transparent about the impact of the updated national strategy upon the expenditure framework.

3. Parliamentary approval

3.1. Constitutional provisions

According to the Constitution, Parliament has to approve the budget, which has the legal character of a draft law or bill. For that purpose Parliament must receive the budget bill at least three months prior to the beginning of the fiscal year. The Budget System Law states that the fiscal year is the calendar year, so the budget must be submitted on 1 October.

Box 3. Structure of Parliament

The Parliament of Georgia is unicameral. Parliamentarians are elected for four years through a combination of proportional representation and majority voting. (The president is elected for five years for a maximum of two terms.) 150 Members of Parliament are elected through proportional voting from election lists with a minimum 5% threshold for gaining a seat. 85 Members of Parliament are elected directly according to majority votes. The current government has a very large majority in Parliament of over 85%. The prime minister is appointed by the president. Ministers need not be Members of Parliament.

Budgetary legislation and tax legislation are delegated to the Finance Committee before they are discussed in plenary session. The Finance Committee is assisted by a small number of permanent staff. The original idea to establish an independent budget office under the authority of Parliament has recently been abandoned.

A fundamental change to the Constitution concerning the role of Parliament in budgetary decision making was made in February 2004 (*i.e.* after the Rose Revolution). It entails that Parliament can no longer make amendments to the budget bill. It is now entitled to an up-or-down vote on the budget bill and may be dissolved if it rejects the government's

bill three consecutive times. However, Parliament can make recommendations that have to be considered and decided upon by the government.

3.2. Spring review of aggregates

Parliament has an early role in the budget process. By May, the president is required to submit the Basic Data and Directions document. Many countries have a two-step budget process where Parliament votes on aggregate spending (and thus the government's activity in the economy) some months before it votes on the draft budget. This permits Parliament to participate in fiscal discipline by endorsing the total numbers.

In the case of Georgia, the Basic Data and Directions document is not voted on by Parliament. It is only published for information purposes. Nevertheless, the Finance Committee holds hearings and discussions on the document. By 1 June, Parliament issues a report on its views to the president, with comments and suggestions on the overall fiscal stance.

Members of Parliament noted that, in the past, this review of the aggregates was a mere formality and essentially pointless. This was because the aggregate totals discussed in the spring bore no relation to what was then released in October with the draft budget. In 2005 the situation improved somewhat, but not much, since the expenditure forecasts were hard to interpret, as noted before. The adjustment of the expenditure classification of the Basic Data and Directions document in accordance with the regular budget classification (per spending agency and programme area) would not only contribute to a better internal process within the government but also to more effective parliamentary oversight.

3.3. Submission and review of the budget bill

The Constitution requires the president to submit the budget bill to Parliament by 1 October. Historically, the bill has not been submitted on time and often, even when it was submitted on time, the documents were merely summaries, and details of the budget followed later. In 2004 and 2005, compliance with the submission date has largely been adhered to, although some documents were sent in late.

Following the submission of the budget bill, it is divided by chapter and sent to the sectoral committees for review. The sectoral committees hold hearings on the chapters and then draft recommendations. The hearings are open to the public and the media. There are no limits on the hearings.

Committees may ask for testimony from ministers, interest groups, the Chamber of Control, and actors in civil society.

Significant innovation has taken place during the presentation of the 2006 budget to Parliament. After the initial introduction of the budget by the prime minister, each minister, beginning with the minister of finance, made a presentation about his/her proposed budget and operational plans. This is an improvement over the previous process in which only the prime minister and the minister of finance were responsible for explaining the government's proposed budget to Parliament. By involving different ministers in this process, the accountability and profile of the line ministries in the annual budget process is strengthened. Ministers now have a stronger interest in making sure that their budgets are developed properly with justifiable proposals, as they will have to explain their plans to Parliament in person. Another improvement in the government's budget presentation to Parliament was the use of detailed presentation materials, including PowerPoint presentations, to better describe the proposals for each of the main line ministries. While the quality and content of the presentations and the budget document need significant improvement, the use of more detailed information for 2006 has contributed to a more open and transparent budget process.¹⁹

3.4. Making recommendations

Each committee drafts a report and recommends changes in its chapter and submits the report to the Finance Committee. The recommendations for changes are reviewed by the Finance Committee; however it must transmit all sectoral committee recommendations. The Finance Committee has no right to modify, approve or reject the budget bill, only to comment on it. The Finance Committee compiles its report and forwards it to the government.

Any committee or Member of Parliament may submit a recommendation to the government on the budget. There are no requirements that the recommendations identify financing for the recommended changes. Since there are no offsetting changes attached to the recommendations, and because of the weak constitutional position of Parliament, there is little effect from these recommendations.

The number of recommendations is often quite large, perhaps 1 000. The recommendations are usually small individually: they tend to be for local projects (*e.g.* construction). Yet, when summed up, they are often more than the entire budget.

Any changes or amendments to the budget after submission on 1 October must come from the government. After Parliament has issued its

recommendations and the government has modified the budget, Parliament must approve the budget bill by 31 December.

3.5. The consequences of not passing the budget bill

If Parliament does not pass the budget bill, the minister of finance can automatically fund central government operations each month by not more than one-twelfth the amount of the previous year's appropriations.

If Parliament rejects the budget bill three times, the president can call for the dissolution of Parliament. Thus not only can the government start funding in the absence of approval, but Parliament can also be dissolved for not agreeing with the proposed budget bill.

3.6. Reports to Parliament

In addition to the budget documents, Parliament is entitled to receive other reports on budget execution, accounting and auditing. Parliament receives monthly and quarterly reports on budget execution, a more detailed mid-year report on budget execution, and a mid-year and annual report from the Chamber of Control. In addition to these reports, Parliament is not constrained in its oversight and may hold hearings on any issue it deems necessary.

The quality and timeliness of the expenditure reports were called into question by parliamentarians. Expenditure reports were characterised as more often late and not very specific. Reports were not useful for holding the government to account. It should be emphasised, though, that this referred more to historical fact than current practice. Thus it remains to be seen what reports will be released in the future.

3.7. Conclusion

A fundamental change to the Constitution concerning the role of Parliament in budgetary decision making was made in February 2004 (*i.e.* after the Rose Revolution). It entails that Parliament can no longer make amendments to the budget bill. Instead it can make recommendations that have to be considered and decided upon by the government.

Parliament has an early role in the budget process. By May, the president is required to submit the Basic Data and Directions document containing macroeconomic forecasts and revenue and expenditure estimates. The document is not voted on by Parliament, but Parliament does react to it by a report to be issued by 1 June. Parliamentarians noted that, in the past,

this review of the aggregates was a mere formality because of deficiencies of the Basic Data and Directions document. This year (budget for 2006) the situation has improved considerably, but further improvements of the document are possible and will contribute to parliamentary oversight.

In recent years the budget bill has been submitted in time and has allowed Parliament to structure its review activities more thoroughly.

Parliament has used its position in the budget process to make many recommendations. There are no requirements that the recommendations identify financing for the recommended changes. The parliamentary approval process could be strengthened and the effectiveness of parliamentary recommendations improved if Parliament would revise its procedures and provide offsets or financing sources for its recommendations.

Reports to Parliament on budget execution have come late in previous years and have lacked sufficient specificity to allow effective parliamentary oversight. In this area there is ample scope for improvement.

4. Budget execution

4.1. The organisation of budget execution

Budget execution in Georgia is very much based on controlling the cash flow. This reflects previous experiences in Georgia with revenue shortfalls and expenditure overruns and the government's need to meet them with cash limits.²⁰ Although cash control is a tool for keeping spending in line with revenues, it has a negative effect on financial management and the government's reliability in the eyes of contracting partners and citizens.

Previously, budget and revenue forecasts were poor and budget ceilings were often changed after the beginning of the year. The combination of inaccurate budgets, often too positive revenue forecasts and *ad hoc* cash controls resulted in a substantial build up of arrears – typically back salaries, unpaid contracts and back funding of schools and hospitals. The situation has improved substantially in the last two years. Like other parts of the budget process in Georgia, the execution phase of the budget has been profoundly overhauled. Due to enhanced tax collection and sale of government assets, domestic arrears have mostly been cleared. The bad experience with arrears – as well as pervasive corruption – has driven many of the changes undertaken in the budget execution process.

The basic principles of budget execution are laid down in the Budget System Law of 2004. The law is not an organic act in the sense that it has

legal priority over other laws; this drawback is important for budget execution. The aim of the government is to upgrade the Budget System Law to an organic law.

The Budget Department (*i.e.* the State Budget Division) of the Ministry of Finance has the main responsibility for budget execution (see Figure 3). It has to approve all spending before commitments are made. The Treasury (part of the Ministry of Finance²¹) is responsible for cash and debt management and is the main contact point between the Budget Department and budget users.

In addition to Budget Department control and Treasury procedures, the minister of finance must approve all spending in person (except for wages, utility services and transfers). This is largely a formality, and the ministerial power to disapprove spending is more theoretical than practised. Yet on a daily basis, the minister must sign for spending. When asked if the minister would ever disapprove spending, the reply was that if there were large treasury imbalances, the minister might not give approval.

4.2. Spending flexibility

The new Budget System Law abolished many earmarking practices, thereby improving the possibilities to redirect spending according to changing political preferences both from year to year and during budget execution (IMF, 2005a).

Rules for reallocating appropriations are set in the Budget System Law and do not differentiate between the reasons for reallocation, such as changed macroeconomic conditions, forecast errors, etc. The general rule is that a budget user, after the approval of the minister of finance, can reallocate between line item appropriations as long as the total change per appropriation remains within a 10% band of the appropriation in the budget. In this case the relevant line ministry sends a letter to the Ministry of Finance explaining the reason for, and the amount of, reallocation. After approval the Treasury is notified. The procedure is described by the Treasury as simple, and small reallocations occur on a regular basis. Reallocations of more than 10% or reallocations between budget users require supplementary budget legislation.

The minister of finance has very strong powers in budget execution: all basic spending disbursements themselves must be signed personally by the minister of finance. Also, the minister of finance can withhold up to 10% of a ministry's funds without notifying Parliament.

The president and the government of Georgia each have small reserve funds within the state budget. According to the Budget System Law, the

funds may not exceed 2% of total appropriations. In 2006, the appropriations for the president's reserve fund and the government's reserve fund amount to GEL 30 million and GEL 25 million respectively. Parliament recently approved a government proposed amendment to the Budget System Law that specifies that the funds are for "unexpected state expenses" and that the "directions for the Georgian state budget reserve funds shall be determined by the president of Georgia and the government in accordance with the amounts and conditions set out in the annual budget law". Funds from this reserve are allocated for contingencies of national significance, such as natural disasters and contingent liabilities. Line ministries can apply for resources from this fund with approval of the president or the government.

Carryovers from year to year of unused appropriations are not allowed.

4.3. Cash and debt management

The budget execution process starts when the annual budget bill has been approved by Parliament. Appropriations are normally apportioned on a quarterly basis, with the default distribution being four equal parts. If a budget user wants another division of its appropriation, it has to get approval from the Budget Department of the Ministry of Finance.

The quarterly division of appropriations applies to all budget users, which correspond roughly to offices. For example, the Irrigation Department has 68 offices or budget users. In total, there are about 2 300 budget users.

To combat the arrears and overspending problems, Georgia implemented a new Treasury system in 2005 that includes a registry for all transactions. The system requires that all intended commitments shall be approved and registered at the Treasury prior to entering into the commitment.

For a budget user to be able to enter into a commitment, the budget user's regional treasury (line ministries' treasuries either in Tbilisi or located in the regions) has to create a commitment document, which is sent to and registered with the Treasury. The Treasury approves or disapproves the budget users' commitment request. The decision is forwarded to the budget user by the Treasury, through the budget user's regional treasury.

Regional treasuries cannot register more commitments for a budget user than are available within the current quarterly cash apportionment, not even if the payment of the commitment is due in a future quarterly period. When a budget user receives an invoice, it contacts its regional treasury which sends a verification document to the Treasury. The Treasury then orders the payment, which has to be approved by the minister of finance. Without a

recorded commitment, the Treasury will not pay the claim and will not pay more than was originally recorded.

Box 4. The budget execution process

1. Budget bill approved by Parliament.
2. Appropriations divided quarterly for all budget users.
3. Budget users send request for entering commitments to be registered by Treasury.
4. Ministry of Finance approves budget user commitments.
5. Treasury forwards decision to budget user.
6. Payment request from budget user to Treasury.
7. Ministry of Finance approves spending.
8. Treasury sends payment orders to the central bank.
9. Central bank pays contractor/supplier/etc. directly or via budget user accounts.

According to the Budget System Law, budget users must have the approval of the Treasury before entering into a contractual agreement, but this procedure is hard to apply in practice. Instead, budget users normally enter into contracts before they have the agreement of the Treasury, and it is only afterwards that agreement from the Treasury is sought. According to the Treasury, this is not a major problem, as suppliers know about the procedure. But still, budget users could run into problems if the Treasury does not accept commitments, especially if contracts do not contain a clause that makes their validity conditional on Treasury agreement.

The registration and payment system is only available for the Treasury. Line ministries, regional treasuries or budget users cannot enter commitments into the Treasury registration system themselves. Instead, the process of developing commitment documents by regional treasuries is done by hand. Couriers often physically go to the Treasury with forms to be recorded in the system. Communications between the Treasury and the regional treasuries is only partly automated. There are plans to make the whole process automated in the coming years as part of the information technology master plan of the Ministry (Georgian Government, 2005c).

Concurrently to the adoption of the Treasury registry system, Georgia has started implementing a Treasury Single Account (TSA) system. Previously budget users operated their own bank accounts outside central control. The problems with budget users having their own accounts are well

documented – little transparency, corruption, hoarding funds, etc. – and Georgia was no exception.

Box 5. Systems of cash management

There are basically three models of cash management in central governments.

In the decentralised model (in place in Georgia for expenditures), all budget users have their own account with the commercial banks (in Georgia, most of these accounts are in the National Bank, but not yet part of a Treasury Single Account). These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budget users make payment orders by drawing on their own accounts.

In the centralised model (now mainly in place in Georgia for revenues) budget users are not allowed to have their own accounts with the commercial banks. There is only a single account (with sub-accounts) usually kept at the central bank, which is under the Treasury. Since the Treasury is not allowed to borrow from the central bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budget users have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget users are allowed to have their own bank accounts with a single commercial bank, but the positive balances on these accounts are daily transferred to the Treasury account with the central bank and daily supplied with cash advances. The contract with the commercial bank is auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget users make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term borrowing at the Treasury.

With IMF and USAID assistance, Georgia started consolidating separate accounts into a single account in 2003. The introduction of a TSA is being done in two steps. In the first step of April 2004, more than 10 000 transit accounts for revenues at the central bank were closed and all budget revenue since then is recorded in a Treasury Single Revenue Account (TSRA). The TSRA is located in the Georgian National Bank and has approximately 300 zero-balance sub-accounts for transaction purposes. The second step will be to close all expenditure accounts and create a fully operational TSA. The aim of the Treasury is to fulfil the second step in 2006.

Since April 2005, all central and local revenues go to the TSRA. Tax revenues that belong to sub-national governments are then transferred to the sub-national governments. Since January 2004, budget users' non-tax revenues are estimated on a gross basis at the revenue side of the budget and are paid into the TSRA. For expenditures there is still no single account. Approximately 30 expenditure accounts exist, most of them at the National Bank, but if no regional National Bank office exists where budget users are located, budget users use accounts in commercial banks. According to the Budget System Law, budget users are not allowed to have bank accounts without the specific permission of the Treasury. The Treasury may authorise accounts in banks if they are deemed necessary for operational purposes. The Treasury also have the authority to withdraw previously given authorisations for own bank accounts.

In accordance with the quarterly division of appropriations, budget users have to report their needs for the coming month, divided per week, before the 25th of each month to their local treasury which then submits this information to the Treasury. The cash planning process is regulated in the "regulation on operative planning of cash release and cash management for the budget organisation" of the Ministry of Finance.

For operative cash planning, the Treasury uses the information from the local treasuries and revenue forecasts to determine if cash will be available to meet expected payments. It determines the daily amounts of expected payments one week in advance. If expected payments exceed revenues, the Treasury notifies the Ministry of Finance (State Internal Debt Division) which decides on adequate financing.

Local treasuries ensure that budget users' payment requests are within their weekly limits, and forward the payment requests to the Treasury which then orders payments from the accounts in the National Bank. The Treasury also monitors overall development of local treasuries' payment requests to make sure that they are within limits.

According to the Treasury, for the last 18 months there has been no need for short-term debt financing, as the government has had a positive cash balance at the National Bank large enough to meet payments. This situation is dependent on the size of the balance which has been approximately GEL 100 million on average. This capital lies idle in the government accounts at the National Bank. More advanced cash management methods would make it possible to reduce the positive average balance (and/or to receive interest on it²²).

Georgia operates a cash management system with extensive preventive controls (by the Budget Department, the Treasury and the minister of finance). The need for preventive cash control is a consequence of a lack of

budgetary discipline. If the budget cannot be relied upon as a tool for spending control, the Ministry of Finance has to pursue control through the cash management process. However, this leads to bureaucratic costs and in general diminishes the financial reliability of the government in the eyes of contracting partners and citizens. Preventive cash control can be reduced or eventually abandoned to the extent that budgetary discipline in line ministries improves. For that purpose it is important that the budget is continuously monitored and updated during budget execution and that the Ministry of Finance ensures that line item estimates are timely adjusted and accommodated within the agreed sectoral ceilings or, in the ultimate case, within the overall ceiling with cabinet approval. Monitoring of the budget during its execution is a task for the Budget Department, not for the Treasury. Monitoring requires sufficient oversight capacity by the sector specialists.

The responsibility for debt management is divided between the Budget Department and the Foreign Relations Department, both in the Ministry of Finance. Domestic debt management is the responsibility of the State Internal Debt Division of the Budget Department, and foreign debt – mainly loans from international financial institutions – is managed by the Foreign Debt Division of the Foreign Relations Department (see Figure 3).

Government debt is mainly foreign debt, but approximately 10% of GDP is borrowed in the domestic market. The recording of domestic debt used to be deficient, but that has now mainly been corrected. In November 2004, the State Commission for Studying the Issues of Accumulated Internal Debt (the so-called “historical debt”) was set up. By 1 May 2006 the Commission has to develop recommendations on the strategy and mechanisms for clearance of recognised internal debts, which will subsequently be submitted to the government and Parliament. The interest rate on domestic borrowing peaked at rates as high as 80% but has now stabilised at around 10%. The practice of Treasury borrowing from the National Bank has been abandoned. Instead, deficit financing will henceforth be carried out by the issuance of securities and bonds. This is expected to contribute to the development of a Georgian capital market. It should be noted, though, that the 2006 budget includes no issuance of securities and bonds as a source of deficit financing.

Projects that are to be financed by loans from donors are discussed by the Ministry of Finance and line ministries. The Foreign Relations Department of the Ministry of Finance then negotiates and manages these loans. A rescheduling of debt by Paris Club creditors was agreed in 2001, but lax policy kept the debt burden high, and arrears on foreign debt accumulated in the following years (IMF, 2004). A new rescheduling arrangement with the Paris Club was completed in July 2004 (see

section 1.3 above) and discussions with other bilateral creditors (Armenia, Azerbaijan, China and Kazakhstan) are currently in a final stage (IMF, 2005b). The aim of the Ministry of Finance is to conclude these discussions before the end of 2005.

4.4. Service delivery

Service delivery in Georgia is to a large extent concentrated at the central government level. In 2004, sub-national government expenditure amounted to 15% of general government expenditure. Service delivery at the central level is partly organised in regular ministerial departments and partly in **public law entities** (PLEs). These agencies are publicly funded but have considerable management autonomy and legal personality. PLE formation started in 1998. Presently there are more than 500 PLEs (Table 3).

Table 3. Public law entities created 1998-2004

Year created	Number of PLEs created
1998	3
1999	14
2000	39
2001	43
2002	27
2003	504
2004	2
Total	632

Source: Gentry (2004).

Since PLE budgets are separate from ministerial budgets, PLE formation can be seen as a step towards improvement of cost information and programme budgeting. However, in order to reap the benefits of better cost information, it is also necessary to collect information about outputs and efficiency, for instance through benchmarking of PLEs with comparable tasks (schools, hospitals, etc.). Output monitoring of PLEs is still in its infancy in most line ministries.

Public procurement has traditionally not been well regulated in Georgia. This has been one of the main reasons for widespread corruption. From 2006 a new law on procurement will be in force. It specifies thresholds for public tenders and describes tendering procedures. The value threshold differs between regular goods (value of tender more than GEL 10 000) and construction (more than GEL 300 000). The law also specifies that a public procurement agency is to be set up to monitor compliance and regulate appeal procedures.

Box 6. Public law entities

Since 1998 the government has pursued a policy of converting units that provide government services into public law entities (PLEs). These agencies can generally be described as a way to contract out public service provision. PLEs are run by a board of supervisors and are funded by public payments and user fees. PLE expenditures are entered on a net basis in the budget (only public payments; user fees are considered as own revenues of the PLEs, not as non-tax revenue of the government).

Before 2003, just over 100 PLEs existed. Spurred by the present government's privatisation efforts, more than 500 were created in 2003, and the aim is to continue this process.

The general aim of the government's PLE strategy is to reduce costs of service provision. PLEs exist in a number of areas of government service delivery, for example hospitals, schools, nursing homes, and cultural institutions such as museums and theatres.

In 2003, an "Association for Competition and Development in Georgia" was set up by five former employees of the Ministry of Finance, the State Chancellery, and the National Bank. It has provided privatisation advice to the government and now organises training courses on the management of PLEs. The Association currently employs around 30 staff.

Problems that have been identified in the present functioning of PLEs are: insufficient monitoring of outputs, leading to inefficiency; and insufficient regulation of service quality and access, leading to deficient services and possibly corruption.

Sources: Gentry, 2004; Zohrab, 2005.

4.5. Sub-national governments

Except for the autonomous republics of Abkhazia and Adjara, Georgia is a unitary state with three layers of sub-national government: regional, district, and municipal. The highest level in the sub-national structure is the regional level with nine administrative regions plus Tbilisi and the autonomous republics of Abkhazia and Adjara. The district level (rural districts and cities, *rayons*) consists of 65 units and, in budgetary terms, is the most important level. Closest to the citizens are the 966 municipalities (villages and towns). The only sub-national level with direct representation is the municipal level. The districts have no directly elected council. Instead, district councils consist of delegates from the municipal level. There is currently a debate in Parliament about merging sub-national units. The following text refers to districts and municipalities.

The sub-national government sector is quite small, and its expenditure share of general government expenditure amounts to approximately 15%. Given the relatively small size of the sub-national sector, its tasks are quite limited – mainly parts of the educational and health system, local infrastructure, water, sewerage and street lights. Another responsibility for the sub-national level of government is capital expenditures for schools. From 2006, more responsibility is to be transferred in the educational area. In 2003, excluding the regional level, the districts' share of sub-national spending was 60% with the remaining 40% at the municipal level (UNDP, 2005).

The main revenue source for sub-national governments is taxation. Sub-national tax bases are income (from 2005), property and gambling. Property tax and tax on gambling are sub-national own tax revenue, but the central government sets the floor and ceiling for tax rates. Property tax is shared with the central government. The size of tax bases varies considerably between regions. Tax collection is done by the central government. Revenues collected are transferred to the districts where some are kept and the rest is distributed to the municipal level. Tax shares of regions, cities and villages do not need to coincide with tax collection shares. The tax-sharing arrangement contains elements of tax base and cost equalisation.

Taxes finance between 50% and 100% of sub-national activities, reflecting significant horizontal imbalances in own resources between sub-national government units. The rest is mainly made up by grants from the central government. Due to improvements in tax collection, tax revenue has increased in recent years, and the number of sub-national units in need of grants to finance their basic activities has decreased from 60% to 45%. Sub-national governments are allowed to borrow with approval of the Ministry of Finance. Loans are provided or guaranteed by the central government and is restricted to cases where the government sees that the sub-national unit has budgetary resources available to repay the loan. Sub-national government borrowing is not common, and the debt-stock of sub-national governments is not seen as a reason for concern by the Ministry of Finance.

Grants from the central government are mainly of two types: special purpose grants and grants to fill the fiscal gap between own (mainly tax) revenue and spending need. In total GEL 110 million, or almost 1% of GDP, was transferred in 2005. The division of total grant expenditures between the two types is around 50% for each type. Special purpose grants are distributed according to political priorities of the central government. The fiscal gap grants are not formula-based but distributed by a commission with representatives from the Ministry of Finance and the districts. The gap-filling and discretionary nature of the grant system can provide negative incentives for own revenue collection at the sub-national level and brings an

unpredictable element into the budget planning of sub-national units. Even though grants are supposed to equalise revenues, there is still a large variation in per capita expenditure between districts (UNDP, 2005), implying that equalisation does not cure differences in own revenue-raising capacity.

The legal framework for the sub-national part of Georgia's government sector is regulated mainly in the organic Law on Local Self Government from 1997. In addition, there is also a Local Budget Law. According to UNDP (2005), there is still an unclear delineation of responsibilities for regulating, financing and implementing tasks assigned to sub-national governments. Together with limited expenditure autonomy, discretionary distribution of grants from the central government and the ambiguous budgetary relationship between districts and municipalities highlights the need for clearer legislation in this area. The State Committee for Decentralisation, formed in 2004 and led by the president, presents a forum for further work in this area. There is currently a new law being discussed, with possible implementation from 2007, for introducing a formula-based equalisation system for the fiscal gap grants, this would probably solve at least part of the ambiguities mentioned.

After the Saakashvili administration came into power, the break-away autonomous republic of Adjara has been brought back under government control. Georgia still faces a problem with two other break-away regions: the autonomous republic of Abkhazia and the region of South-Ossetia. The government continues to seek a peaceful settlement of these conflicts.

4.6. Conclusion

The Georgian procedure of budget execution leans heavily on preventive cash control. This leads to bureaucratic costs and in general diminishes the financial reliability of the government in the eyes of contracting partners and citizens. The need for preventive cash control is a consequence of a lack of budgetary discipline. Preventive cash control can be reduced or eventually abandoned to the extent that budgetary discipline in line ministries improves. Monitoring of the budget during its execution is a task for the Budget Department, not for the Treasury. Monitoring requires sufficient oversight capacity by the sector specialists.

According to the Treasury, the current procedure for reallocation is working well, but it could be enhanced by introducing a facility that enables budget users under appropriate conditions to transfer unused appropriations from one budget year to another.

At the moment the Treasury registration system is only available to the Treasury itself and not to the local treasuries in the line ministries. This is mainly because communication between the Treasury and the local treasuries is only partly automated. It is important that further information technology improvements are pursued energetically and that the Treasury registers become accessible to the local treasuries.

The Treasury Single Account is operational for revenues since January 2004. The expenditure side of the system is under development and will become operational soon. This will contribute to the efficiency of cash management. Further efficiency gains in cash management are possible by improving cash flow forecasts.

Domestic lending plays a lesser role in Georgia than foreign lending. The Ministry of Finance has abandoned the practice of borrowing from the National Bank and will henceforth issue state securities and bonds to cover its financing needs. It is expected that this will foster the development of the domestic capital market. It is noteworthy that the budget for 2006 does not include any issuing of securities or bonds to finance the fiscal deficit.

The international indebtedness of Georgia is gradually decreasing due to consolidation and rescheduling of existing debts and future maturities in the Paris Club agreement of July 2004, follow-up agreements with individual creditors, and better debt service discipline. Discussions with non Paris Club creditors are in the final stage and will, if successful, lead to further reduction of foreign debt.

The creation of PLEs is an interesting development in Georgia. It is in line with the government's efforts to reduce the size of government. The creation of PLEs raises some questions, however. The government has so far made efforts to bring extra-budgetary funds on budget. To make PLEs successful, it must be ensured that they do not become a new kind of extra-budgetary fund. Legislation is now in place to provide a general framework for PLEs but this legislation can be further improved. In particular, the separation between financier and service provider should be enhanced, and systems for collecting information on PLE performance should be established.

Decentralisation can provide benefits in government service provision. Georgia has started a process of decentralisation which will be further developed in the coming years. The proposed law on improving equalisation transfers is a good step and a precondition for further steps.

5. Accounting and auditing

5.1. Accounting

The Treasury of the Ministry of Finance is responsible for developing the chart of accounts as well as accounting policies and procedures. The Georgian government reports its accounts on a cash basis in accordance with IMF standards and partly on a commitment basis (at present the main difference being the clearance of domestic arrears). Work is under way to adjust the functional and economic classifications from the 1986 Government Finance Statistics to the GFS 2001 standards. According to plan, the GFS 2001 standards will be applied to the 2007 budget. The level of reporting in Georgia is relatively extensive and comprehensive. The budget documents now cover most of the central government expenditures, including extra-budgetary funds, and the reports show appropriations versus realisations. The Treasury generates reports on daily, weekly, monthly, mid-year and annual budget outturns. The daily reports are purely for the Ministry of Finance. The weekly and monthly reports are sent to the government and Parliament.

The establishment of a TSRA for revenues has improved accounting and information at the revenue side of the budget. The next step is the development of a TSA for expenditures in 2006. Another important step in this area is the development of a new Treasury ledger for all budget users. The Treasury indicated that this work had to be completed by 2007. The Ministry of Finance has adopted a long-term reform strategy in the accounting area covering these and other future reforms (Georgian Government, 2005c).

The annual accounts are published very quickly after the end of the year, but they are audited only later in the year by the Chamber of Control. International practice suggests that audited accounts should be presented to Parliament within three months of the end of the fiscal year.

5.2. External control: The Georgian Chamber of Control

The Georgian Chamber of Control has a history dating back to the early 20th century. Since 1926 a Public Control Office existed. Before that, from 1918 to 1922, there was already an independent Chamber of Control in Georgia. The Georgian Chamber of Control exists in its present form since 1993. It was then staffed by 100 people. By 2004 staffing had increased to 800. About one and a half years ago the Chamber went through fundamental change. Management was replaced and 300 staff at all levels were laid off. The move was made to prepare the Chamber to concentrate on

combating corruption and to make its reports more reliable and effective. Since then moderate growth has been allowed and the Chamber now employs 700 staff.

The law providing for the foundation of the Chamber is Article 97 of the Georgian Constitution, adopted in August 1995. According to the Constitution, the Chamber of Control is independent, accountable only to Parliament, and exercises control of the use of government assets and expenditures. All reports by the Chamber are published and made available to the public. Twice a year the Chamber has to submit a report about the national budget and once a year it has to submit a report about its activities to Parliament.

The Constitution refers to the “Law of the Georgian Chamber of Control” which defines its authority, structure, and functions, and guarantees its independence. The main duties of the Chamber are the following:

- Supervision of the budget process and use of government funds;
- Control of the regularity, expedience and effectiveness of the utilisation of government expenditures, state-run capital, property, and foreign credit and loans;
- Preparation of conclusions of the state budget, including tax legislation;
- Examination of proposed laws, both before and after they go to Parliament;
- Delivery of an expert opinion by order of Parliament concerning legislative plans and finance programmes;
- Co-ordination of the activities of other elements of financial and economic control in the financial-economic field.

The Chamber of Control has the authority to audit all units that receive government funding or use government property, including all elements of the legislature, the executive, and the judiciary, elements of local administration, extraordinary governmental funds, the National Bank of Georgia, and other organisations and authorities. It is generally prohibited from examining private firms, but if private units receive government funds or use government property, the use of these funds and property can be audited by the Chamber. The Chamber is funded through the national budget of Georgia.

The Chamber of Control makes yearly and quarterly plans of its activities. The Chamber has its own right to initiate audits; it can also be

asked to initiate audits by Parliament and by the president of Georgia. Apart from scheduled audits, the Chamber also carries out “unplanned” audits.

Audits are generally financial audits. Performance audits are not carried out at present, but training has been started, in co-operation with donors, to improve the competence in this area. Audits are carried out *ex post*. Preventive control and system control are planned, and training for staff has also begun in this area.

The Law of the Georgian Chamber of Control specifies the rights and duties of the members of the Chamber. The chairperson is appointed by Parliament for five years adapting to the proposal by the chairperson of Parliament. The chairperson of the Chamber proposes the candidates for the deputies and other members of the presidium. Apart from the chairperson and his/her deputies, the presidium contains other members such as the Chamber’s heads of departments and other senior staff. The chairperson is allowed to hire and fire employees of the Chamber, and is granted immunity. The law defines some minimum standards for qualification of the chairperson and his/her deputies and does not allow them any party affiliation. For the other civil servants of the Chamber, preconditions concerning their qualification are regulated by law.

The Chamber of Control performs its tasks by prompt controls, general audits, focal point audits and expert opinions. Time limits are defined for the information about public revenue and spending. The extent, limits and places of audits and revisions in the whole national territory are defined by the chairperson of the Chamber or the chairpersons of the sub-units (territorial units and autonomous republics). In four cities small teams are established which carry out regular controls. To implement audits and revisions, experts can be invited.

The official responsible for the unit being audited has to answer questions concerning the audit in written form within two weeks. The Chamber of Control informs the responsible official afterwards about the results of the audit. Any materials of the audit which may contain characteristics of felony are assigned to agencies of prosecution (Office of the Public Prosecutor).

The Chamber performs approximately 300 audits each year, of which 15-20% are “unplanned” audits. It is noteworthy that around one-third of the annually performed audits are referred to the Office of the Public Prosecutor.

The Chamber makes two types of comments about audited units. The first are recommendations, the second are instructions. The latter must be signed by the chairperson of the Chamber and must be followed up.

The reports and recommendations are also sent to responsible ministers who must reply to the Chamber with comments on the recommendations. The parliamentary Finance Committee also receives the recommendations and reports and can hold hearings. Sometimes the reports and recommendations are sent to the government.

The Chamber of Control is obliged to work closely with other state organs. Agencies of prosecution, the national tax office, national agencies of financial and economic control and other state agencies are obliged to support the Chamber of Control. The Chamber is responsible for the co-ordination of control agencies in the financial economic area. Furthermore it is supposed to develop standards and instructions for auditing, which apply to all control agencies in the financial-economic area.

5.3. Internal control

A problem emphasised by the staff of the Chamber is the lack of internal control by budget users. Very little progress has been made in this area, and the Chamber staff mentioned that further progress would be most welcome not only to improve the quality of accounting and administrative organisation in government but also to facilitate the work of the Chamber.

A few ministries like Justice and Finance have internal inspectorates but they do not carry out formal internal audits. The internal inspectorates enjoy a certain independence, and support the ministers in a number of investigatory capacities which can include payment monitoring and other anti-corruption efforts.

5.4. Conclusion

The quality of financial reporting has greatly improved since 2004. The annual accounts are published very quickly after the end of the year, but they are audited only later in the year by the Chamber of Control. International practice suggests that audited accounts should be presented to Parliament within three months of the end of the fiscal year.

Although the Chamber of Control still needs to improve its capacity in fields such as performance audit and preventive control, the Chamber seems to be functioning relatively well, and it plays an important role in the government's attempt to improve the functioning of the public sector, improve the quality of the use of public resources, and fight corruption. Continued training of staff in the mentioned areas should be a priority. Training in performance auditing is especially important as more and more services are provided through PLEs.

While internal control is a stated priority of the Ministry of Finance, it has not yet been fully launched. This is an important priority for the coming years, not only in view of the effects of internal control on the quality of accounting and administrative organisation, but also because it will facilitate the work of the Chamber of Control.

Notes

1. Transparency principles are developed in the *OECD Best Practices for Budget Transparency* (OECD, 2002).
2. The PRGF is a low-cost facility, which carries an interest rate of 0.5% and is repayable over ten years with a 5.5 year grace period on principal payments. PRGF-supported programmes are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a poverty reduction strategy paper.
3. Earlier IMF arrangements were made in February 1996 (USD 240 million, fully drawn) and December 2001 (USD 70 million drawn to date).
4. At end 2002, legacy debt comprised an estimated GEL 1.2 billion (Georgian lari) in past obligations of the electricity sector that cannot be serviced in the light of short and medium-term cash flow prospects of the sector. (The value of one Georgian lari in 2002 was USD 0.46. In January 2006, the value of the GEL was about USD 0.55.)
5. Thus far the IMF has reviewed the progress on the PRGF programme twice, namely in January 2005 (IMF, 2005a) and in August 2005 (IMF, 2005b).
6. According to GFS standards, privatisation receipts do not reduce the deficit since they are a means of financing rather than a source of revenue.
7. The value of the Georgian lari in 2004 was USD 0.51.
8. Major sales included the Ocean Shipping Company and a major industrial complex in Western Georgia including the Vartsikhe hydro power station.
9. The terminology differed somewhat in both stages. In the second stage the document was called “strategic sectoral expenditures matrix”, its second column “objectives/prospects”, its third column “priority reforms”, and its fourth column “budget implications”.

10. In previous years there had also been ceilings in the Budget Circular, but only for the budget year.
11. The budgets of Parliament and the Chamber of Control are decided by the president and exempted from the process.
12. In some countries, including some OECD countries, medium-term expenditure frameworks are established from year to year without much consideration of the ceilings of the previous year. This does not make the exercise entirely senseless, because it still focuses attention on the multi-annual budgetary consequences of policy changes from year to year, but it removes the stability enhancing effect over the years and it hampers transparency, especially if the new ceilings are not explained in relation to the previous ones.
13. Multi-annual stability in this sense requires, in addition to a clear distinction between existing policies and policy changes, a clear distinction between expenditure changes following from policy changes and from updating of estimates on the basis of existing policies.
14. This distinction is partly the case already, since the matrices have columns for the current situation and for reform actions. However, it could be made more explicit, and the link with existing and new expenditure estimates could be emphasised.
15. The Budget System Law refers to the Basic Data and Directions document as “The Basic Directions for Budget and Tax Policy”.
16. The submission of the document to Parliament is a democratic feature of the process which contributes to transparency. This feature is in accordance with the *OECD Best Practices on Budget Transparency* (OECD, 2002).
17. The EU Policy Advice project developed an alternative model, which however showed other weaknesses in its technical specifications and forecasting capabilities and was not used during the budget cycle for 2006.
18. The fiscal year corresponds to the calendar year in Georgia.
19. In addition to this new way of presenting the budget, for the first time the Ministry of Finance organised a retreat with Parliament to discuss the government’s proposed budget for 2006. The retreat was held outside of Tbilisi over two consecutive weekends. In attendance were the finance minister and his senior team, the Speaker of Parliament, and 13 MPs, including the heads of the finance, procedures, and foreign affairs committees. Parliamentarians of the opposition were not invited to attend. During the sessions, there was disagreement and constructive debate

between the government ministers and the parliamentarians of the governing coalition. A benefit of this type of retreat is that the government is forced to justify and defend its proposals in a less politically charged environment than would be possible in Parliament, either in committee or on the floor. It allowed for a more “technical” debate on the merits of the proposals, which may translate into better understanding, if not agreement, between the government and the legislature (at least the majority) regarding the government’s plans.

20. In 2001, actual budget expenditures amounted to 82% of what was originally budgeted. This was an improvement from the previous year, when final expenditures amounted to only 63% of what was originally budgeted (World Bank, 2002).
21. When the Treasury is mentioned, it refers to the Treasury of the Ministry of Finance as opposed to treasury units in line ministries.
22. The government receives no interest on this balance, but on the other hand, it pays nothing to the National Bank for its role in collecting revenues and executing payments. The Treasury has stated that it is quite satisfied with this situation.

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Intergovernmental Transfers and Decentralised Public Spending

by

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Intergovernmental grants are used in many countries to finance sub-national spending and to implement national policies. However, the governance of grants is complex, and practices vary widely across OECD countries. The aim of this article is to provide a study of grant design that will be useful to policy makers. The article attempts to integrate both theoretical and empirical insights from the fiscal federalism literature as well as information obtained directly from practitioners concerning their experiences with the implementation of different types of grants. A typology of grants is presented, as well as an overview of the purposes of grants. The article concludes with some principles of grant design and implementation issues.

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1. Introduction

The most important resources of sub-national government are tax revenue and intergovernmental grants. The issue of the efficiency of different types of sub-national taxation was explored in the 2004 meeting of the OECD Network on Fiscal Relations across Levels of Government and will be analysed further in another paper. In this paper the focus will be on grants.

Intergovernmental grants are used in many countries to finance sub-national spending and implement national policies. However, the governance of grants is complex, and practices vary widely across OECD member countries. The aim of this paper is to provide a study of grant design that will be useful to policy makers. For the purpose of this paper a grant is defined as a transfer from central government to a sub-national government. Central government and sub-national governments are defined in accordance with the standard definitions of the national accounts as in *SNA 1993* (CEC, 1993).

The paper attempts to integrate both theoretical and empirical insights from the fiscal federalism literature, as well as information obtained directly from practitioners concerning their experiences with the implementation of different types of grants. For the latter purpose a group of experts from OECD countries was convened and asked to provide case studies about various types of grants.¹ Many of the examples in this paper come from these case studies. This paper also makes use of the answers given by the members of the Network on Fiscal Relations across Levels of Government to a statistical questionnaire distributed at the beginning of 2005, together with a follow-up of that questionnaire in late 2005 and early 2006, and in particular, the answers to the section on grants.

The main findings of the research can be summarised as follows:

- Although there are important differences between countries, the most common way of transferring resources from central to sub-national government is through earmarked grants (according to the data provided by member countries of the network in response to the statistical questionnaire).
- Grants are used for the purposes of financing and subsidisation of services and for equalisation of tax or service capacity.
- An important cause of inefficiency in many countries is the use of the same grant for various purposes, for instance, subsidisation

grants that simultaneously attempt to equalise, or financing grants that simultaneously attempt to subsidise.

- Grant reform is a gradual process. The guidelines developed in this paper should therefore not be seen as a prescriptive blueprint. Grant reforms can constitute improvements even if they are not yet fully in accordance with the guidelines.
- Non-earmarked grants are usually more efficient instruments for financing purposes than earmarked grants. Nevertheless, there are some cases where earmarked grants can be used in an efficient way for financing sub-national services. Such cases are particularly likely to occur with temporary risk-sharing and co-operation projects or programmes. In the latter case, earmarked discretionary grants can be used to co-fund projects. This makes it possible to provide guidance to sub-national decision makers in cases of expenditures that are difficult to target on the basis of predetermined criteria.
- Equalisation aims at a more equitable distribution of tax capacity and service capacity, but is in fact often based on indicators of actual tax revenue and actual spending. The latter practice creates incentives to decrease tax rates and to increase spending and consequently interferes unnecessarily with the competence of sub-national government to set tax rates and spending levels as it sees fit. Capacity indicators, on the other hand, measure the size of the tax base and spending needs, independently from actual tax revenues or spending.

The paper is structured around the following questions:

- What does the statistical data tell us about the different types of grants that countries can choose from? (section 2)
- What are the basic principles of grant design?² How does grant design deal with concrete problems? How can problems arising during the implementation phase be solved? (section 3)

Concluding remarks are developed at the end of the paper in section 4.

2. Types of grants and their uses

2.1. Fiscal autonomy and fiscal decentralisation

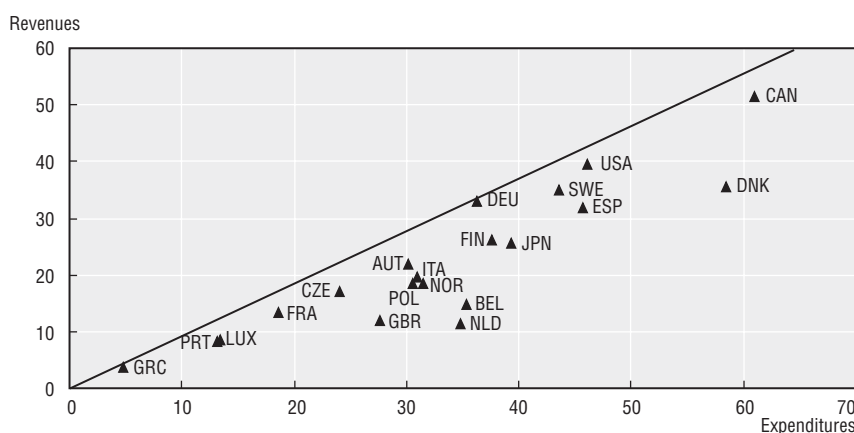
Intergovernmental grants are one of the revenue sources of sub-national governments. This section aims to explore the empirical significance of this

revenue source. First, the role of grants in sub-national public finance in general will be examined. Second, a typology of grants will be presented. Third, the choices of countries will be presented through the actual patterns of grant use as they appear in the statistical data. The findings presented in this section are mainly based on the results of the OECD questionnaire that was distributed at the beginning of 2005.

Grants are an important source of revenue for sub-national governments, complementing their own revenues which include revenues from direct and indirect taxation and non-tax revenues (fees, rents, interest, etc.). The fiscal autonomy of sub-national governments, defined as the share of their own revenues in the total revenue of sub-national government, varies widely among OECD countries. Furthermore, there does not seem to be a relation between fiscal autonomy and fiscal decentralisation (defined as the share of sub-national expenditure in total general government expenditure³, see Figure 1). It would also appear that the constitutional framework of government in a country – federal⁴ or unitary – has little impact on the extent of fiscal autonomy or fiscal decentralisation.

Figure 1. Indicators of fiscal decentralisation in OECD countries

Sub-national governments' share in general government revenues and expenditures in 2003 (percentages)

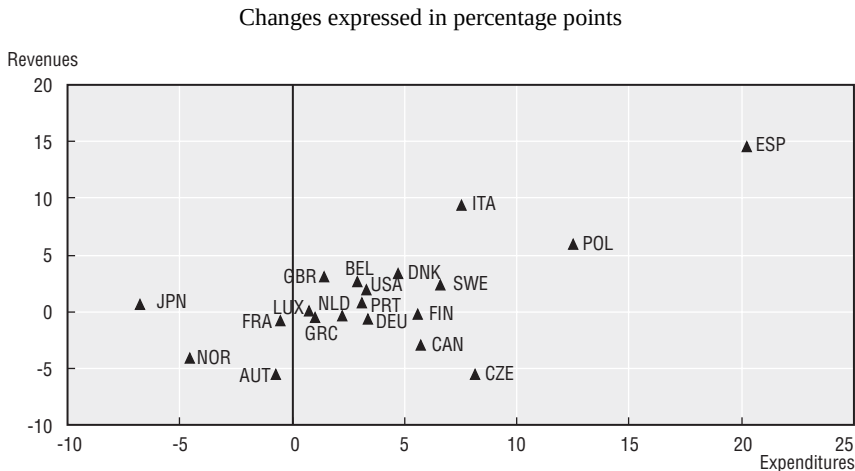


Source: OECD, National Accounts.

The gap between sub-national tax and expenditure shares has widened in the last twenty years. While in most countries the share of sub-national expenditures has increased, sub-national taxing power declined or remained stable (Figure 2). Accordingly, the dependence of sub-national governments

on grants has increased. Fiscal decentralisation has led to increased sub-national responsibilities in the area of spending, while at the same time sub-national governments have become more dependent on central governments for their resources.

Figure 2. Changes in the share of sub-national government contributions in total public revenues and expenditures between 1995 and 2003



Source: OECD, National Accounts.

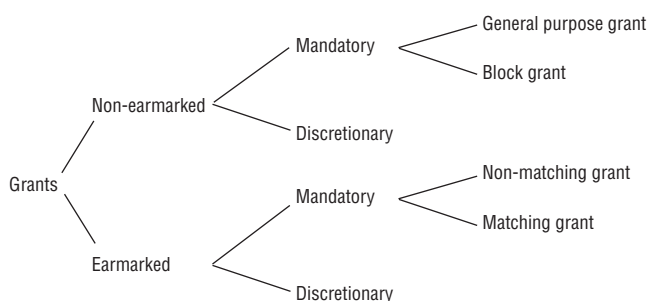
The growth of sub-national expenditure needs in combination with insufficient sub-national tax bases and the unwillingness of central governments to increase the size of sub-national tax bases (vertical imbalance) are not the only reasons why grants have become an important part of sub-national revenue. A substantial share of grants is also the result of disparities in tax bases or financial needs between jurisdictions that central governments want to correct (horizontal imbalances). Finally, a sizeable proportion of grants are due to central government imposition of service delivery requirements or central government encouragement of sub-national spending through financial incentives. In these cases, the grants are directly related to the initiative of central government concerning service provision by the sub-national governments.

2.2. A typology of grants

This paper uses the typology of grants indicated in Figure 3. This typology is largely identical to the one developed by the Council of Europe

(2004). However, the proposed definitions sometimes differ in detail. As will be discussed in section 3, the typology is based on criteria that are important for grant design.

Figure 3. Types of grants



2.2.1. Earmarked and non-earmarked grants

Grants can be either earmarked or non-earmarked. An earmarked grant is a grant that is given under the condition that it can only be used for a specific purpose. Non-earmarked grants can be spent as if they were the receiving sub-national government's own (non-earmarked) tax revenues.

2.2.2. Mandatory and discretionary grants

Both earmarked and non-earmarked grants can be either mandatory or discretionary. Mandatory grants (entitlements) are legal, rules-based obligations for the government that issues the grant. This requires that both the size of the grant and the conditions under which it is given be laid down in a statute or executive decree and that these conditions be both necessary and sufficient. Typically, sub-national governments can also appeal to a court or administrative judicial authority in order to obtain the grant. Most grants that are given to sub-national governments on a regular basis are mandatory. The size of discretionary grants, and the conditions under which they are given, are on the other hand not determined by rules but decided on an *ad hoc*, discretionary basis. Discretionary grants are often temporary in nature and include, for example, grants for specific infrastructural projects or emergency aid to a disaster area.

2.2.3. *Matching and non-matching grants*

Earmarked mandatory grants can be matching or non-matching. Matching grants complement sub-national contributions. Matching grants are dependent on normative or actual spending for services⁵ for which the grants are earmarked or on local revenue collection related to these services.

In particular, matching grants may be dependent on:

- Norm costs per unit of service, or norm budget (norm costs times norm volume) per programme of services; or
- Actual costs per unit of service or actual costs (actual costs times actual volume) per programme of services; or
- Revenues from fees or earmarked levies raised by sub-national government to cover the costs of the programme of services.

If the grants are based on norm costs per unit of service, the grant cannot exceed a fixed sum per unit. From the perspective of the grantor there is a fixed money ceiling per unit of the grant. Similarly, if the grant is based on a norm-budget for the entire programme (total cost of services), then it cannot exceed a fixed absolute sum for the programme. This amounts to a fixed money ceiling for the programme as a whole (the grant can then be called a “close-ended grant”).

All mandatory earmarked grants that are not given complementary to sub-national contributions are non-matching. Note that mandatory earmarked grants may also be dependent on contingencies other than sub-national contributions, for instance on local circumstances or performance indicators. In such cases, the grants are considered as non-matching. The decisive question is whether the decrease in sub-national spending would automatically lead to a decrease in the grant (this would not be the case if the grant were dependent on a performance indicator, because performance is not automatically dependent on sub-national spending).

One special case worth mentioning is when a mandatory earmarked grant is dependent on normative or actual spending or on revenue collections related to the service but is not given complementary to sub-national contributions.⁶ This is the case when an earmarked mandatory grant covers 100% of the service (cost-covering grants). Because the central government covers the entire bill and there is no mandatory financial contribution from sub-national government, this type of grant is classified as a non-matching grant.

Sometimes discretionary grants are given under the condition that sub-national governments also contribute to the project or programme. These

grants will be called co-funding grants. They are not included in the definition of matching grants. The background is that a matching grant is by definition mandatory and thus creates a permanent incentive for increased provision. A discretionary grant is *ad hoc* and does not create a permanent incentive (the co-funding contribution is limited to a concrete project or programme).

2.2.4. General purpose and block grants

Non-earmarked mandatory transfers can be general purpose or block grants. Both types are similar in that they increase the sub-national governments' revenue without changing relative prices in the provision of services. The difference is that a block grant is given by the grantor for a specific purpose (or purposes). However, since the grant is not earmarked, the grantee's actual use of the grant is not controlled. Instead, the output could be regulated through, for example, a set minimum standard that the sub-national government would have to provide. In this case, resources are transferred in the form of a grant to the sub-national governments to cover all or part of the cost for certain sub-national services. The criteria used to calculate the level and distribution of the grant are usually connected to the normative cost of providing the goods or services for the sector as a whole, using variables that a specific sub-national government cannot directly control. The rationale for this type of grant is to improve efficiency in the use of resources at sub-national level, whereas the activity is financed, in part or fully, by the central government. If a sub-national unit is able to perform the activity at lower than normative costs, the grant will not be reduced for that unit as a consequence, thereby giving the sub-national government an incentive to fully explore the advantages of decentralised service provision. This kind of grant can be a means of moving away from earmarked grants.

Although non-earmarked grants are generally perceived by the grantors as transfers with no strings attached, one could argue that there are sometimes indirect strings attached. For instance, the central government may impose national minimum standards for service delivery and provide general purpose grants to finance the services partly or entirely. However, since these legal requirements are independent from the grant entitlement, they do not change the character of the grants as non-earmarked.

2.2.5. Capital versus current grants

Earmarked grants may be current or capital expenditures. The distinction is made in accordance with the national accounts. Note that in the

national accounts non-earmarked grants are assumed to be current expenditures (although they may be used for investments).

2.3. Countries' decisions concerning the use of different types of grants

To get a picture of how countries actually use different types of grants, a questionnaire was sent to OECD member countries through the Network on Fiscal Relations across Levels of Government during the spring of 2005. The questionnaire was also sent to non-members of the network through the OECD Working Party of Senior Budget Officials. An updated version of the questionnaire was sent out in late 2005 to improve the quality of the answers. The following part of this section is, to a large extent, based on the results of these surveys.

The data provide an overview of the extent to which sub-national governments are dependent on grants to finance their activities, the size of the transfers and the choices countries make concerning the transfer of resources. The data reveals a great deal of variation in the approaches countries have adopted.

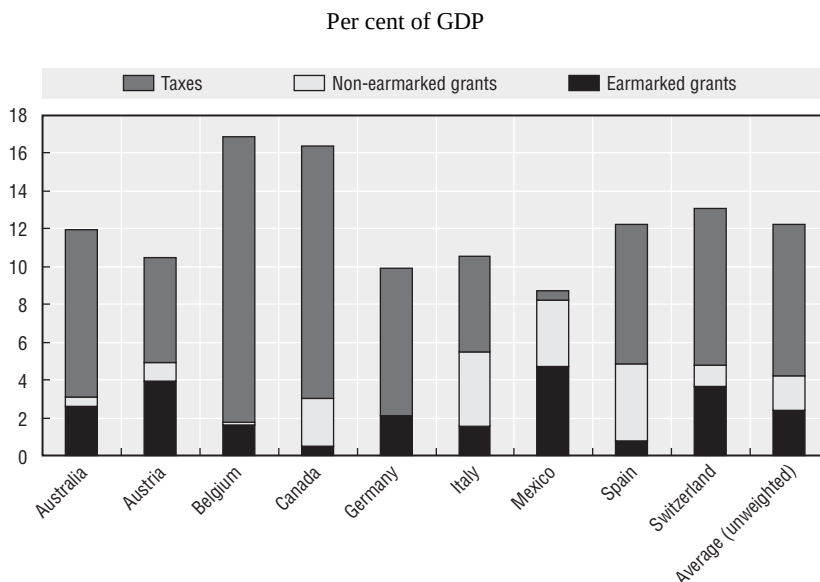
The two main revenue sources for sub-national governments are taxes and grants. (Other revenues, such as user fees, generally play a less important role in financing sub-national services.) Of the two main sources of revenue, taxes are the main source of sub-national income, although the use of taxes and grants for financing sub-national governments varies among countries. In the sample, grants represent almost 40% of total tax and grant revenue for states, regions and provinces. For the local government sector, grants amount to just over 40% of total revenue from taxes and grants.

Figures 4 and 5⁷ show state and local revenue from taxes and grants. As can be seen, the size of grant financing varies between countries. States receive on average 4.3% of GDP in grants, ranging from 1.8% of GDP in Belgium to 8.3% of GDP in Mexico. Grants to states in Mexico correspond to 95% of total revenue from taxes and grants, compared to 10% in Belgium.

For the local government sector, differences are even larger, ranging from Australian local governments which receive 0.3% of GDP, to Polish and Danish local governments which receive 13% and 12.1% respectively. The importance of grants as a source of finance for local governments also differs to a large extent. The percentage of grants in Denmark (12.1% of GDP) corresponds to just over 40% of local government revenue from taxes and grants. In the Netherlands, also a country with large grants to local

governments, the percentage of grants (11% of GDP) represents almost 90% of local government revenue from taxes and grants.

Figure 4. State revenue from grants and taxes in federal countries (2003)



Note: Data for Australia and Italy are from 2002. Grants for Mexico are for both state and local level of government.

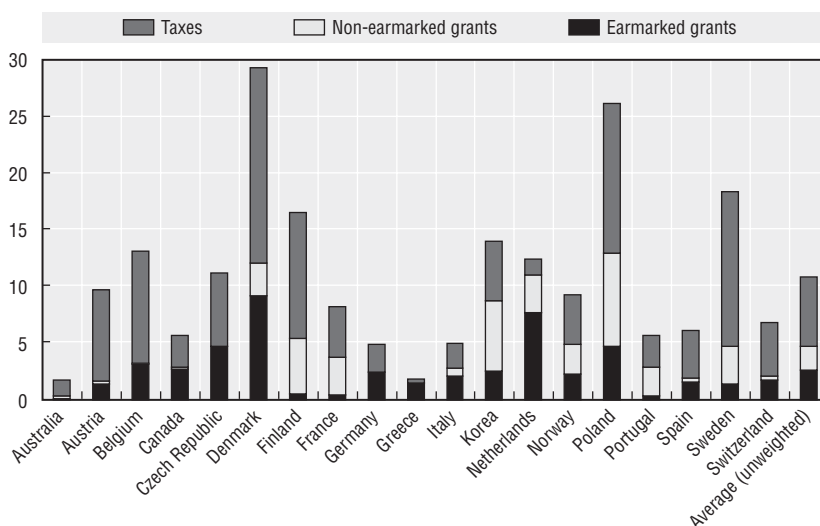
Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

Sub-national governments receive grants from various sources. Table 1 shows grant flows to states and local jurisdictions from different sectors as a per cent of total grants. The central government is by far the most important source of grant revenue for both states and local jurisdictions. States receive on average over 85% of their grants from the central government, varying from almost 70% in Austria to 100% in Australia and Mexico.

The picture is more varied at the local level, with on average over 70% of its grants from the central government. Canada and Switzerland receive 0.4% and 0.2% of all grants from the central government level whereas the Netherlands and Norway receive 100% of all grants from the central government level. Almost half of the countries report that their local government levels receive 100%, or almost 100%, from the central government.

Figure 5. Local government revenue from grants and taxes (2003)

Per cent of GDP



Note: Data for Australia and Italy are from 2002. Data for Greece, Netherlands, Poland and Portugal are for 2003.

Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

In countries with a state level of government, the state is usually an important grantor for the local level of government. This is the case especially in Canada and Germany with almost 100% of local government grant receipts from the state level. International or supranational bodies are in general not an important grantor, except in Portugal, with 19% of total grant revenue for local governments. The German and the Italian state levels of government also receive notable amounts from international or supranational sources. Grants from social security funds mainly occur in Austria (both state and local level of government) and Hungary.

Some countries have horizontal transfer schemes. This is the case for Austria, Belgium and Switzerland at the state level of government, and for the local level primarily in Austria, Korea and Switzerland.

The data show that countries use grants in different ways. On average, earmarked transfers dominate with more than approximately 55% for both the state and the local level of government (see Table 2). The picture differs substantially between countries. The Australian state level of government receives just over 10% of its grants non-earmarked, while in Spain more

than 85% of the grants are earmarked. For Australia the picture is completely the reverse at the local level, with over 80% of grants non-earmarked.

Table 1. Receipts of grants by issuing sub-sector (2004)

Per cent of total grants, unconsolidated

	Per cent of total tax revenue	Issued by					Total
		Central govern- ment	State, region, etc.	Local govern- ment	International/ supranational organisation	Social security fund	
States							
Australia ^a	9.8	100.0	0.0	0.0	0.0	0.0	100.0
Austria	11.5	69.4	5.1	3.8	0.6	21.1	100.0
Belgium	3.9	81.3	13.9	3.6	1.0	0.1	100.0
Canada	9.0	99.8	0.0	0.2	0.0	0.0	100.0
Germany	5.9	79.0	0.0	14.7	6.4	0.0	100.0
Italy ^a	12.7	94.8	0.0	0.0	5.2	0.0	100.0
Mexico ^c	43.4	100.0	0.0	0.0	0.0	0.0	100.0
Spain	14.0	77.7	0.0	16.7	0.0	5.6	100.0
Switzerland	16.1	73.7	5.6	20.7	0.0	0.0	100.0
Average	14.0	86.2	2.7	6.6	1.5	3.0	100.0
Local jurisdictions							
Australia ^a	1.1	67.2	32.8	0.0	0.0	0.0	100.0
Austria	3.8	49.2	16.1	12.7	0.3	21.7	100.0
Belgium	7.1	26.4	73.3	0.0	0.0	0.3	100.0
Canada	8.5	0.4	99.6	0.0	0.0	0.0	100.0
Czech Republic	12.4	99.1	0.0	0.0	0.9	0.0	100.0
Denmark	25.0	99.7	0.0	0.0	0.3	0.0	100.0
Finland	12.1	98.5	0.0	0.0	1.5	0.0	100.0
France	8.6	97.0	0.0	0.0	3.0	0.0	100.0
Germany	7.0	1.4	98.4	0.0	0.0	0.2	100.0
Greece ^b	4.1	100.0	0.0	0.0	0.0	0.0	100.0
Hungary	16.7	67.2	0.0	3.0	0.5	29.4	100.0
Iceland	1.9	100.0	0.0	0.0	0.0	0.0	100.0
Italy ^a	6.4	54.3	45.7	0.0	0.0	0.0	100.0
Korea	34.4	82.6	0.0	17.4	0.0	0.0	100.0
Netherlands ^b	28.3	100.0	0.0	0.0	0.0	0.0	100.0
Norway	11.3	100.0	0.0	0.0	0.0	0.0	100.0
Poland ^b	37.9	99.6	0.0	0.4	0.0	0.0	100.0
Portugal ^b	7.9	79.8	0.0	0.0	19.9	0.3	100.0
Spain	5.5	66.6	31.2	0.0	0.0	2.2	100.0
Sweden	9.4	100.0	0.0	0.0	0.0	0.0	100.0
Switzerland	7.2	0.2	77.6	22.3	0.0	0.0	100.0
Turkey	15.8	100.0	0.0	0.0	0.0	0.0	100.0
Average	12.4	72.2	21.6	2.5	1.2	2.5	100.0

Notes: a: 2002 data; b: 2003 data; c: Including grants to local governments.

Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

Table 2. Receipts of earmarked and non-earmarked grants

Per cent of total grants

	Earmarked grants	Non-earmarked grants	Total
States			
Australia ^a	87.5	12.5	100.0
Austria	79.8	20.2	100.0
Belgium	94.0	6.0	100.0
Canada	18.6	81.4	100.0
Italy ^a	28.6	71.4	100.0
Mexico ^c	59.2	40.8	100.0
Spain	14.8	85.2	100.0
Switzerland	77.8	22.2	100.0
Average	57.5	42.5	100.0
Local jurisdictions			
Australia ^a	17.2	82.8	100.0
Austria	86.1	13.9	100.0
Belgium	95.9	4.0	100.0
Canada	95.7	4.3	100.0
Czech Republic	100.0	0.0	100.0
Denmark	69.8	30.2	100.0
Finland	9.2	90.8	100.0
France	11.7	88.3	100.0
Greece ^b	100.0	0.0	100.0
Hungary	56.9	43.1	100.0
Iceland	21.0	79.0	100.0
Italy ^a	75.5	24.5	100.0
Korea	27.7	72.3	100.0
Netherlands ^b	70.0	30.0	100.0
Norway	44.9	55.1	100.0
Poland ^b	29.5	70.5	100.0
Portugal ^b	11.4	88.6	100.0
Spain	33.8	66.2	100.0
Sweden	28.7	71.3	100.0
Switzerland	80.4	19.6	100.0
Turkey	77.3	22.7	100.0
Average	54.4	45.6	100.0

Notes: a: 2002 data; b: 2003 data; c: Including grants to local governments.

Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

Table 3. Receipts of grants by type

Per cent of total grants

	Earmarked						Non-earmarked		Discre- tionary	Total
	Mandatory				Discretionary		Mandatory	Block		
	Matching		Non-matching		Cur- rent	Capital	General purpose			
	Cur- rent	Capital	Cur- rent	Capital						
States										
Australia	–	–	–	–	76.4	11.2	8.6	–	3.9	100.0
Austria	57.0	1.8	2.0	18.4	0.6	0.1	12.5	0.2	7.5	100.0
Belgium	67.2	10.9	14.7		1.0		6.0	–	–	100.0
Canada	–	–	18.6		–	–	81.4	–	–	100.0
Italy ^a	4.7		4.7		10.6	8.7	71.4	–	–	100.0
Mexico ^c	53.9		–	–	5.3		40.8	–	–	100.0
Spain	8.1	5.4	–	–	0.9	0.5	85.2	–	–	100.0
Switzerland	64.8	12.9	–	–	–	–	22.2	–	–	100.0
Average	31.4	4.5	4.4	2.9	11.8	2.6	41.0	–	1.4	100.0
Local jurisdictions										
Australia	–	–	–	–	17.1	0.1	82.8	–	–	100.0
Austria	39.3	3.5	7.4	34.8	1.2		13.7	0.1	0.0	100.0
Belgium	71.6		0.1		0.5	23.8	4.0	–	–	100.0
Canada	–	–	91.4	4.3	–	–	4.3	–	–	100.0
Czech Republic	12.4		–	–	74.1	13.6	–	–	–	100.0
Denmark	66.6		0.5		2.6	0.0	30.2	–	0.0	100.0
Finland	5.7		–	–	1.8	1.6	16.3	74.0	0.6	100.0
France	6.5		0.1		1.3	3.8	81.9	6.4	–	100.0
Greece	61.3	38.7	–	–	–	–	–	–	–	100.0
Hungary	40.1	7.4	–	–	3.8	5.6	41.9	–	1.1	100.0
Iceland	3.0		8.4		6.5	3.1	79.0	–	–	100.0
Italy ^a	–		–		39.4	36.1	24.5	–	–	100.0
Korea	6.4		–	–	11.2	10.2	69.9	–	2.4	100.0
Netherlands ^b	70.0		–	–	–	–	30.0	–	–	100.0
Norway	12.2		9.4		19.4	3.9	–	55.1	–	100.0
Poland	24.1	5.4	–	–	–	–	70.5	–	–	100.0
Portugal	–	–	–	–	11.4		85.0	–	3.6	100.0
Spain	14.3	16.4	3.1		–	–	66.2	–	–	100.0
Sweden	–	–	–	–	0.7	28.1	71.3	–	–	100.0
Switzerland	71.7	8.7	–	–	–	–	19.6	–	–	100.0
Turkey	–	–	–	–	77.3		–	–	22.7	100.0
Average (unweighted)	24.1	3.8	5.7	1.9	9.1	9.9	37.7	6.5	1.5	100.0

Notes: a: 2002 data; b: 2003 data; c: Including grants to local governments.

Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

Table 4. Earmarked grants by function (2004)
Functional distribution according to the Classification of Function of Government – COFOG
 Per cent of total earmarked grants

	01	02	03	04	05	06	07	08	09	10	
General public services	Defence	Public order and safety	Economic affairs	Environmental protection	Housing and community amenities	Health	Recreation, culture, religion	Education	Social protection	Other	Total
Belgium	–	–	24.3	21.4	–	–	0.1	–	25.3	28.9	– 100.0
Czech Republic	9.3	0.0	0.5	6.0	0.3	7.5	2.2	0.7	54.3	17.7	1.4 100.0
Finland	5.5	–	0.6	17.2	1.8	0.4	12.0	16.9	27.0	18.7	– 100.0
France	16.9	1.7	8.0	13.0	2.3	22.4	–	30.8	5.0	–	– 100.0
Greece	56.6	–	–	18.9	5.6	5.6	–	7.2	–	6.1	– 100.0
Italy ^a	–	16.9	–	–	40.6	3.8	–	31.7	–	7.0	– 100.0
Norway	79.3	0.2	0.1	–	0.0	0.1	14.0	–	4.7	1.7	– 100.0
Poland	3.1	3.5	16.2	4.4	8.9	5.5	10.8	5.2	17.9	24.6	– 100.0
Spain	42.4	–	0.2	35.4	0.6	3.2	4.7	0.9	2.5	10.0	– 100.0
Sweden	3.5	1.1	0.0	6.2	3.8	–	56.3	–	29.1	–	– 100.0
Turkey	43.2	–	–	14.2	19.1	22.2	–	0.9	–	0.5	– 100.0
Average (unweighted)	23.6	2.1	4.5	12.4	7.5	6.4	9.1	8.6	15.1	10.5	0.1 100.0

a. 2002 data.

Sources: National sources and *OECD Revenue Statistics 1965-2004*, 2005 edition.

Earmarked grants are mainly matching, particularly so in Austria, Belgium, Mexico and Switzerland for the state level of government, and for Belgium, the Netherlands and Switzerland for the local level of government.

Non-earmarked grants are mainly general purpose. Only a few countries use block grants, most significantly Finland and Norway.

The use of earmarked transfers for different functions varies. General public services receive most earmarked transfers, almost 25% of total earmarked grants. After that function, and in descending order, come education, economic affairs, and social protection. In some countries, like Belgium and Italy, earmarked transfers only exist in some areas, while in others earmarked transfers are more widely used. In the Czech Republic earmarked transfers exist for all functions, but with a heavy concentration in education. In Sweden, earmarked transfers are also widespread, but with a concentration in health and in education.

3. Grant design and implementation issues

3.1. Objectives of grants

Central governments can have three objectives in providing grants to sub-national governments (Oates, 1990):

- **Financing sub-national services and investments:** If the central government wants to control sub-national taxation, it can constrain the local tax base and provide grants to sub-national units with the objective of improving their general capacity to finance the provision of services.
- **Subsidisation:** When the sub-national provision of services has cross-boundary or spillover effects, sub-national decision making may not lead to the optimal nationwide provision of services. If that is the case, the central government could affect sub-national provision by subsidising the services.
- **Equalisation:** The central government may want to enable sub-national governments to provide the same basic bundle of services with roughly the same tax effort. This often requires a redistribution of resources to equalise tax capacity and/or service capacity.

In practice, grants often have various objectives at the same time. This can easily lead to inefficiencies, when a single grant is used to accomplish several objectives simultaneously. It is therefore important that the objectives of the grants be clearly stated and that the grant design allows for

a separation of objectives and independent steering and control of grant characteristics that contribute to each of these objectives.

Box 1. Grant reform in Switzerland

Switzerland formerly had a system in which equalisation between the different cantons was mostly achieved via earmarked grants. In 2002, the amount of money devoted to financial equalisation was CHF 2.4 billion. Only part of that amount (CHF 0.9 billion) came from the non-earmarked general purpose grant; the rest was collected via earmarked grants and contributions to the social security system. This meant that specific purpose financing and equalisation were often strictly tied together: financing, subsidisation and financial equalisation could not be carried out independently. This posed considerable efficiency problems, especially because intergovernmental transfers play an important role in Swiss public spending. Among other effects, the poorer cantons were usually the ones suffering most from central government spending cuts, because almost all grants had equalising components. In the new grant system, implemented in 2004, financing, subsidisation and equalisation are separated: no equalisation takes place by means of the earmarked grants. Earmarked matching grants have largely been abolished. Earmarked non-matching grants have been sharply reduced (from more than 50 to 17). All equalisation is carried out by the non-earmarked grants and by horizontal grants (from rich to poor cantons). In this way, the instruments for financing, subsidisation and equalisation can be controlled independently. Furthermore a number of perverse incentives have been removed from the grant system.

3.2. Financing of sub-national services

Financing grants aim to provide sub-national governments with a source of revenue in addition to the sub-national tax base. The central government may choose to provide financing grants, rather than to extend the sub-national tax base or tax-sharing arrangements,⁸ either because of the distortionary effects of sub-national taxes or the high administrative costs of sub-national tax collection, or because it wishes to control sub-national spending. Furthermore, financing grants are perceived as necessary if the central government imposes new programmes or extends the legal minimum standards of sub-national service delivery (the alternative being that sub-national jurisdictions would have to cut back on existing services or increase tax rates, which is commonly seen as unfair or counterproductive).

As indicated in Figure 2, sub-national revenues have tended to decline in the OECD area over the last decades, so that sub-national governments have become more dependent on grants to finance their services. In most

countries, the taxing competences of sub-national governments are decided, or subject to approval, by the central government, and the choice between adjustment of the sub-national tax base and grants is an important policy variable at the central level of decision making. Some OECD countries have opted to limit sub-national tax bases. For instance, in France municipal taxation has been curbed. The choice between the extension of the sub-national tax base and general purpose grants is a subject that merits separate treatment and is not addressed in this paper. It should be emphasised here, however, that this choice is not only a matter of spending control⁹ and/or the technical or allocative efficiency of sub-national taxation. It is also a question of sub-national autonomy concerning the service level in general. If sub-national jurisdictions are deprived of any substantial tax base, they will no longer be in a position to vary the overall level of sub-national services. Of course, they can still vary the mix of services financed by general purpose grants. Allocative efficiency in the sense of equal marginal benefits remains possible in the public domain, but marginal benefits in the public and private domains may diverge. However, since allocative efficiency remains possible in the public sphere, the basic idea of decentralisation – namely that sub-national government is closer to the people and thus better informed about their needs and preferences – is thus still entirely applicable. The minimum sub-national tax base required to avoid divergence between marginal benefits in the public and private sectors equals the difference that would exist between the costs of the lowest and highest average sub-national service levels if every jurisdiction had a substantial tax base.

The first aim of financing grants is to enable sub-national jurisdictions to finance a basic package of services. Since the basic package should reflect sub-national preferences, it is in general not completely uniform. Consequently, non-earmarked general purpose grants are required. In principle, earmarked grants undermine allocative and technical efficiency if used for this aim, because resources or efficiency gains cannot be transferred to spending areas that constitute sub-national priorities. The grant should not extend to “fringe benefits” that reflect additions to the basic package of services. The decision about what constitutes a variation in the basic package and what constitutes a fringe benefit has to be made at the central level.

Most countries that use general purpose grants to finance the basic service package of sub-national jurisdictions use fixed distribution formulas, which are enacted in legislation or government regulation. These formulas reflect the average or normative costs of the basic package (averaging out variations in the basic package) and, in most cases, subtractions or additions following from tax and service capacity equalisation.

In countries where the basic package of sub-national services is mostly financed by sub-national tax revenue, there may be a relatively small general purpose grant that is intended to cover only administrative costs. The number of criteria for distributing the grant will then be small and mainly related to the number of inhabitants. In countries where the general purpose grant is supposed to cover a wide array of sub-national responsibilities for imposed social spending, such as in Sweden, the number of cost-related criteria (*e.g.* number of children, unemployed, immigrants, elderly people) will be large.

Box 2. Earmarked versus non-earmarked grants in the Netherlands, Sweden and the United Kingdom

Although the non-earmarked grant can be spent according to sub-national preferences, central governments sometimes try to control it. Central governments may start by financing a certain activity with an earmarked grant, at the same time promising to change the funding into a non-earmarked grant in a few years – hoping that by that time sub-national governments will continue the existing spending pattern after the change. This has been the case in Sweden, for example, with the financing of child care. In the United Kingdom and the Netherlands, the central government has tried to reach an agreement with the sub-national governments to target the yearly increase of the non-earmarked grant for central government priorities: education policy in the United Kingdom; health, education and police in the Netherlands. Although policy co-ordination like this can be effective, it runs counter to the objective of a non-earmarked grant to provide sub-national governments with a source of funding they can spend freely.

A second aim of financing grants is to provide the resources needed to supply the service delivery programmes imposed by central government or to reach imposed minimum standards for service delivery. In general, imposed obligations do not necessarily have to be financed by central government. Again, the government will have to choose between extending the sub-national tax base and using financing grants. However, assuming that the choice between adjustment of the sub-national tax base and grants is made on its own merits (spending control, efficiency of sub-national taxation), new obligations generally have to be financed by grants. Financing grants are generally based on average or normative service costs. If the grant is non-earmarked, sub-national jurisdictions that are able to provide the service at less than average or normative cost can use the profits for other purposes. If the grant is based on average costs, the profits are

temporary, because the average costs change when all jurisdictions become more efficient. If the grant is based on normative costs, most jurisdictions will make profits after a certain period of time. Therefore normative costs may have to be adjusted periodically. In principle, basing the grant on normative costs is the preferable policy option (taking average costs assumes that the average costs provider is efficient). However, determining the normative costs is difficult for the central government because of asymmetric information. Therefore, average costs are often used as a temporary proxy, particularly in the first few years after new programmes or minimum standards have been imposed. Once the central government has learned more about the cost structure of the service, it can, at a certain point, move to normative costs.

Box 3. Grants for administrative costs in the Czech Republic

The Czech Republic has over 6 000 municipalities in 13 regions. The central government provides a grant that finances 60-80% of sub-national administrative costs. The grant allocation was reformed for 2005 because the old system was not consistent across municipalities, did not provide enough funds, and was not adjusted for inflation. The new model uses a formula that places a 0.95 weight on population. While this is an improvement over the old system, two problems are likely to arise. First, administrative costs probably do not increase one-to-one with population so that real administrative costs will not be reflected in the formula. It seems difficult to believe, for instance, that a town with a population of 50 000 needs five times more money for administrative costs than a town of 10 000. Second, it gives the municipality little incentive to economise on administrative costs.

In general, financing grants for imposed programmes or minimum standards, like those for basic sub-national services, should be given in the form of non-earmarked grants (general purpose or block grants). This creates the best incentives for sub-national jurisdictions to seek opportunities for cost savings. However, in the case of newly imposed programmes or minimum standards, earmarked grants (non-matching) sometimes cannot be avoided as a temporary solution. In some countries, periodical integration operations can be observed in which earmarked grants are added to the general purpose grant. This requires not only an increase of the general purpose grant but also an adjustment of its distribution formula. Since it is important to keep the distribution formula as simple as possible, this will often cause redistribution effects between jurisdictions. In general, such operations can be conducted more easily if many earmarked grants are

integrated at the same time, because then the redistribution effects as a consequence of simplified distribution formulas will even out.

Box 4. Austrian and Mexican grants for education

In Austria the central government gives earmarked non-matching grants to states for teachers' salaries. The states are responsible for recruiting teachers and negotiating teachers' salaries, but the central government is responsible for funding the salaries. The grant effectively reimburses the states for teachers' salaries. This structure creates two inefficient incentives for states. First, the state has an incentive to employ too many teachers. Second, the state has an incentive to negotiate salaries that are too high. In both cases, the state bears only a small part of the cost (its share of national taxes). Austria recognised the problem and negotiated a national limit on the student-teacher ratio in 2000. This limits the number of teachers that can be employed in a given state. According to Austrian state data, the limit has been largely successful in controlling costs, as education spending in terms of euros per pupil was rising rapidly before 2000 and has flattened off significantly since that time.

Mexico has a similar problem with respect to grants for education. Mexico gives states grants for education, based primarily on the number of teachers they employ. One difference with Austria is that salaries are negotiated through a strong national teachers' union. In addition, the large income inequalities in Mexico mean that spending per pupil is unequal across states and is higher for wealthier states.

In general, it is difficult to find good criteria for the distribution of financing grants (whether non-earmarked or earmarked). Criteria used in distribution formulas may not reflect the real service costs and may not give incentives to economise on costs. Population is often one of the criteria used, and this can make sense for the costs of publicly provided private goods that increase with the number of inhabitants. However, this is not a good criterion for the costs of public goods which decrease with the number of consumers.¹⁰

The formulas used in financing grants often do not work in the most efficient way because they are not based on normative or average costs per unit of service but on costs per unit of production factor or intermediate product. They thus affect the production process and prevent sub-national jurisdictions from seeking the optimal combination of inputs.

Since every distribution formula that takes differences in spending needs into account is to some extent subjective, it is an illusion to think that

extensive fine-tuning will make the formula more effective. In general, it will just make it more complex, less easy for the sub-national authorities and the general public to understand and, as a result, less open to accountability. To facilitate accountability, a simple and easily understandable distribution formula is preferable.

There is no essential difference (in the way they can be spent) between block grants and general purpose grants, but new obligations are often financed by block grants for reasons of transparency. However, overall transparency may deteriorate if there are many block grants. Therefore, it is recommendable that established block grants that function appropriately be eventually integrated into the formula of the general purpose grant.

Box 5. Financing social assistance in the Netherlands

The social assistance law was introduced in the Netherlands in 2004 to create incentives for municipalities to reduce the number of people on social assistance. Before this reform the central government largely reimbursed municipalities for the social assistance benefits they paid. This procedure gave municipalities little incentive to constrain expenditures. Since the reform was introduced, municipalities have borne the full responsibility for social assistance and are reimbursed for the cost through a block grant. The level of the block grant is decided by macroeconomic variables that municipalities cannot control (if the general economic situation worsens it increases and vice versa). The grant is no longer based on actual expenditures but, depending on the size of the municipality, on either a set of relevant criteria (large municipalities) or on historical cost data (small municipalities). The criteria used for large municipalities give larger transfers to municipalities with higher levels of “risk” (low income, low education level, migrants, regional unemployment, etc.). If expenditures for social assistance are lower than the grant, the profits can be used freely. This gives municipalities an incentive to move people off social assistance and into employment.

Central governments often feel the need to collect performance information about imposed programmes of service provision or imposed minimum standards. This is particularly the case when the financed services are seen as an instrument which is supposed to contribute to a more general central government objective. In principle, performance information can be collected and used to improve the imposed programme or the minimum standards in a process which is independent from the attribution of the financing grants, for instance, in periodical evaluations of the regulation that imposes the programmes or in benchmarking exercises. However, central

governments generally feel the need to link the monitoring of performance closely to the grant attribution process (which is part of the annual budget cycle). A close linkage is often considered necessary to make sure that funds are used as intended and that central government authorities can be made accountable for the results obtained. If a close linkage is in place, information about unsatisfactory results can be used not only to adjust the programme or the minimum standards but also to adjust the financing grants themselves (for instance, by extending them to cover new services or by limiting them and reallocating the funds).

Box 6. Denmark: Block grant for improved old-age care

During the election campaign in Denmark in 2001 the government party proposed an increase in old-age care spending of DKR one-half billion. The instrument of implementation was part of the annual agreement between the central government and the municipalities. The purpose of the grant was to improve old-age care services, and the agreement between the central government and the municipalities was that the grant should be spent to improve old-age care. The new grant exhibits key features of a block grant. It was distributed among municipalities according to the demographic composition, and it was the government's expectation that the grant would cover the municipal cost of the reform. Municipalities received the grant in 2002 and 2003 and after that it became a permanent annual addition to the general purpose grant to municipalities. In 2004, a number of critics questioned whether the grant had actually been spent according to its purpose. The use of non-earmarked grants is generally hard to trace, but calculations showed that municipalities had actually spent the funds mostly on the purposes of the reform.

A further advantage of performance information is that it provides a good base from which to involve local or regional actors. This can help in many ways, from obtaining local information on problems and ideas for solutions, to giving local actors a stake in the outcome. If local governments have revenue-raising power, co-funding grants linked to performance targets can help to obtain sub-national commitment to the objectives set by the central government. Co-funding can be helpful in fostering responsible behaviour since people will generally take better care of funds to which they have contributed themselves. The European Performance Reserve scheme is an example of a co-funding grant linked to performance targets.

Cost-covering grants are sometimes used to finance imposed programmes. Since sub-national governments may influence the service

level, this might easily lead to overspending. Such grants should only be used if cost and volume levels are fixed (norm budget financing) or bound by a ceiling. In such cases, cost-covering grants would resemble block grants. However, block grants are often conditioned on the circumstances that cause the need for services, rather than on the normative service level itself. Furthermore block grants are non-earmarked and thus contain better efficiency incentives. Therefore it remains important to search for opportunities to replace cost-covering grants by block grants.

Box 7. The European Performance Reserve of the structural funds

The European Union has one of the most innovative performance funds. The EU Performance Reserve sets aside 4% of resources (EUR 8.25 billion) to reward projects that achieved pre-defined goals. To gain access to these additional reward funds, receiving governments are required to monitor and evaluate projects and achieve their pre-defined goals.

The EU Performance Reserve Fund has made important contributions to capacity building and has led to the adoption of good management practices. For example, as a result of the Fund certain regions incorporated monitoring and evaluation methods into their projects for the first time. However, a number of problems have also been associated with the Fund. For instance, since targets are set by the grant-receiving government, it has an incentive to set easily achievable targets, and in fact a very large percentage of projects were awarded additional funds. The EU is proposing new targets that are well-defined and based on increases in GDP and employment, but member states have complained that such objectives are too restrictive. Moreover, it is difficult to control for factors other than the project that might be having an impact on employment or GDP. Nevertheless, the EU example shows that reward incentives do work.

In practice, volatility of non-earmarked grants is a major concern for sub-national authorities. Since, in most OECD countries, non-earmarked grants constitute a considerable share of sub-national revenue, predictability of these grants is essential for planning purposes. For a separate jurisdiction, predictability depends on two elements: first, the predictability of the total non-earmarked grant that is available for all jurisdictions; and second, the predictability of the distribution of the grant over the separate jurisdictions.

The total annual amount of a non-earmarked grant can be based on certain rules (formulas) or on a discretionary decision. The discretionary method is not *per se* less predictable: it can, for example, take the form of a long-term agreement with sub-national governments. One problem is that

agreements may be terminable or conditional upon external circumstances. This might imply that renegotiation has to take place as soon as the budgetary perspectives worsen or ameliorate, which introduces unpredictable patterns.

Box 8. Multi-year agreements in the United Kingdom, France and Italy

In the United Kingdom, public service agreements (PSAs) have been used to improve public service delivery across government. PSAs are essentially targets for a period of four years, negotiated between spending departments and the Treasury. In the same vein, local service agreements are meant to improve the quality of decentralised public services. The agreements are based on measurable outcomes and multi-year budgets, which facilitate planning.

France negotiates contracts for certain services with regional and municipal governments called state-region planning contracts (CPER). They were created in 1982 and last seven years. The current contracts cover the period 2000-06. However, there are no legal consequences if the contract is not fulfilled. Because of budgetary problems, the central government has recently reneged on some of the promised funds. This harms the credibility of the procedure.

In Italy, territorial pacts aim to stimulate territorial development through a bottom-up approach. The central government negotiates programme contracts with regional partners. These contracts include grants for infrastructure investments and incentives for companies to undertake integrated projects in the fields of industry, agro-industry, services and tourism.

Rules-based systems, although more objective, can turn out to be quite volatile and unpredictable over a longer period of time. In many countries the total amount of the grant is linked to (a part of) the national revenues or the national budget. For example, the rule may be that a certain percentage of revenues from the value-added tax be designated for sub-national governments, as is the case in Germany. When the total amount of the non-earmarked grant is linked to a part of the tax base, the central government has an incentive to expand other parts of the tax base in order to be able to keep more of the revenues at the central level. Linking the level of the non-earmarked grant to total central government revenues (or expenditures) will generate less undesirable incentives. However, the precise definition of the concept of total revenues or total expenditures could become the subject of debate. The sub-national governments will prefer a definition that favours them; the central government may prefer another definition. In 2003, for example, the central government in the Netherlands changed the definition

of the total expenditures concept to which the non-earmarked grant was linked (excluding interest payments), in the expectation that this would reduce the non-earmarked general purpose grant.

Box 9. Predictability of municipal income: The tax-dependent general purpose grant in Turkey

An important part of the revenues of municipalities in Turkey consists of a general purpose grant linked to central government tax revenues: municipalities get 6% of the total tax revenues. On average, this makes up 50% of the municipal revenues, but for some municipalities this percentage can be as high as 70%. Municipalities are free to spend the grant as they see fit. The grant is distributed to municipalities on the basis of the size of their populations and paid on a monthly basis via the Bank of Provinces.

This grant provides most municipalities with a simple and predictable source of revenue, even though the central tax revenues are subject to cyclical effects and are not always predictable. For some municipalities, however, the revenue shares are less predictable due to the system of debt reduction. The Bank of Provinces can deduct a municipality's outstanding debt to the central government from its grant parcel. Municipalities can incur these debts because they do not always pay the compulsory contribution to the central government for pensions, income tax, etc. In addition, some municipalities borrow from the Bank of Provinces, but do not always pay back in time. This deduction may be so substantial that nothing much is left from the municipal grant parcel. In some cases, large municipalities lost nearly half of their grant parcel due to this deduction. The deduction is an arbitrary decision by central government, which makes the general purpose grant an unpredictable revenue source for certain municipalities. The system could be improved if the central government would agree to negotiate with the indebted municipalities on payment plans.

Source: Sagbas and Bagdigen, 2003.

All formulas can result in volatile outcomes. The development of a non-earmarked grant is usually not very stable. Annual fluctuations of the total general purpose grant can be as high as 35% (as was the case in Greece in 1998). Grant increases can usually be accommodated by sub-national governments (although they may result in inefficient spending, especially if grants cannot be carried over to subsequent budget years as is the case in Mexico, for instance). Downward adjustments are more problematic, especially if they are large. The total non-earmarked grant in Canada, for example, decreased in 2004 by 13%. For separate jurisdictions, volatility

can work out to be even more extreme (because of simultaneous volatility of distribution): the province of British Columbia suffered a decrease in the non-earmarked grant of more than 50% in the same year.

Fluctuations of this kind can only be anticipated to a certain extent. In the Netherlands, there is an average difference of a few percentage points between forecasts and actual total grants. The difference between forecasts and actual total grants in Canada in 2003 was 14.3%, with differences for individual provinces as large as –76% (Saskatchewan) and –149% (British Columbia).

Central government behaviour can also compromise predictability for sub-national jurisdictions. This is the case, for instance, in Turkey where the debts incurred by sub-national governments can be deducted from the non-earmarked grants they receive.

The fluctuations in general purpose grants may have pro-cyclical effects. This may be undesirable from a macroeconomic perspective and might involve financial risks for sub-national governments: during recessions the non-earmarked grant might decline, whereas the need for social assistance would rise. Solutions that have been proposed in Canada to smooth the cyclical effects in tax-linked general purpose grants include using moving averages and reducing time lags in the feedback of actualisation data into the projections.

Conclusions on the efficiency of financing grants

If the central government wants to control sub-national taxation, it can limit the sub-national tax base and provide grants to finance imposed programmes or minimum standards and basic sub-national services. Non-earmarked general purpose and block grants are the most efficient instruments to finance sub-national services. However, earmarked discretionary grants are a good instrument for the co-funding of temporary projects or programmes if the commitment of sub-national authorities to performance targets is sought. In the case of newly imposed programmes or minimum standards, earmarked non-matching grants cannot be entirely avoided (in the initial stage).

3.3. Subsidisation

Subsidising grants aim to compensate for spillover effects. From an economic point of view, spillover effects are external effects or discrepancies between the tax prices paid by citizen-consumers and the benefits from the services financed by those taxes.¹¹

Traditional grant theory recommends earmarked, matching grants to internalise positive spillover effects.¹² A matching grant alters the relative price of a service at sub-national level. If the tax price is lowered and if demand is downward sloping so that the lower tax price stimulates spending, provision of that service will increase. Because of the price effect, it is generally cheaper for the central government to stimulate a unit of spending on a sub-national service through a matching grant than through a non-matching grant. While both matching and non-matching grants stimulate spending by effectively increasing a community's income (or ability to spend), the matching grant provides an extra stimulus through the lower tax price while a non-matching grant does not (the matching grant has an income effect and a price effect, a non-matching grant only has an income effect).

Box 10. Matching grants in the United States

Matching grants only provide a positive incentive for service provision, if the grants are paid on condition that the services are actually provided. This was not the case when the US federal government paid matching grants to the states for Medicaid services in the 1980s. In 1986, West Virginia did not have state funds to pay hospitals for Medicaid services and thus could not draw federal Medicaid matching dollars. Hospitals helped by “donating” money to the state. The state then immediately paid back the hospitals with the acquired matching funds. Thus, West Virginia was able to receive the federal match, without in fact having to spend any state dollars (Coughlin and Zuckerman, 2002). The same principle underlies the provider tax programmes, in which states collect tax revenues from providers, often hospitals, to use these funds as the state share for making Medicaid payments. In both cases the amount actually spent on medical services was lower than the grant plus the state share. Congress restricted the use of these schemes in 1991, but afterwards many states turned to intergovernmental transfer programmes (IGTs) which, since then, have led to similar problems.

A number of researchers have attempted to estimate the impact of matching and non-matching grants on decentralised spending. When the sub-national government has the power to raise its own taxes to increase spending, one would expect that a non-matching grant would be equivalent to the increase of income of the citizens of the sub-national government. However, widely duplicated empirical research commonly finds that one currency unit of non-matching grant money stimulated much more public spending than one currency unit of average private income.¹³ This has been dubbed the “fly-paper” effect because grant money tends to stick to the local

politician's hands rather than returning to the local taxpayer.¹⁴ The existence of the fly-paper effect does not contradict the central conclusion of traditional grant theory that earmarked matching grants are more effective in stimulating spending than earmarked non-matching grants.

Spillovers vary with respect to their reach. Some may affect the nation as a whole and others mainly affect neighbouring communities. National spillovers may occur, for example, in research and development, health, infrastructure and tourist attractions of national importance. Regional spillovers may apply to cultural services that attract a regional audience or educational establishments that recruit students from the region.

Earmarked matching grants can be efficient instruments to internalise national spillovers, but not to internalise regional spillovers, as they force the national taxpayer to pay for services that only benefit sub-national taxpayers. Regional spillovers often occur because the appropriate size of sub-national jurisdictions is different for different services, making it hard to create optimal jurisdictions. One way to solve the regional spillover problem is to increase the size of sub-national jurisdictions so that they can provide a larger bundle of services. Another way to internalise regional spillover effects is to charge non-residents for the use of services. This requires excludability.¹⁵ A third way is to facilitate or impose interjurisdictional fiscal contracts. Voluntary contracts are preferable, but in general such agreements have to be supported by regulatory instruments at the national level, because jurisdictions that benefit from positive spillover effects may lack incentives to contribute (free riders). If contracts can be imposed, voluntary contracts will arise more easily than otherwise.

Grants can be designed to encourage co-operation between sub-national units of government, as demonstrated by the LEADER programme of the EU and the French support for intermunicipal co-operation.

Matching grants are not necessarily open-ended. The central government may fix the norm cost of the service it wants to subsidise, in which case the price component of the grant is not open-ended. The central government may also fix the quantity of the service it wants to subsidise, in which case the volume component of the grant is not open-ended. In the latter case, the central government may either maintain the per unit character of the grant, in which case the grant is a variable sum with a fixed ceiling, or it may give the grant as a lump sum, in which case the grant is independent of the number of units that are actually provided, but still dependent on sub-national matching of resources.

Box 11. The EU LEADER Programme and French support for co-operation

The LEADER (*Liaison Entre Activités du Développement de l'Economie Rurale*) Programme of the European Union aims to bring an integrative approach to rural development. It attempts to use subsidies to encourage public-private and intergovernmental co-operation and private initiative in a particular geographic area encompassing many municipalities through innovative multi-sectoral projects. It has gone through three stages: LEADER I which started in 1991, LEADER II which was carried out from 1994-99, and the current LEADER +, from 2000-06.

Intermunicipal co-operation has been and remains an important element of most national programmes. This is especially true in France where there are more than 36 000 municipalities and where mergers are resisted by local politicians and citizens and are not promoted by the central government. In order to increase the scale of local service provision, the French authorities have favoured the use of incentives to encourage co-operation. These incentives were systematised in 1999 with central support for "*structures à fiscalité propre*" (intermunicipal structures with their own tax), even if other types of intermunicipal structures remain. The principle is the following: the intermunicipal bodies continue to be voluntary structures; the parent communes have 10 years to progressively converge towards the same business tax rate (the most important local tax) and the "losers" in this converging process receive compensatory payments; the tax rate is decided by the intermunicipal body which will also directly receive the tax revenue. In order to stimulate local authorities to participate in these structures, the French government pays a supplementary grant to the EPCI (*établissements publics de coopération intercommunale*) in addition to the general purpose grant to all sub-national levels, the DGF (*dotation globale de fonctionnement*). This supplement is called the "*dotation d'intercommunalité*" (intermunicipal grant), and its size depends upon the type of EPCI. Six years after the launch of this new programme, 84% of the French population lives in an area covered by an EPCI with its own tax revenue (88% of French municipalities are located in these areas).

A specific type of externality that could be internalised by a matching grant is the "information externality" that has figured in valuable experiments conducted by a number of sub-national governments (Oates, 1999). Various types of institutional innovation that can be applied nationwide originate in individual sub-national jurisdictions (in environmental policy, social security policy, etc.). The knowledge provided by such experiments travels relatively fast and is not costly for other jurisdictions. As is usual in innovation theory, the innovator pays for the

others, but in this case it is impossible to protect the institutional innovation and, above all, if it creates greater efficiency in public spending, it will not be in the collective interest to do so. Central government has to support institutional innovation in order to internalise the positive effects for “free rider” regions. For that purpose, the central government can use matching grants in which the costs and the risks of new programmes put in place locally are shared. A matching grant is a better support for experimentation, since it allows a better sharing of information with central powers than a non-matching or non-earmarked grant.

Conclusions on the efficiency of subsidising grants

Earmarked matching grants can be an efficient instrument if the central government wants to stimulate the provision of a sub-national service because of national spillover effects. If regional or local spillovers occur, central government intervention is often required as well, and should, in general, take the form of stimulation or imposition of local or regional co-operation. Matching grants can also be used for temporary projects or programmes in case of stimulation of institutional innovation.

3.4. Equalisation of tax and service capacity

Equalisation grants aim to enable sub-national governments to provide an average package of services at roughly the same tax effort. Equalisation of tax capacity is directed at compensating jurisdictions with a relatively small tax base; equalisation of service capacity is directed at compensating jurisdictions that are facing relatively high costs for basic services.

Equalisation can, in principle, proceed entirely via horizontal grants. The central government then imposes the obligation on jurisdictions with a large tax base or low service costs to transfer a part of their revenues to jurisdictions with a low tax base or high service costs. This is the case, for example, in Germany. In practice, however, equalisation often proceeds through vertical grants from central government. This is particularly likely if sub-national governments are, to a large extent, dependent on vertical grants for financing purposes anyway. Tax capacity equalisation then takes the form of differentiation of the non-earmarked general purpose grants that are available for financing purposes (subtracting the payments to be made by rich jurisdictions and adding these payments to the grants for poor jurisdictions). Combinations of both methods occur as well, for instance in Switzerland where tax capacity equalisation between the cantons proceeds partly by horizontal grants and partly by vertical ones.¹⁶

Equalisation can, in principle, take place via earmarked as well as non-earmarked grants. The equalisation component in a non-earmarked general purpose grant covers an average package of services, namely a package of average costs (mainly the basic sub-national services and imposed programmes or minimum standards). The equalisation component in an earmarked grant will apply exclusively to the earmarked services. The equalisation component in earmarked grants can be as efficient as the equalisation component in non-earmarked grants, but this observation should not detract from the earlier conclusion about the efficiency advantages of general purpose grants for financing purposes (see section 3.2).

It has been observed that, from an economic point of view, both tax capacity equalisation and service capacity equalisation are forms of redistribution. Equalisation is also often primarily motivated by redistributive considerations (solidarity). However, in the fiscal federalism literature much emphasis is placed upon the fact that tax capacity equalisation can also be justified by increased allocative efficiency. In particular, it has been noted that decentralisation often disturbs horizontal equity (equal tax prices for equal services). General purpose grants can serve to restore horizontal equity between jurisdictions. This rationale for grants was adopted early on in the fiscal federalism literature (Buchanan, 1950; Musgrave, 1961).

In general, decentralisation will lead to the unequal treatment of citizens in equal positions, even if both the central government and the sub-national government treat citizens in equal positions equally. This is the case for three reasons. First, in so far as sub-national services have public good characteristics (decreasing marginal costs with respect to the number of consumers¹⁷), tax prices of services will be lower to the extent that the tax base of a sub-national jurisdiction is larger. In other words, citizens pay less for their services if their fellow citizens are more numerous and richer. Second, in so far as sub-national services are not pure public goods, the production of these goods may be subject to economies of scale, implying that citizens pay less for their services if their jurisdiction is more populous. Third, in so far as sub-national taxes are not levied strictly in accordance with the benefit principle, but contain an element of redistribution on the basis of ability to pay, and expenditures are neutral in respect to distribution, individuals with equal ability to pay and similar needs in different jurisdictions will experience an unequal fiscal residuum (the net benefit of taxes paid and services received). This is the case because in a poor jurisdiction redistribution is more costly to the rich and less beneficial to the poor than in a rich jurisdiction. For instance, assuming that sub-national taxes are roughly proportional to income and benefits are equal per citizen, a

poor person living in a rich jurisdiction will experience a larger fiscal residuum than a poor person in a poor jurisdiction and a rich person living in a poor jurisdiction will experience a higher negative fiscal residuum than a rich person living in a rich jurisdiction.¹⁸

Box 12. Incentives of the Canada equalisation scheme

Canada has an extensive equalisation scheme. It takes into account all 33 tax bases in all 10 Canadian provinces. A province gets an equalisation transfer when its tax base per capita is lower than the standard (average) tax base per capita. Seven provinces are net gainers, three provinces are net payers. This standard tax base is calculated as the weighted average of five predetermined provinces. The turnover in the system is CAD 8 billion per year.

For many taxes the exact tax base cannot be established. Instead, the actual tax revenues are used as a proxy. This creates a disincentive for provinces to collect tax revenue. There is another way in which the fiscal behaviour of a sub-national government can affect its equalisation grant: for a large province (one of the five provinces in the calculation) an increase in its tax rate will increase the standard tax rate used to calculate the grant for that base and thereby reduce the province's grant if it has a high relative fiscal capacity with respect to that base. This will affect the province's choice of tax rates.

The deviations from horizontal equity introduce inefficiencies in the economic system.¹⁹ All other things being equal, an individual will have an incentive to locate in a jurisdiction with a relatively large tax base, where he or she can consume services at relatively low tax prices and where redistribution is large if he or she is poor and where redistribution is small if he or she is rich.²⁰ This incentive does not reflect differences in real costs or other considerations relevant to efficient resource utilisation.²¹ The practical relevance of inefficient migration may differ between countries. In the Nordic countries the services provided by sub-national jurisdictions are important (education, health) but hardly exhibit public good characteristics. Economies of scale for these services may not exist (and have not been proven).²² In spite of substantial differences in tax and service levels between jurisdictions, migration in these countries is not a problem.

Horizontal equity can be restored through horizontal or vertical non-earmarked general purpose grants.²³ Such grants compensate for differences in the tax base between jurisdictions and will remove the largest interjurisdictional inequities and thereby largely prevent inefficient patterns of migration.

Tax capacity equalisation requires the calculation of a tax capacity measure. For that purpose the tax base of each of the jurisdictions has to be estimated. If sub-national jurisdictions can, for instance, levy taxes on income and real estate property, the total income and the total value of real estate in the jurisdiction has to be estimated. This requires the availability of accurate statistical data. Subsequently, the average weighted jurisdictional tax rate for each tax can be determined as the sum of all jurisdictional tax revenues divided by the sum of all jurisdictional tax bases. The tax capacity measure can now be defined as the jurisdictional tax base times the average tax rate. This is the revenue that the jurisdiction would collect if it depleted its tax base at the average rate. Note that this measure is independent from the actual tax rate in the jurisdiction, which means that it is a pure capacity measure. By equalising tax capacity in this sense the grant fully respects the autonomy of sub-national governments in the level of taxation and benefits. Also, all incentives to increase or decrease the jurisdictional tax rate in order to receive a higher grant will be removed.²⁴

It has been noted that full equalisation removes the incentive to increase the jurisdictional tax base by attracting new economic activity. In order to maintain this incentive, central government could opt for less than complete equalisation, so that the gap between the jurisdictional and average tax base is only partially compensated. The grant system could, for instance, be designed in such a way that the tax capacity of the poorest jurisdiction after equalisation is within a range of 10% or 20% of the average tax capacity. Another possibility is that equalisation aims to reduce the difference between a minimal guaranteed tax capacity and actual tax capacity. For instance, the Swedish equalisation grant (for municipalities) aims at equalising 95% of the difference between a guaranteed tax capacity (set at 115% of the average) and the actual tax capacity of low capacity municipalities (this percentage will be lowered in 2006). The Dutch general grant equalises 80% of this difference. No country studied in this paper used full equalisation or 100% compensation of the difference with a set minimum tax capacity. To maintain the incentive for tax base expansion, partial equalisation must not lead to a change in the rank order of tax capacities.

The “base taxback rate” is the share of additional revenue from tax base expansion that a sub-national government loses through the reduction of the equalisation grant (Courchene and Beavis, 1973). High taxback rates may discourage sub-national governments from investing in the development of economic activity associated with particular tax bases.²⁵ In order to encourage the Canadian provinces to develop their natural resources, for example, some researchers have argued that natural resources should be removed from the equalisation formula (Boessenkool, 1998). This could,

however, lead to an ineffective allocation of resources if some regions have large rents from natural resources.

Intergovernmental grants are also an efficient instrument to compensate for differences in service capacity that result from cost differences (also called equalisation of spending needs). Cost differences may have to do with natural circumstances (mountainous areas, areas prone to flooding, islands) or with socio-demographical circumstances (demography, population density, urbanisation), depending on the expenditure responsibilities assigned to sub-national governments.

Box 13. Service capacity equalisation in Japan

Sub-national authorities should not be able to influence the criteria for service cost equalisation. This requirement is not entirely met in Japan, where at least part of the borrowing by sub-national governments (and consequently the worsening of Japanese public finances) can be ascribed to the fact that road construction volumes and interest payments are important distribution criteria for the non-earmarked grant (the LAT, local allocation tax). Each of these criteria creates an incentive for Japanese prefectures to borrow and overspend on roads. Other OECD member countries where road construction volumes constitute an important distribution criterion for the equalisation grant are Portugal, the Slovak Republic and Denmark. In the latter country, the number of local road kilometres was a criterion for the need for road spending during the 1980s. Local authorities then began to turn small, private dirt roads into public roads. This led to much more equalisation compensation than the costs of maintaining the dirt roads (which only involved a truck and some gravel every second or third year). The criterion was later abandoned. The reason for the wrong incentives is that the grants do not equalise service capacity (the need for roads or borrowing) but the actual level of road construction or borrowing.

From an economic point of view, service capacity equalisation cannot be justified by the efficiency argument of horizontal equity. Indeed, migration from high-cost to low-cost areas could be beneficial from an efficiency point of view. However, many governments give priority to the redistributive argument of vertical equity, implying that similar sub-national services must be available in every jurisdiction at roughly the same tax price. This is a solidarity argument which must be applied with some care, because it can harm allocative efficiency and economic growth if applied on a large scale.

Service capacity equalisation requires the calculation of service cost indicators; these indicators can refer to actual costs or assumed norm costs. The indicators measure the difference between the average or norm costs and jurisdictional costs of a bundle of services to which the measure applies. Equalisation can also take the form of an assessment by the central government of the spending needs of a sub-national jurisdiction, as is the case in the United Kingdom. Service capacity equalisation does not necessarily apply to all jurisdictions, but may be limited to those that have extremely high costs for certain services.

Conclusions on the efficiency of equalising grants

Equalising grants aim to enable sub-national governments to provide an average package of services at roughly the same tax effort. Equalisation can be directed at compensation of low tax capacity or high service costs. Equalisation can be achieved in an efficient way via horizontal grants between sub-national jurisdictions and additions or subtractions from general purpose grants that are given for financing purposes. Full compensation of differences in tax or service capacity may compromise the incentive to expand the tax base and should be avoided. High taxback rates should also be avoided.

3.5. Collective decision making

The approach to grant design followed thus far is basically the traditional approach in the fiscal federalism literature. It treats the central government as a unitary, completely informed actor that aims to maximise social welfare for the national community as a whole. This approach offers useful insights, but is limited in scope because it ignores several dimensions of management and governance of grants that are important in OECD countries. Over the last decade, a number of new approaches have focused on new and different aspects of intergovernmental grant management and governance, and constitute what Oates (2004) has called a “second generation” set of models. The new models draw on public choice theory, principal agent theory and the economics of information. Since the results of these approaches are mostly positive and empirical, they cannot easily be translated into normative conclusions that are useful for practitioners involved in grant design. Nevertheless, there are some new insights which are applicable to policy making.

The traditional approach assumed that central government was a unitary actor that maximised the social welfare of the nation. That is, it did not address the political environment at the central level. Politicians at the

central level have loyalties at the sub-national level and they will attempt to direct grants in the direction of their regional or local constituencies and to influence decisions on distribution formulas of general purpose grants. Discretionary grants are often the subject of negotiation between central and sub-national authorities in which central authorities may be more or less inclined to favour the particular regions or localities to which the grants apply. Furthermore, central government is not completely informed about the policy options of sub-national governments. Indeed, the whole idea of the decentralisation of execution of centrally imposed programmes is based on the assumption that sub-national policy makers have better insight in the adoption of policies to local or regional circumstances. But if central governments are not informed about these circumstances and the policy options available, sub-national authorities may choose non-optimal courses of action from the central point of view.

The main critical points in grant design that are subject to lobbying and log-rolling practices, which may compromise the efficiency of grant design, are the following:

- The choice between non-earmarked grants and earmarked grants;
- The determination of the distribution formulas of non-earmarked general purpose grants covering basic service packages (including the demarcation of basic service and fringe benefits, the latter to be covered by sub-national revenues);²⁶
- The determination of the tax capacity of sub-national jurisdictions and the extent to which differences in tax capacity should be equalised;
- The determination of the service capacity of sub-national jurisdictions and the extent to which differences in service capacity should be equalised; and
- The choice between mandatory grants and discretionary grants.

There is a large amount of academic literature about collective decision making in these areas.

It is important that proposals for the revision of grant systems that concern the general principles – including the choice between earmarked and non-earmarked grants, distribution formulas, the determination of tax capacity and service capacity, and the choice between mandatory and discretionary grants – be decided without the undue influence of sub-national lobbying groups. Decision making about the general principles should be reserved to national authorities on the basis of neutral expertise. The views of sub-national authorities are important, but should be developed

in a setting that encourages objective debate – for instance, in a consultative council that is informed by neutral expertise. Also, the advice of sub-national representatives should focus on the technical aspects of the grant systems, such as the estimation of relevant variables and the quality of statistical data, rather than on principles.

Box 14. Grant committees in the Australian states and in Canada

Every state in Australia has its own local government grants commission. These bodies are independent, and their task consists of calculating the non-earmarked grants for their local jurisdictions. They have to take certain conditions for granted, such as the level of overall funding provided by the central government, the need for horizontal equalisation, and the requirement to provide each sub-national government with at least a minimum grant. But apart from that, each commission can decide how it will assess needs and thus how it will distribute the non-earmarked grant to the sub-national governments in the jurisdictions concerned (Travers and Esposito, 2004). Since evidence for the political-tactical distribution of grants has been found in countries as diverse as Albania (Case, 2001), Austria (Worthington and Dollery, 1998), Sweden, and the United States (Grossman, 1994), but not in Australia (Bungey, Grossman and Kenyon, 1991), it might be assumed that the independent body in Australia actually manages to achieve an impartial distribution.

A somewhat different case is provided by Canada, in which the evaluation of the allocation system is left to an independent technical commission. These kinds of solutions could avoid situations of stalemate, as was the case in Italy, where no political compromise could be reached on revision of the allocation criteria of the non-earmarked grant, resulting in a situation where the criteria has not changed since 1976 (Emiliani *et al.*, 1997).

As far as financing of imposed programmes is concerned, sub-national resistance to block grants or general purpose grants may be mitigated by allowing for a certain degree of matching, at least in an initial stage. In the principal agent model, such modalities of risk sharing are known as “low-powered” incentive schemes. They can be justified if sub-national jurisdictions are risk adverse and do not want to take the responsibility for the risks connected to the execution of centrally imposed programmes. Under these circumstances, block grants could be considered a “first best” solution because they transfer the execution risk entirely to the sub-national jurisdiction (“high-powered incentive schemes”). If the consequence of block grants is that sub-national governments refuse to take on the task,

matching may be an acceptable solution if the price elasticity of the service is low (so that the risk of overspending is low).

Discretionary grants are especially prone to undue sub-national influence. Although they are necessary in the case of unique or temporary projects, such as the construction of infrastructure or the improvement of the regional or local economic structure, it is important that the central level choose the procedures of project selection and design and the role of negotiations and contracts with sub-national authorities. In general, discretionary grants should not be used if law-based grants are a viable alternative.

Conclusions from insights into collective decision making on grant design

Decision making about the general principles of grant reform should be reserved for central authorities on the basis of neutral expertise. The views of sub-national authorities are important, but should be developed in a setting that encourages objective debate, for instance in a consultative council that is informed by neutral expertise. As far as financing of imposed programmes is concerned, sub-national resistance to block grants or general purpose grants may be mitigated by allowing for a certain degree of matching, at least in an initial stage.

4. Conclusion

4.1. Principles of grant design

In many OECD countries, grants systems are beset by numerous inefficiencies. The most common are:

- Earmarked matching grants that are (partly) used for equalising purposes and thus encourage sub-national jurisdictions to provide higher than optimal service levels.
- Earmarked matching grants that are (partly) used for financing purposes and thus encourage sub-national jurisdictions to provide higher than optimal service levels.
- Earmarked non-matching grants (including cost-covering grants) that are used for financing purposes; these grants lack incentives for technical and allocative efficiency and could, in many cases, be replaced by general purpose or block grants.

Modernisation of grants systems should start with a reflection on the objectives of the central government and a separation of the grant instruments so that independent steering of the various instruments becomes possible. In general, the only feasible combination is between non-earmarked general purpose grants aimed at financing and at equalisation. The equalising elements then take the form of additions and subtractions from the financing grants, so that horizontal grants (grants given by rich or cheap jurisdictions to poor or expensive jurisdictions) become wholly or partly unnecessary.

Table 5 summarises the efficient use of the various types of grants. The headings of the last five columns indicate the concrete aims that can be distinguished under the general purposes of subsidisation, equalisation and financing. These concrete aims can be distinguished according to whether (a) the central government takes the initiative to impose or influence sub-national service provision, or (b) the sub-national government itself takes the initiative to provide the service. The second column is the instrument column and indicates the various types of grant instruments that are available. Because the table aims to provide a general overview of efficient instrument use, the instrument column also contains some regulatory instruments (imposition of co-operation and extension of the sub-national tax base) that are efficient for reaching aims for which grants are often used in practice (in a non-efficient way). A mark in one of the columns of the table indicates that the grant instrument can be used in an efficient way to attain the concrete aim.

Discretionary grants are mentioned as a possible instrument for co-funding purposes. Co-funding arrangements are used in some countries to finance projects with objectives that are hard to achieve using matching grants and where both central and sub-national governments have to be committed (see section 3.2).

Earmarked non-matching grants (including cost-covering grants) are mentioned in Table 5 as a possible instrument for financing purposes because they cannot be entirely avoided (see section 3.2). However, in many countries there are still numerous opportunities for replacing them with more efficient general purpose or block grants. Table 5 also mentions matching grants that are given as risk-sharing arrangements (see section 3.5).

Table 5 should not be seen as a prescriptive blueprint. Countries have different traditions of decentralisation, which are sometimes rooted in culture or history. Theoretical distinctions are not always easily applied to grants in practice. Furthermore, reform of grant systems is a gradual process in which separate (groups of) grants are revised sequentially and for

different reasons. For instance, an earmarked grant may be reformed to improve the distribution formula or to remove wrong incentives. This is different from trying to integrate it into the general purpose grant, which is a more fundamental reform. Integration of earmarked grants into a general purpose grant is a reform that can be more easily achieved if more grants are integrated at the same time. Redistributive effects then tend to even out. Partial reforms can constitute improvements even if the guidelines implied by the table are not (yet) entirely followed.

Table 5. Efficient use of grant instruments

Purpose	Efficient type of grant or regulatory instrument	Central government initiative			Sub-national government initiative	
		Imposed programmes or standards	Compensation of spillovers	Temporary projects and programmes	Basic services	Fringe services
Financing	Extension of sub-national tax base	X			X	X
	Non-earmarked general purpose grants	X			X	
	Non-earmarked block grants	X				
	Earmarked discretionary grants			X (co-funding)		
	Earmarked matching and non-matching grants	(X)		X (risk sharing)		
Subsidisation	Earmarked matching grants		X (national spillovers)	X (experiments)		
	Imposition of co-operation		X (regional spillovers)			
Equalisation	Imposition of horizontal grants	X			X	
	Non-earmarked general purpose grants	X			X	

4.2. Implementation issues

General purpose grants that are dependent on criteria such as total tax revenue or total expenditures of central government tend to be volatile. They are influenced by central government fiscal policy and are subject to macroeconomic cyclical effects. In order to enable sub-national jurisdictions to plan their activities on a multi-annual basis, it is important that a mechanism be put in place that constrains volatility. In general, such a mechanism would link the size of the general purpose grants to trend estimates (for tax revenue or expenditures), rather than to real estimates or realisations.

In designing grants, governments need to take into account the implementation steps that will follow after the choice of instrument has been made. As has been illustrated by various case studies in the paper, interaction among different levels of government opens the door to strategic behaviour, which in turn can produce complex situations.

Grant reform has to take place in a context of institutional, historical and cultural circumstances that are unique to each country. Financing, subsidising and equalising grants have to take into account the nature of fiscal decentralisation, the degree of local financial autonomy, the competences of the various levels of administration, the willingness of the political elite to proceed with reforms, the principles of regulation (more or less consensual), the degree of disparity between regions and the lock-in aspect of these disparities, the extent to which sub-national governments have succeeded in forming a coalition, and the specific challenges faced by the countries. Thus, even if this aspect has not been dealt with in this paper because the focus has been on grant design, the institutional, historical and cultural background is a key factor in designing the grants, implementing them, and evaluating their performance. These factors explain the absence of a “one-size-fits-all” grants system.

Notes

1. OECD Experts Meeting on Intergovernmental Grants, Siena, Italy, 18-19 April 2005, under the auspices of the Fondazione Monte Dei Paschi Di Siena, the Province of Siena, the OECD Working Party of Senior Budget Officials, and the Territorial Development Policy Committee of the OECD.

2. This paper will not present institutional specificities of decentralisation in each country. Even if this aspect is important for understanding the choices made in each country, this theme is beyond the scope of this paper, which is devoted to the design of grants and their implementation.
3. Total sub-national expenditure amounts to total consolidated expenditure by sub-national governments (with transfers between levels of government netted out).
4. A federal country is a country in which the constitution guarantees the competences of the highest level of sub-national government and provides sub-national authorities with an appeal to the courts in case of infringement upon those competences.
5. Throughout this paper the term “services” is used for the outputs of government, regardless of whether these concern immaterial goods (services in a narrow sense) or material goods.
6. Note that a non-matching grant can either be independent of service costs or revenues collected or dependent on service costs, but 100% cost-covering.
7. It should be noted that Figures 4 and 5 cannot be added to get total transfers from central to sub-national governments, because that would require a consolidation of transfers between state and local level, which are not available.
8. A tax share flowing from a tax-sharing arrangement is not a grant. A grant is fully determined by the central government whereas tax sharing implies some degree of autonomy or co-decision on the part of sub-national government with respect to the tax base or the tax rate.
9. Curbing the sub-national tax base can be an indirect means of spending control, but for this purpose there are alternatives such as fiscal rules for sub-national governments and stability pacts. This topic has been explored by the OECD Network on Fiscal Relations across Levels of Government.
10. Pure private goods may exhibit economies of scale but even then total costs increase with the number of consumers. Pure public goods (defined in the Samuelsonian sense of non-rivalry in consumption) exhibit constant total cost (proportionally decreasing average costs and zero marginal costs for the additional consumer). For impure public goods that exhibit costs of congestion (local public goods), total costs (defined as production costs plus congestion costs) may start to rise after a certain point.
11. Spillover effects of services should be distinguished from “fiscal externalities” flowing from tax incidence. In the latter case, outsider non-

beneficiaries pay for the services of inside beneficiaries (tax exporting). Tax exporting lowers the price of sub-national services and leads to overprovision at the local level, for instance the taxing of tourists for the use of local assets (McLure, 1967). Grants are, in general, not a suitable instrument to remove this externality.

12. Given that externalities result in non-optimal tax prices faced by decentralised governments, a natural solution is to follow the Pigouvian prescription for solving externalities and change the tax prices faced by decentralised governments so that tax prices reflect resource costs including any external costs or benefits.
13. Perhaps the most widely cited early study is that of Gramlich and Galper (1973), though many studies followed. A typical study finds that an additional currency unit of average private income stimulates 0.10 currency unit of additional spending, while an additional currency unit of non-matching grant generates about 0.40 currency unit of additional public spending.
14. The fly-paper effect can only be explained by studying the collective decision-making process in the sub-national government. While the traditional median voter model of sub-national democracy would predict an equal reaction to an increase of average private income and a non-matching grant (Bradford and Oates, 1971), the fly-paper effect has been explained by a number of alternative models, for instance models in which sub-national bureaucrats get political credit for increasing service levels without increasing taxes and voters are unaware of the source of the funds.
15. A service is excludable if it is technically and economically possible to exact a price for accession to the service.
16. For a comparison between the vertical and horizontal grant methods see Lotz and Mochida (1999).
17. This includes both pure public goods that accommodate additional consumers at zero marginal cost and local public goods that are susceptible to congestion.
18. One could argue of course that sub-national government should not interfere with income distribution to begin with, but this is a rather theoretical argument in a time when, given the nature of sub-national services, taxation according to the benefit principle would lead to strongly digressive rate structures. For instance, in the Nordic countries most sub-national services are social services (mostly benefiting low income groups).

19. However, Scott (1950) has argued that these inefficiencies are the price to be paid for freedom of residential choice.
20. In more recent literature, the emphasis is placed on another possible effect, namely that sub-national governments (or more generally governments in open economies) that use taxes on mobile factors tend to underprovide public services because they fear an exodus of their tax base (tax competition). Consequently, the sub-national governments tend to tax the mobile factors less than is commensurate with the benefits these factors receive from the services provided (Zodrow and Mieskowski, 1986; Wilson, 1986).
21. Apart from the horizontal equity argument, there exists another efficiency argument in favour of equalising grants (Boadway and Flatters, 1982). In a Ricardian model in which the rents generated in a region (from factors such as agglomeration, a unique location or natural resources) accrue only to residents of that region, a mobile factor that moves into a jurisdiction will add to the tax payments but (eventually because of diminishing marginal product) subtract from per capita rents (the value of output after labour costs). Efficient migration patterns that maximise overall welfare should equate net benefit of a worker across jurisdictions. To correct for disparities in net benefits, jurisdictions that have large per capita rents should receive lower grants. The central government essentially taxes away any rent advantage and redistributes it so that all jurisdictions have equal rental income; a worker will then decide whether to migrate by comparing his/her marginal product in one jurisdiction versus another. To the extent that rents are capitalised into land values, average rent discrepancies will disappear. In practice, not many countries have tried to actually estimate average rent differences and to use such estimates in the design of their equalisation systems. However, according to Boadway and Flatters (1982), rents generated from natural resources have been a main historic catalyst for the evolution of the Canadian intergovernmental grant system. Note also that even if capitalisation does not occur, the argument by Scott (1950) implies that inefficient incentives may be the price to be paid for freedom of residential choice (and for economic growth through migration to the areas that have the jobs and natural resources).
22. Cost differences may also be capitalised in land values. Although this does not remove the inefficiency (unlike the capitalisation of natural endowments), it does remove the inefficient incentive for migration.
23. In principle, a more ideal method for restoring horizontal equity is through discriminating income taxes. By levying higher rates on residents of relatively wealthy jurisdictions, the central government could in effect compensate for the lower tax prices of sub-national services as well as the lower contributions of the rich to the sub-national services consumed by

the poor (Buchanan, 1950). This method equalises tax prices and redistributive contributions at the level of the individual taxpayer. However, as Musgrave has pointed out, this method is beset by many practical problems (Musgrave, 1961).

24. Musgrave has suggested that central governments may want to maintain an incentive to increase the sub-national tax rate, especially in poor jurisdictions (Musgrave, 1961). This may be achieved by measuring tax capacity by tax base times jurisdictional tax rate (rather than average tax rate). However, this suggestion does not entirely restore horizontal equity. Moreover, the suggestion is not neutral in respect to the budget (poor jurisdictions might receive more than rich jurisdictions pay or the opposite).
25. Denmark has a legal limit to the taxback rate of 90% (so that jurisdictions will always gain by developing their tax base).
26. For instance, politicians may use the distribution of grants as a means to ensure their re-election by providing swing states with relatively more grants. It has been shown that not only earmarked discretionary grants are used in this way (Dahlberg and Johansson, 1999), but also non-earmarked grants with a formula-based distribution mechanism (Johansson, 2003). Although the Swedish non-earmarked grant has formula-based distribution criteria – and thus seems to be quite objective – in practice it turns out that swing states get relatively more of the non-earmarked grant, corrected for all other factors.

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Design Choices for Fiscal Policy Rules

by

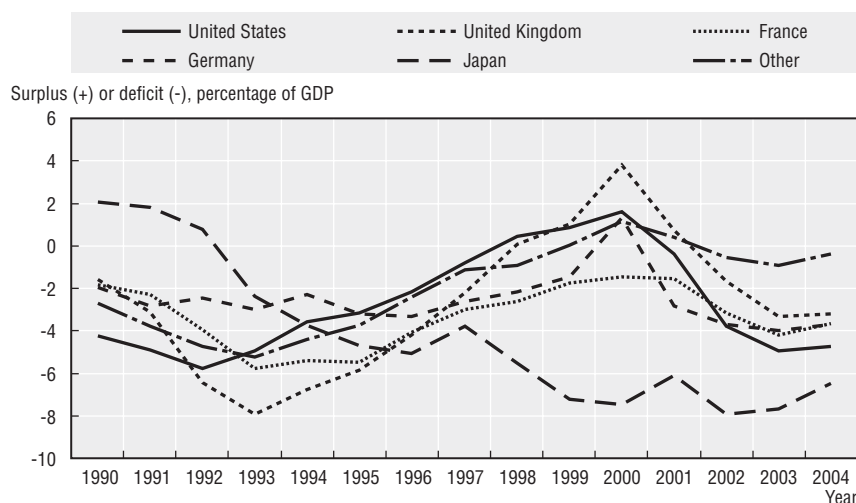
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This article discusses issues regarding budget process rules in the context of the current pattern of rising fiscal deficits. It begins by explaining the premise that budget process rules have multiple objectives, and so must be judged according to multiple criteria. Prominent among those criteria, given the apparent economic sluggishness of the early years of the 1990s and the resulting fiscal deficits, are how any particular set of rules might facilitate economic recovery and growth, but also maintain fiscal responsibility and public credibility. This discussion is pertinent to both the euro area countries and the United States, and the article explores aspects of the European Union Stability and Growth Pact and the United States Gramm-Rudman-Hollings system. The article then proceeds to analyse alternative fiscal control measures according to these and other criteria, such as the ability to maintain sound core operations of government to attain all of its long-standing policy objectives, including the funding of public investment. The article concludes by weighing the alternative rules against these criteria.

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Fiscal deficits have reclaimed their place as a pressing public policy issue around the world, as the brief respite of smaller deficits and even budget surpluses in the late 1990s has come to an abrupt end. The swing back toward large deficits is somewhat concentrated in the developed world's largest economies, with Germany, the United Kingdom and the United States all moving from surplus five years ago to deficits in excess of 3% of GDP. France's deficit has swelled from well under 2% of GDP to almost 4% in 2004; Japan's budget gained ground in the 1990s from its larger deficit, but has lost that ground again. The smaller OECD countries, taken as a group, have also seen a budget deterioration, but of smaller magnitude (see Figure 1).

Figure 1. General government deficit for OECD countries, 1990-2004



Source: OECD, *OECD Factbook 2006: Economic, Environmental and Social Statistics*, March 2006.

Large sovereign credit demands on the part of the world's major developed countries are potentially destabilising, both domestically and in the global financial markets. To the extent that those demands are met by transnational borrowing, they could eventually and suddenly cause substantial drops in debtor country currency values, which could in turn increase domestic interest rates and raise prices of imports, challenging macroeconomic stabilisation policy. Over the longer term, large fiscal

deficits can reduce domestically financed investment, and thus future incomes.

Large fiscal deficits on the part of the wealthiest countries are problematic also in that they draw capital out of the world's developing countries, where it is urgently needed to raise the lowest living standards.

These pressing issues have again drawn the attention of fiscal specialists to effective budget process rules – or the lack thereof. Different OECD countries face different procedural or political issues.

In the European Monetary Union (EMU), the Stability and Growth Pact (SGP) imposes medium-term budgetary objectives to achieve and maintain a status close to balance or in surplus, and a ceiling on fiscal deficits at 3% of GDP. In the early years of the SGP (and before that, the Maastricht Treaty), budget rules helped to bring the European countries toward or fully into compliance with the conditions for membership (Kopits, 2004, p. A9). However, recent developments tested the procedures for enforcement. Problems encountered in the implementation of the SGP, particularly the decisions of the ECOFIN Council in November 2005, have made it clear that the credibility of the framework to constrain deficits of member countries has been, in the words of the European Commission itself, “seriously dented” (European Commission, 2004, p. 107). Others, who are not quite so charitable in their description of the ECOFIN Council's decision, say that the legal framework of the SGP has been “effectively suspended” (Annett and Jaeger, 2004, p. 25). Whatever words are used, it is clear that the EMU's current fiscal rules need to be revised. Whether the 2005 revisions, which were intended “to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline” (European Commission, 2005, p. 68), will be successful or not remains to be seen.

Certain attributes of the SGP played a big role in the decision to discard the current mechanism, including:

- “[R]igid adherence to annual deficit targets can impart a procyclical bias to fiscal policy through contractionary measures to buttress revenues in a downswing and a temptation to spend windfall tax receipts in an upswing” (Dabán Sánchez et al., 2003, p. 1).
- In particular, the current mechanism permitted pro-cyclical loosening of fiscal policy during the good times.¹
- The measurement uncertainties involved with the estimation of potential output and budgetary elasticity have led to confusion, not the least of which concerns what constitutes a valid one-off

measure. “The basic problem is that changes in the primary CAB [cyclically adjusted balance] may correctly measure neither the impact nor the final effect of fiscal policy on aggregate demand” (European Commission, 2004, p. 81).

- The SGP does not deal with country-specific circumstances in a consistent manner.
- “[T]he enforcement procedures of the SGP have been found wanting at critical junctures. In particular, the early-warning mechanism was not effective” (European Commission, 2003, p. 52).
- The SGP process is complicated and confusing, and it has been difficult to communicate effectively with the media, markets, and the public on how the SGP works.

The European Commission recognises that the “number of countries that experienced excessive deficit positions in the past few years, and the difficulties in the co-ordination and surveillance processes, have highlighted the need for improvement[s]” (European Commission, 2004, p. 113) in the SGP process. Thus, they have reviewed and promoted a number of ways to rejuvenate the SGP, including:

- Allowing for country-specific circumstances by redefining the medium-term budgetary objectives of “close to balance or in surplus”;
- Placing more focus on debt and sustainability in the surveillance of budgetary positions;
- Ensuring earlier actions to correct inadequate developments to foster both prudent and symmetric-over-the-cycle behaviour, and surpluses in good times;
- Catering for protracted slowdowns and ensuring consistency with the medium-term budgetary objectives by, for example, redefining the clause on “exceptional circumstances” concerning the application of the deficit criteria; and
- Allowing for country-specific elements in the enforcement of the correction of excessive deficits.

The EC recognises that by placing even more emphasis on attempting to adjust the current deficit and debt targets of the SGP for the business cycle, it may be introducing additional problems. For example, making budgetary corrections conditional on economic growth may give rise to moral hazard in forecasting GDP, because countries may have an incentive to make over-

optimistic growth projections *ex ante* in order to blame lower than expected growth *ex post* for any slippage compared to plans. Likewise, the EC recognises that assessing budgetary adjustments by means of observed changes in the cyclically adjusted balance (CAB) has proven to be problematic, because changes in the budget can result from either fiscal policy actions, or higher- (or lower-) than-expected growth. In addition to these reforms of the current SGP process, the EC reviewed two alternatives to the SGP: a permanent balance rule (Buiter and Grafe, 2002) and a golden rule. But it found even more weaknesses with these alternatives than it did with rejuvenating the current SGP (European Commission, 2004, pp. 108 and 119).

Nevertheless, the proposed changes to the deficit/debt-based mechanisms of the SGP can, at best, only mitigate some of the problematic attributes of the current process; they do not fix them. The SGP process, even with the changes proposed by the EC, does not prevent countries from taking pro-cyclical actions during the good times, does not provide for consistently applied country-specific limits, and is not measurably more enforceable than the current process. At the same time, the changes proposed by the EC would make the process more complicated, with no certainty that the additional adjustments for the cycle would be accurate. Efforts to provide for more flexibility in the current system appear particularly misguided; as was stated in a 2004 *Financial Times* op-ed: “Germany and France are on course for their fourth year of excessive deficits. What would they do if they had even more flexibility?” (Munchau, 2004, p. 11).

Budget process issues are also under scrutiny in the United States. After an extended period of compliance with that country’s latest budget rules (enacted in essentially their final form in the Budget Enforcement Act [BEA] of 1990), which helped to bring about significant fiscal improvement, the rules were repeatedly waived in the fiscal years of the 1990s until they expired at the end of 2002. Despite occasional discussion and some abortive legislative attempts, they have not been renewed.

Scholars have considered the effectiveness of fiscal rules, and have concluded that countries that practice fiscal discipline without rules do not need them, and that countries that flout rules will not achieve fiscal discipline with them (Kennedy and Robbins, 2001; Kopits, 2004). However, at the same time, some countries (those of the EMU among them) have determined that they need fiscal rules, and others (the United States prominently) have achieved favourable fiscal results when following sound fiscal rules, and have failed when ignoring those rules (or allowing them to expire). For this reason, the current authors undertake this inquiry regarding fiscal rules, and believe that it is useful.

This paper discusses issues regarding budget process rules in the context of the current pattern of rising fiscal deficits. It begins by explaining the premise that budget process rules have multiple objectives, and so must be judged according to multiple criteria. Prominent among those criteria given the apparent economic sluggishness of the early years of the 1990s and the resulting fiscal deficits are how any particular set of rules might facilitate (or at least not harm) economic recovery and growth, but also maintain fiscal responsibility and public credibility. This discussion is pertinent to both the euro area countries and the United States, because both have budget process issues on their respective policy agendas.

The paper then proceeds to analyse alternative fiscal control measures according to these and other criteria, such as the ability to maintain sound core operations of government to attain all of its long-standing policy objectives, including the funding of public investment. The paper concludes by weighing the alternative rules against these criteria.

1. Criteria for sound fiscal discipline rules

The core motivation of every fiscal policy rule is to promote stable economic growth through control of the accumulation of debt. As evidence of that fundamental point, every step in the evolution of the United States budget rules came on the heels of bad fiscal news – from the creation of the congressional budget process in the early 1970s, to the initial so-called Gramm-Rudman-Hollings deficit limit rule in the mid-1980s, to the enactment and refinement of the final stage of the rules in 1990, 1993, and 1997. Then, demonstrating the obverse, when concern about the budget faded with the achievement of a surplus in the late 1990s, the interest in the budget rules waned, and they were eventually allowed to expire.

The motivation behind the European Union Stability and Growth Pact was reportedly a variation on that same theme. Leaders of EU member countries believed firmly that the benefits of a credible common currency could be maintained only if all the members of the Union achieved fiscal credibility as well. The SGP was designed to counteract the potential motivation of each individual country to attempt to enjoy budgetary freedom while relying on all the others to endure the fiscal discipline necessary to maintain institutional credibility. A “free rider” country might assume that a single central bank for the entire EMU would not raise interest rates to punish a lack of fiscal discipline on the part of just one country.

However, even though every fiscal policy rule has one primary motivation, creating such a rule requires a multi-dimensional choice. There

are at least two proximate objectives: (a) long-term fiscal responsibility and sustainability; and (b) short-term macroeconomic stabilisation.

The first objective, fiscal responsibility, is measured most simply in terms of control over the accumulation of debt. Assuming rational financial markets and economic actors, that criterion must extend over time into the foreseeable future, raising issues about the long-term outlook and sustainability. It also requires that the fiscal authorities establish confidence in the public that future policy choices will be sound and responsible.

At the same time, control over the accumulation of debt should be achieved at the least possible cost of unemployment and economic slack in the near term, very simply for the well-being of the population at large. In the extreme, policy that needlessly prolongs an economic downturn could prove self-defeating even in the long run. It would add to the stock of debt, even if only on a one-time basis. It may deter private business investment, at least for a time, extending the period during which economic performance would be sub-par and fiscal deficits and debt accumulation would be larger than necessary.

Thus, achievement of long-term fiscal sustainability requires credibility with the financial markets and the public. Achievement of either long-term sustainability or short-term stabilisation requires that the fiscal rule be transparent and administrable, in terms of both its ongoing implementation and its enforcement, and that it be viable in the political domain. A rule that is impossible to enforce cannot have its desired effect on debt accumulation, sustainability and credibility. Likewise, credibility will not be achieved by a discipline mechanism that is not publicly accepted as politically sustainable over a meaningful time horizon. And no fiscal rule should interfere with the core functions of government as it strives to achieve all of the public sector's other long-standing objectives. This involves, among other things, predictable funding and adequate funding for public investment.

Because of the multi-dimensional objectives of fiscal rules, the apparent superiority of any rule on the basis of one criterion is not a sufficient justification for adoption. This is most obviously true regarding the need for a balance between macroeconomic stabilisation and debt restraint. However, it may be especially noteworthy with respect to real-world constraints such as administrability, credibility and political viability. Because so much of the public benefit of fiscal responsibility comes through the behaviour of financial markets, any successful budget rules must be demonstrably workable and credible.

Furthermore, because debt control is solely a function of budgeting, whereas macroeconomic stabilisation can be pursued through monetary as well as fiscal policy, any policy must have substantial advantages with

respect to the secondary goal of stabilisation to offset any disadvantage with respect to the primary goal of fiscal control. There is some difference of circumstance between the European Monetary Union, with its single central bank and numerous fiscal authorities, and the United States. However, this distinction should not be exaggerated; the 50 states are not small and are quite diverse, and the EMU countries have for decades been constrained in their fiscal and monetary policies by trade and currency considerations. The European Central Bank can be expected to respond to adverse macroeconomic shocks that are strong enough to affect the greater part of the EMU, and the SGP does provide exceptions that would apply if a significant shock should be more localised. So to a certain degree, the principle remains that monetary policy can carry at least some of the load of macroeconomic stabilisation, and that fiscal rules therefore should focus somewhat more closely on debt accumulation.

For the same reason, fiscal policy rules should be judged as well on their harmony with sound monetary policy making. Predictability and stability should be important considerations. Monetary authorities would be more confident in taking important decisions, either to act or not to act, if they could rely on the fiscal process to follow a sound and steady course. On the other hand, a fiscal rule that could respond to sharp movements in budget outcomes with abrupt changes in the fiscal stance would make monetary policy making much harder, and make monetary authorities in effect compete with fiscal policy makers, rather than co-operate with them.²

In sum, the choice of a fiscal rule, like fiscal policy making itself, requires perspective and judgment. The focus must extend over time and across policy making criteria. The optimal choice may not be the best by one particular standard, but must balance several important objectives and must be durable under stressful economic and political conditions.

2. Some alternative fiscal rules

Among the numerous fiscal rules that have been implemented, there are probably two distinct broad classes that may serve as potential models: (1) deficit-and-debt-based rules, and (2) expenditure rules.

Deficit-and-debt-based rules (“deficit rules”, for convenience) generally operate through numerical limits on the amount of the annual deficit – either a limit denominated in terms of currency, such as zero, or a limit set as a percentage of the GDP. Examples of this type of fiscal rule include the European Union’s Stability and Growth Pact, and the United States Gramm-Rudman-Hollings system (which was in effect for fiscal years 1986 through 1990).

The US system was based on statutory dollar deficit limits, gradually falling to zero, which were revised once (to ease the restrictions) before the system was replaced. The Stability and Growth Pact sets a maximum deficit of 3% of GDP.

A possible alternative to this approach, to be discussed in some detail in this paper, is to adjust the deficit limit according to the state of the economy – for example, to set a deficit limit as a percentage of potential, rather than actual, GDP. This would leave unchanged the maximum permissible fiscal deficit in currency for a country whose GDP was determined to have dropped below (or risen above) an unchanged estimate of potential. Some would argue that such a modification would be an improvement upon a fixed percentage-of-GDP limit (although the Stability and Growth Pact already allows exceptions for temporary increases in deficits).

The key characteristic of the second broad class of fiscal rules, expenditure rules (or “spending rules” for short), is that they aim to limit policy-induced increases in spending and reductions in taxes, rather than to focus directly on the deficit. Note, importantly, that the terms “expenditure rules” and “spending rules” should **not** be construed necessarily to exclude controls on revenue-losing changes in tax policy. The now-expired US system was in some respects the most elaborate model. It used dollar-denominated caps on annually appropriated spending, with pay-as-you-go (PAYGO) restrictions on the aggregation of spending mandated by permanent appropriations (mostly for programmes with important automatic stabilisation implications) **and taxes**. In the US case, it is unlikely (in the judgment of the present authors) that the rule would have succeeded without including revenues as well as spending. Other examples of spending rules use caps on all spending, or on a broader range of spending than did the United States; this is a policy choice that can accommodate the rule to different countries and institutions, as is discussed further below.

A second characteristic of the US version of a spending rule is that it has its effect *ex ante*, rather than *ex post*. In other words, the spending rule constrains policy actions as they are taken, and thus their future effects, rather than requiring remedial action for their budgetary results after those results are recorded for a past fiscal year. The enforcement of the spending caps therefore constrains appropriations as they are enacted, and the enforcement of the PAYGO rule constrains the estimated future effects of changes in tax policy and in mandatory spending programmes. The US system used across-the-board spending cuts (“sequesters”) to remedy policy overages shortly after they were enacted.

The US version of an expenditure rule was enacted at the start of fiscal year 1991, to replace the prior deficit-based rule. It continued in force,

having been re-enacted twice, through the end of fiscal 2002, when it expired. It was, however, overridden by statute numerous times in the last three years of its life, after helping the budget to leave fiscal deficit and enter surplus in the late 1990s.³

This paper will analyse an expenditure rule generally following the US model in more detail, as an alternative to a deficit rule (with or without cyclical adjustment). In keeping with the discussion above, this comparative analysis will aim to determine which of the two alternative classes of rules might better satisfy, on balance, several criteria. To be preferred, an alternative should achieve the better mix of debt control and counter-cyclical macroeconomic policy, taking into account the administrability, political viability and credibility of the rule itself.⁴

3. Evaluating two alternatives

3.1. Background: Uncertainty and fiscal rules

At the outset, it is important to discuss a possible simple misconception. A deficit rule might be assumed to be superior to a spending rule for purposes of long-term sustainability and control of debt, for the simple reason that it at least in name targets precisely the ultimate cause of additional public borrowing, the deficit, rather than the controllable proximate causes, spending increases or tax decreases. However, that assumption is incorrect; the linkage between the rule and the ultimate borrowing outcome is by no means exact. The US experience helps to explain this point.

The long-term goal of fiscal rules – sustainability – necessarily extends over time. Thus, any deficit rule, to be successful, must control future deficits – and therefore must operate through estimates. (Deficit rules can also target the deficit in an ongoing fiscal year. The US system from fiscal years 1986 through 1990 purported to limit deficits in the ongoing fiscal years, though it was never effective. In part, its ineffectiveness in constraining deficits for ongoing fiscal years arose because of the difficulty of predicting the deficit even for a fiscal year in progress.) Experience shows that it is uncertainty about the future that leads such estimates to be imprecise, much more than imprecision in the relationship between the components of the budget (spending and revenues) and the deficit itself.

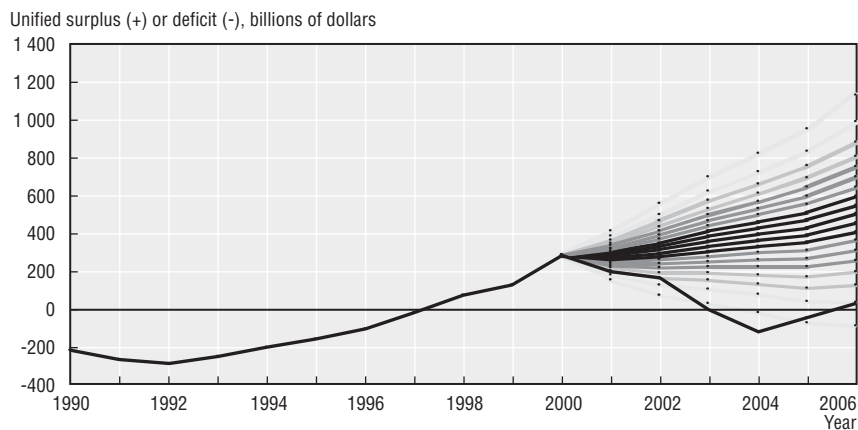
For example, the United States dissipated a large budget surplus and fell into substantial fiscal deficit in the last five years. However, throughout the crucial policy decisions that contributed to this adverse development, policy makers maintained that the budget would not and could not fall into deficit.

Thus, a substantial part of that development arose not because of the policy changes that were undertaken, but rather because of economic and technical developments that drove the budget far below its previously estimated path in the absence of policy changes. This was true both in the sense that the unwinding of overly optimistic estimates played a major numerical role in the disappearance of the budget surplus, and in that those erroneous estimates were used to justify the policy steps that contributed still further to the fall from fiscal grace.

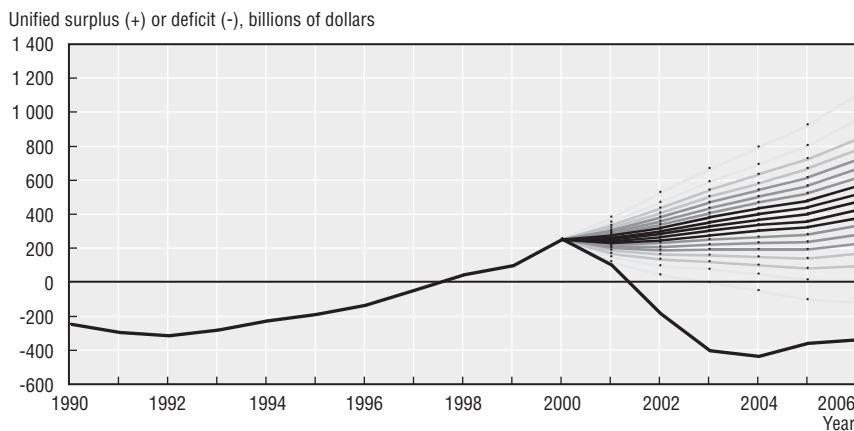
Figure 2 illustrates that development. It reproduces the probability map of future budget outcomes released by the US Congressional Budget Office (CBO) in January 2001, based on its statistical analysis of available prior years of data. Superimposed upon that probability map is the actual outcome – that is, the best estimate included in that same map, adjusted only for the economic and technical budget re-estimates subsequently published by the CBO. By the now-current fiscal year (2006) and over all preceding years since 2000, the outcome is approximately the 10th percentile expectation (with the 50th percentile being the most likely estimate, and percentile rankings below that designating more adverse outcomes), even before considering the effects of any policy changes. As is apparent from the figure, economic developments and the correction of prior technical forecasting errors would have driven the budget into deficit even before policy changes. Because US policy changes – including large tax cuts and substantial increases in defence and health-care spending – during and since 2001 have sharply increased the deficit, the actual budget outcomes have been worse still than the so-called baseline, as is shown in Figure 3.⁵ (Still, had the US budget rules been obeyed, budget outcomes would have been far superior and well within the bounds of, for example, the EMU guideline of 3% of GDP.)

There is no reason to believe that the US experience in this respect is atypical. Countries around the world have been surprised by the strength of the descent of budgets into deficit in the 1990s.

The reality, then, is that **any** fiscal rule, whether based on deficits or spending, must be implemented through imperfect knowledge of the future. Imperfect foreknowledge is the primary source of error in any such rule. Thus, in this most important respect, the same key problem afflicts any fiscal rule, and a deficit-based rule, even though it focuses nominally on “the deficit”, has no inherent superiority.

Figure 2. Uncertainty in CBO projection of the US budget deficit: Baseline

Source: Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2002-2011*, January 2001.

Figure 3. Uncertainty in CBO projection of the US budget deficit: Actual

Sources: Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2002-2011* (January 2001) and *Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006).

Put another way, the creation of any fiscal rule, whether based on deficits or spending, involves the selection of policies that achieve a

satisfactory projected future deficit path, under conditions of uncertainty. Therefore a deficit-based rule would immediately require the choice of an economic forecast and policies that would reach a deficit below the reference level. Thus, for example, countries under the SGP would present an economic forecast and programmes that would take their budget results “close to balance or in surplus” within the requisite number of years. Similarly, a spending-based rule would likely be initiated using prospective estimates of the policies, both spending and tax levels, which would be required to achieve a target deficit level; that was the US experience. The issue is not that a spending rule is sensitive to longer-term budget forecasting, and a deficit rule is not; **both** require budget forecasts. One might argue that under a deficit rule, those forecasts must be reviewed with each budget cycle, and that this constitutes a safeguard. However, the track record of currently operating deficit rules is not encouraging. And on the other hand, a spending rule would likely keep a tighter leash on policy.

In fact, in the three instances of enactment and re-enactment of the most recent US system – in 1990, 1993, and 1997 – the rule was designed so that the budget would reach its target of balance or significant deficit reduction five years hence if annual appropriations hit their numerical caps for the next five years, and if taxes and mandatory spending taken together were precisely deficit neutral. The same structure could have been initiated to achieve greater deficit reduction if the discretionary caps were lower, and/or if the pay-as-you-go rule were programmed to achieve net savings over time, rather than to be precisely deficit neutral. That is, the same “PAYGO scorecard” that was created to keep track of subsequent policy action could have been initiated with future-year debits, rather than zeros, that would have required future policy savings. These design issues will be important in the discussions on spending rules and on all of the objectives of fiscal rules in general, to follow later.

A deficit-based rule may have one limited advantage over a spending rule, in that the public at large may be more reassured by a fiscal discipline rule that at least in name places a limit on the deficit itself. The economics and policy science professions would likely see through the nominal distinction fairly quickly, and participants in financial markets would surely engage in deeper analysis; but for immediate public relations purposes, a deficit limit might have some additional impact. Still, experience suggests that the performance of fiscal discipline rules will be the telling issue for the public over the longer term.

Thus, the use of proximate spending and tax-policy targets, rather than a target with respect to the deficit itself, might be thought an imprecision and a disadvantage. However, a deficit-based rule would be implemented through the same estimates of the effects of spending and tax policy, chosen

to achieve the particular deficit target. Thus, under the EU model, fiscal authorities are expected to set policy to limit deficits to less than the reference value of 3% of GDP, and to achieve the medium-term “close to balance or in surplus” objective, on the basis of economic forecasts and budget projections. At the outset, the two processes are in substance the same; policy under both rules would be made based on the same kinds of forecasts and estimates. Thus, there is no inherent precision or superiority in the deficit-based rule.

3.2. Compliance with alternative fiscal rules

An explicit deficit rule might be preferred on the belief that it would be easier to enforce if adverse budgetary developments pushed the fiscal result into deficit. The presumption would be that the measurement of the problem and the selection of a solution would be easier, again because the measure used by the rule is the deficit itself. However, again, this conclusion presumes too much.

For one thing, as was noted earlier, a deficit rule would provide policy makers with no more information than a spending rule. The excess of an historical fiscal deficit over the chosen target is a datum, available whether the rule was based on the deficit or on spending. The excess of a projected future deficit over a target is uncertain in any event.

Nor would a deficit rule provide any greater precision as to the magnitude of the solution for a fiscal problem. Corrective action would of necessity be based upon forecasts of the future, which would be uncertain in either case. Therefore, the policy remedy under either a deficit or a spending rule would be the amount of savings – spending reductions or tax increases – needed to reach a target future fiscal deficit, which would in either case be uncertain.

And finally, the policy measures needed to solve the problem would be no more palatable under a deficit rule. Whatever rule were being applied, an excess of borrowing of any given amount would require that same amount of pain to be imposed upon taxpayers and spending beneficiaries. The type of rule that had been imposed would yield no difference in the ease of accepting and enduring a remedy.

Therefore, an understanding of this choice must begin without preconceptions and with an understanding that any rule operates through an uncertain future and, in the event of trouble, through reducing government spending or increasing taxes. There is no obvious inherent advantage to either rule on these grounds; decisions must be made on the basis of a deeper analysis.

This paper will proceed with discussions on alternative fiscal rules and the criteria of fiscal responsibility, macroeconomic stabilisation, and the effectiveness of the core functions of government.

4. Alternative fiscal rules and long-term budget responsibility

For purposes of analysis, one might separate changes in the budget outlook from year to year into two classes: they may be cyclical, or they may be trend-related (as, for example, with an enduring productivity shock). If the distinction between the two were hard and fast, they would require separate analysis. However, one lesson of the economic boom of the 1990s was that what might appear to be an enduring productivity shock can in fact be short-lived. In the discussion that follows immediately, and in the later discussion pertaining to macroeconomic stabilisation, this distinction will be considered, but will not be assumed to be crucial to the argument.

4.1. Deficit rules and fiscal responsibility

A deficit rule such as that imposed by the SGP sets an upper bound on the fiscal deficit that in essence applies at all times, regardless of the cyclical condition of the economy. (There is an “early-warning system” based on the cyclically adjusted balance [CAB], intended to head off a growing fiscal deficit that has not yet reached the 3% of GDP reference limit. However, that system has not in practice led to any tangible action by the European Commission.) Such a constant reference limit on the fiscal deficit might cause significant problems, and some would argue that the incentives embodied in such a rule are not conducive to fiscal discipline.

For example, assuming the most perverse motivations, one country’s fiscal authorities might choose to set their budget deficit as close to the limit as possible (taking into account any effective early-warning system) when the economy is operating at its potential. That country would forecast an optimistic fiscal outlook that would bring the budget into close-to-balance status (CTB) within the time period required. If the economy should surprise and grow even further, then the percentage-of-GDP reference limit would yield even more room for fiscal deficits. If the economy weakened and thereby raised the deficit, however, policy makers might expect that those deficits could be exempted from discipline on the grounds that they were “temporary”. The result would be that this country could hope to reap the benefit of monetary stability paid for through the discipline of the other EU members, while itself enjoying the fruits of public spending in excess of revenues collected. Of course, if every country were to behave in such a

fashion, monetary stability would not last long; but such short-sighted policy making is not unusual.

Beyond the threat to monetary stability, the fiscal stability of the country in question would be short-lived. With fiscal deficits just within the boundaries of sound policy in the best of times, any cyclical economic weakness, or any adverse productivity shock, would see the budget in excessive and substantial deficit.

As was noted above, the country in question might well throw itself upon the mercies of the Commission, claiming that the excessive deficit was caused by recession and was temporary in nature. Frequent appeals of this sort would strain the cohesion of the EU, and also would cause the country in question to add significantly to its accumulated burden of debt by the time the procedural issues were resolved. The additional debt would make it harder for the country in question to meet the Commission's fiscal standards in the future.

4.2. Cyclical adjustment

It might be thought that a variation on the deficit rule, in which the reference value for the fiscal deficit is simply set at a percentage of potential rather than actual GDP, would solve this problem. At best, however, it would moderate the problem, not solve it. In practice, the difference in the fiscal target from such a revised rule would be too small to change incentives and behaviour; a country's fiscal authorities would have the same incentive (and perhaps even more so; see below) to target their deficit as close to the limit as possible.

In an economy operating at its potential, for example, the reference fiscal deficit amount of 3% of GDP, measured in currency, would be unchanged under such a revised rule. If the economy grew beyond its estimated potential, the deficit limit would not grow in currency terms if the rule were based on potential rather than actual GDP; but with a strong economy, the actual deficit would decline, leaving policy makers more room for spending and tax reductions in any event. And of course, this assumes that the extra spurt of growth would be recognised quickly as beyond potential. If it were interpreted as an increase in potential, then there would be still further room for pro-cyclical deficit-increasing policy.

On the other side of the coin, if the economy grew less strongly, policy makers would have more room to expand their deficit, because 3% of potential GDP would be greater than the same fraction of actual GDP.⁶

Given these limited differences in the deficit rule, policy makers still might be expected to push their near-term deficit toward 3% of GDP in an

economy at its potential, relying on favourable assumptions for the coming years to demonstrate eventual compliance with a close-to-balance-or-in-surplus standard. Given exceptions for recession, they might expect that they would need to tighten policy even less if budget outcomes proved less favourable. In this regard, a deficit rule is no less vulnerable to long-term forecasting error than is a spending rule.

It is surely at least somewhat cynical to assume that countries would choose to manipulate a deficit-based fiscal rule to the limits of its elasticity. Policy makers are mindful of the well-being of their constituents, and understand that debt begets debt service, which can beget further debt. Even those who believe that the incentive effects of existing deficit-based rules are powerful enough to lead to some measure of fiscal irresponsibility would concede that this is in spite of policy makers' concern about the public interest, as they define it.

However, it cannot be denied that a deficit-based fiscal rule such as that described above is in the nature of a one-way instrument. It provides no meaningful, productive guidance to countries whose deficits are smaller than the reference level, allowing them to move toward that limit with impunity – thereby adding to their accumulations of debt, and their debt-service obligations. (The medium-term CTB requirement might be thought to provide such guidance, but recent practice has not been encouraging, perhaps in part because it is easy to project budget improvement beyond a current fiscal year with an economy that is forecast to grow, and with hopeful assumptions of future spending restraint.) One might argue that the structure and incentives of the deficit-based fiscal rule do not require malfeasance to yield adverse results; the pressure of short electoral cycles against long-term interests, plus a little bad luck, will suffice.

4.3. Enforcement

Furthermore, based on experience in the United States from 1985 to 1990, there would be significant opportunities for manipulation and evasion under a deficit-based budget rule. The rule in the United States had attempted to impose spending discipline prospectively, before the beginning of a fiscal year. Alternatively, one could try to enforce the rule retrospectively, during the final months of a fiscal year. Both instances would be subject to manipulation.

A deficit-based rule does, in some circumstances, allow manipulation through the choice of an economic and budget forecast that drives a politically desirable outcome. For example, the authority responsible for the economic forecast used in the budget could forestall the need for tax increases or spending cuts by issuing a more optimistic economic forecast,

and therefore a lower projected budget deficit. In the experience of the United States, such manipulation allowed different actors in the budget process to force the responsibility to recommend policies to achieve budget savings onto other actors, which presented an additional political motive to manipulate the system. Because a spending rule does not rely directly on a budget forecast (but rather involves a pre-stated appropriations cap and a pay-as-you-go requirement for mandatory spending and taxes, which are often less dependent on the underlying economic forecast), it raises less of a prospect of such a moral hazard.⁷

At present, enforcement in the EU appears to be based mostly upon retrospective views of deficits in excess of the reference amount. However, at the time of enforcement, optimistic budget projections might be used to argue that the past deficit was merely temporary. This pattern suggests that enforcement under deficit rules can often be unsatisfactory.

5. Spending rules and fiscal responsibility

Based on a view of incentives and experience, an alternative fiscal rule based upon spending might well be judged more conducive to responsible fiscal policy under a range of economic conditions.

As was noted above, spending rules have been initiated to achieve targeted fiscal goals over a period of years, based upon underlying economic and continuing spending programme forecasts and prescribed annual caps for appropriated spending. The underlying economic forecast has typically assumed that the economy would gradually converge to its estimated potential output. This process and its underlying assumptions are really no different than the plan that a government would need to formulate to comply with a deficit rule over time. Once such budget policy amounts have been determined, the spending rule might require that entitlement spending and tax policy changes be no worse than deficit-neutral, and that annual appropriations comply with the stated caps. However, the spending rule could be made more rigorous with lower discretionary caps and a requirement for future budget savings through mandatory spending and taxes; the opposite, of course, could also be true.

A spending rule would provide continual guidance to policy makers, under any and all economic and budget conditions. If budget results proved more favourable than expected, whether because of cyclical economic improvement or a positive productivity shock, the rule would allow no additional budgetary resources to the fiscal authorities. Therefore, unlike a deficit rule, under which a lower deficit or a higher GDP (actual or potential, depending on the formulation) would allow (some might say “encourage”)

greater spending or tax cuts, a spending rule would require that policy remain unchanged, and thus that the budgetary bonus be saved. Given the lesson of the 1990s – that even apparently durable positive budgetary shocks might well evaporate – this aspect of spending rules would seem advantageous and prudent; it would make it more likely that budgets would remain in balance over the macroeconomic cycle and into the long run. (It also would make sense from a counter-cyclical point of view, as will be discussed below.)

A spending rule might seem well suited for the current situation of the EMU. With already high government expenditure ratios in most EU member countries, it might be desirable to put more policy focus on attaining sustainability through spending restraint. Some countries have already taken this approach. Another case for greater focus on the expenditure side is that it is where slippages have often occurred (European Commission, 2003). The European Commission noted that expenditure rules can be a national complement to the deficit rule, but given the success of expenditure rules in some countries, more focus on this issue would be valuable.

On the other side of the coin, should fiscal performance prove weak, a spending rule would tolerate the deterioration of the budget through its automatic stabilisers, but would not allow further shifts in policy. (Some might contemplate allowing inter-temporal policy shifts, in which greater spending or tax cuts in one or two years could be offset by future spending restraint or tax increases. Going even further, a spending rule might allow a purely one-time counter-cyclical stimulus without offset. Such policy flexibility might make sense if future compliance could be assured. Whether such future discipline should be relied upon is a matter of judgment.) If the fiscal deficit remained below the reference level, a deficit rule would, like the spending rule, tolerate the deterioration. However, if the fiscal deficit did cross the reference level, policy makers would have to choose between raising taxes or cutting spending, on the one hand, and seeking extraordinary relief (through, for example, an appeal to treat the deficit as temporary), on the other. Such fiscal constraint might possibly be seen as appropriate discipline, but it would raise potentially serious macroeconomic stabilisation concerns (discussed below).

Thus, one possible argument for the spending rule is that it provides continual guidance to the fiscal authorities; at all times and under all circumstances, policy changes must be deficit-neutral. In contrast, a budget rule does not bind policy makers unless the budget deficit is in proximity to the reference value. Some might argue that this limited restriction implicitly condones, or even encourages, the fiscal authorities' moving their deficit toward the reference limit in a pro-cyclical fashion in good times.

5.1. Administrability and enforcement

One potential way to strengthen the deficit rule from this perspective of fiscal responsibility might simply be to reduce the reference limit – in the EU instance, for example, to a smaller deficit or even balance rather than the reference level of 3% of GDP. That would make the reference level binding in more instances, and would limit the fiscal damage even if countries chose to operate close to the reference level. Which raises the question: Why was the US spending rule aimed toward a budget in balance with the economy at potential GDP, whereas the EU deficit rule sets a reference value at 3% of GDP? Why not set the reference value for the deficit rule at a smaller deficit, or at balance?

The answer might centre on administrability. A maximum fiscal deficit amount of zero would lead to more frequent episodes of apparent overstepping of the limit, which in turn would result in numerous contentious debates and inevitable instances of alleged unfair treatment of one country or another. Those disputes would rest on controversial estimates of the affected countries' entire budgets.

In comparison, questions of compliance with a spending rule would be more transparent and less disputable. Even if there were dispute with respect to an estimate of a policy change in entitlement spending or taxes, the universe in dispute would be only that one change; and because the rule would require the policy change to aim for a net effect of zero, the amount at stake would be much smaller than in controversies regarding a deficit rule. Thus, routine enforcement of a spending rule would focus more on policy changes before the fact. Enforcement of existing deficit rules has tended to arise after deficits are already excessive, and has not been notably successful.

Overall fiscal outcomes depend upon both central and sub-national government policy, especially in those countries where local government constitutes a comparatively large share of the total. This issue could be approached in several ways. One would be to impose an expenditure rule at the sub-national level. Particularly for a pay-as-you-go type rule, this could be complex for the governmental units involved. However, this course might not be necessary if those governments do not have significant counter-cyclical roles. The alternative would be to use deficit-based rules at the sub-national level. This is *de facto* the approach in the United States, where virtually all sub-national units face constitutional or statutory balanced budget requirements. Of course, even deficit rules can be problematic for sub-national governments, for all of the same reasons as for national governments.

In the end, these advantages in administrability might lead to greater compliance and cohesion among the countries involved under a spending rule.

5.2. Limits to and values of rules

Still, there are limits to the effectiveness of any fiscal rule which should be clear from experience – for example, the United States fell back into deficit while its spending rule remained nominally in place – but might still be forgotten as the advantages and disadvantages of any alternatives are weighed. At bottom, no fiscal rule should be expected to do the impossible. No fiscal rule will achieve its desired budgetary results if and when the political will of policy makers is to the contrary. A legislature's procedural rules can be changed or waived, and restrictive laws can be amended or repealed; and the recent experience of both the United States and the largest countries of Europe makes clear that these contingencies are very real, for both spending and deficit rules.

However, what a fiscal rule can do is expose steps contrary to stated fiscal guidelines. Policy makers must vote to waive or change the procedural rules, and to amend or repeal the statutory fiscal rules. These steps must usually be in addition to the enactment of the policies themselves. These additional procedural steps usually involve an explicit admission that the policies that follow do violate the budget restrictions that had hitherto been accepted rules. Such restrictions clearly are not insuperable, as recent experience again would show clearly. However, they might provide some measure of deterrence against violations of fiscal responsibility, because they are transparent, and because they can be cited later by political opponents if events go awry.

This deterrent value of fiscal rules may apply more tellingly to a spending rule than to a deficit rule. Budget deficits are incontestable only after the fact, and – long after policy actions have been taken – policy makers can argue with optimistic assumptions or estimates that their policies will not result in further deficits in excess of reference limits. In contrast, policy steps that might violate appropriations caps or pay-as-you-go restrictions are apparent as soon as they are taken and, as was noted above, the numerical results are more transparent and less subject to dispute. Therefore, policy makers who could deny that their actions would push fiscal deficits beyond a reference limit would more likely be confronted with the certainty that their policies violated a spending rule.

5.3. Credibility

Achievement of the benefits of fiscal responsibility rests heavily on the credibility of fiscal policy. Currency will not be respected, and investment within a country's borders will not be attractive, unless fiscal policy is perceived as responsible and as likely to remain so. (The recent retroactive re-designation of the dates of an economic cycle in the United Kingdom to provide additional flexibility under a fiscal rule – a voluntarily self-imposed rule, to be sure – cannot be ignored in this regard.) No fiscal rule can add to credibility if it is flouted, but a rule that is more conducive to compliance might fairly be scored more highly than one that is less so. Here again the advantage probably rests with the spending rule.

From the political perspective, there are risks to allowing fiscal targets to move up and down with some frequency. If spending targets are allowed to rise or revenue targets are allowed to drop because of improvements in the budget outlook, it may be difficult for government to reclaim those ostensibly temporary benefits if and when circumstances reverse. And should there be resistance in the budget process to any formula-induced imposition of pain, it may erode the credibility of that process.

This suggests that the difficulty of complying with and enforcing a deficit rule, which calls for continual (even if usually small) adjustment of the fiscal targets and of budget policy, might in the end raise greater concern in the financial and investment markets. This would be especially true if policy makers were eager to loosen fiscal policy when circumstances allowed, but were reluctant to tighten policy when situations required. From this perspective, a deficit rule would create more occasions for loss of credibility than would a spending rule, which would allow freedom of action for automatic stabilisers, but would limit tax and spending policy changes to deficit-neutral steps.

5.4. Productivity shocks

There could be differences in circumstances depending upon whether the changing budget fortunes were caused by a purely cyclical economy or by an enduring productivity shock.⁸ As was argued earlier, the budgetary benefits of apparent favourable productivity shocks can themselves prove to be temporary. However, in theory, a productivity shock could confuse the implementation of a cyclically adjusted deficit rule, because potential GDP would be mismeasured until the shift was recognised and estimates were corrected. But in truth, any fiscal rule would be confused by an unrecognised productivity shock, and economic policy makers could be expected to search the data for productivity changes, whether a fiscal rule

were cyclically adjusted or not, and to adjust their budget policy making accordingly. So it would not appear to be productive or fair to judge any fiscal rule differently because of the possibility of a change in productivity growth. If a shock can be accurately perceived under a cyclically adjusted deficit rule, it can be accurately perceived under a spending rule. In either instance, corrective action would have to be undertaken by policy makers.

Still, theoretically, it could happen that a true, enduring productivity shock would be recognised quickly and distinguished from a cyclical movement in the economy. In that event, and should the productivity shock be adverse, a cyclically adjusted deficit rule would perceive the lower level of potential GDP and would reduce the reference deficit limit in currency, thus requiring a reduction in the budget deficit – if, again, at that time, the deficit was already in proximity to the deficit limit. Such a development could be conducive to good policy if, yet again, the economy were not at that time sufficiently weak that an additional stimulus would be needed for reasons of macroeconomic stabilisation. On the other hand, recognition of a favourable productivity shock could lead to an increase in estimated potential GDP, and so in the reference deficit limit in currency; and the allowance of a higher deficit in currency at the time of a favourable productivity shock would likely not be helpful for reasons of either fiscal responsibility or stabilisation. Furthermore, if such a favourable shock should in time prove to be temporary rather than permanent, as was the case in several countries during and after the 1990s, the initial allowance of additional room for deficit spending could prove difficult to reverse.

A spending rule would not be affected directly by any productivity shock. Thus, in the event of a favourable productivity shock, a spending rule would not allow a higher deficit – which would likely be judged to be the preferred outcome. A negative productivity shock, similarly, would not force a fiscal tightening. This could be unfortunate if the shock in fact proved to be permanent, but not if it reversed itself in time. One might imagine formalising a looser, longer-term deficit rule to back up a spending rule, to cover instances of enduring adverse productivity shocks. Alternatively, the judgmental political process would have to step in.⁹

In sum, one might conclude that a spending rule would prove superior to a deficit rule – even one that was cyclically adjusted – in maintaining fiscal responsibility in a satisfactorily performing economy. This conclusion rests in part on the workings of the rule itself, but also on its probable greater credibility and durability in the political process. The argument for a cyclically adjusted deficit rule is theoretically plausible, but is based on what would seem to be an unlikely combination of hypothetical circumstances.

6. Fiscal rules and macroeconomic stabilisation

Just as fiscal responsibility requires control of debt at times when the economy is strong or weak, so macroeconomic stabilisation requires sound budgeting in good times and bad. The discussion above has already suggested that a deficit rule is an imperfect instrument for macroeconomic stabilisation.

6.1. Deficit rules and macroeconomic stabilisation

Under a deficit-based rule, the stabilisation options available to fiscal policy makers depend upon the pre-existing state of the budget. If, for example, the economy softens with the budget in surplus or small deficit, the reference limit on GDP would decline in currency terms (because the amount of GDP would fall short of expectations), but there might still be budgetary room to allow the automatic stabilisers to increase the deficit, and for additional action to stimulate the economy and/or provide relief for affected persons and businesses. If, however, the fiscal deficit were already close to the reference level of 3% of GDP, a lower amount of GDP would reduce the room even for operation of the automatic stabilisers, and might force policy makers to consider pro-cyclical tightening of the budget (European Commission, 2004, Graph II.10, p. 90). The affected country could contend that its deficit was temporary, because it was caused by an economic cycle, and ask for forbearance with respect to the deficit reference level until the economy recovered; this would involve uncertainty for policy makers and the affected public, and possible contentiousness with the Commission authorities.

In the case of a strengthening economy and an improving budget, the effects of a deficit rule are again, if anything, pro-cyclical. As actual GDP increases, the currency value of the 3% reference level of GDP increases, and the fiscal authorities have more room to cut taxes or increase spending. If the budget began in deficit beyond the reference level, the growth of the economy would either reduce the necessary amount of fiscal rationalisation or eliminate it entirely. Although these deficit-rule effects would not themselves compel a country to act, the incentives would in fact be perversely pro-cyclical.

To summarise, the failings of a deficit rule are that it allows – perhaps encourages – countries to run excessively loose fiscal policies in good times, and may constrain counter-cyclical fiscal policy, including notably the workings of automatic stabilisers, in bad times. One frequent reaction is that the deficit rule should be cyclically adjusted to solve these problems. However, again, to solve these problems it would take a policy change far

more complicated than merely using cyclically adjusted GDP rather than actual GDP in the existing deficit rule.

6.2. Macroeconomic stabilisation: A deficit rule with cyclical adjustment

If the deficit rule were cyclically adjusted and based on estimated potential rather than actual GDP, the perverse incentives would be reduced but not eliminated. In a weakening economy, the currency amount of permissible deficit would not decline, because potential GDP would not decrease. However, the actual deficit would go up, and so it would still be possible that the affected country would find itself in excess of the deficit reference amount, facing pro-cyclical budget policy tightening. In the case of a strengthening economy, the converse would be true. The deficit reference level would not change in currency terms, because estimated potential GDP would not change; but the actual deficit would decline, and so policy makers would find that they had increased latitude to engage in pro-cyclical fiscal expansion.

So to solve the pro-cyclical tendencies of deficit rules, one would need to do more than merely substitute potential for actual GDP in the rule itself. Rather, one would need to reduce the maximum percentage of GDP allowed for a deficit in a strong economy, and increase the percentage in a weak economy. In short, reasonably speaking, one would need to make the deficit rule behave more like a spending rule.

6.3. Macroeconomic stabilisation: A spending rule

Design choices for the categorisation of spending programmes for constraint by numerical caps as opposed to pay-as-you-go procedures would affect macroeconomic stabilisation. In the US implementation, spending programmes were assigned to one or the other instrument by a fairly simple rule. Programmes subject to annual appropriation were limited by the spending caps; programmes funded by continuing law were subject to pay-as-you-go procedures. To some extent, that distinction was based on the perceived length of time needed so that programme changes could be implemented and have meaningful effect on the amount of outlays. However, an alternative criterion for this distinction could be the strength of the automatic stabiliser effects of different spending programmes. In the US context, the two criteria would yield approximately the same result.

In another governmental structure, however, a categorisation based directly on automatic stabiliser effects could be just as valid. Depending on that governmental structure, the amount of spending subject to numerical

caps, as opposed to pay-as-you-go, could be comparatively large or it could be smaller. In Sweden, for example, all of central government non-interest spending is subject to a cap; there is no pay-as-you-go category. Spending rules can be accommodated to different governmental institutions in different countries through similar policy choices.

With such design choices determined, a spending-based fiscal rule would not change in character with cyclical fluctuations in the economy. That provides some significant advantages, but in some measure does constrain policy responses.

In a weakening economy, a spending rule requires continued compliance with the caps on annual appropriations. At the same time, the rule fully accommodates increases in counter-cyclical spending programmes, and decreases in revenue, that would occur without changes in the underlying law. In other words, a spending rule fully accommodates the workings of the automatic stabiliser programmes in the budget. This is in favourable contrast to a deficit rule, whether cyclically adjusted or not, that could require pro-cyclical budget tightening if the deficit approaches the reference limit. Furthermore, the spending rule is, in effect, cyclically adjusted in real time; because it unconditionally allows the workings of the automatic stabilisers, it raises no questions in the minds of policy makers, the public or the financial markets as to whether the automatic stabilisers in tax and counter-cyclical spending policies can be allowed to work.

A spending rule would have further advantages in the instance of a strengthening economy and an improving budget. Unlike a deficit rule, where a larger GDP would allow a larger pro-cyclical deficit, a spending rule would require that policy remain deficit-neutral. That would allow the automatic stabilisers in the budget to restrain a strengthening economy, in a counter-cyclical fashion.

Thus, a spending-based fiscal rule would have the appropriate effect of allowing the automatic stabilisers in the budget to work continuously, whether the economy was on the upside or the downside. In a strengthening economy, increases in revenues and declines in entitlement spending would tend to dampen any excess growth. The rule would, of course, allow the fiscal authorities to enact further restraint in a strengthening economy. The monetary authorities could also act more freely. (It is possible that monetary policy could be more effective if it could count on comparative budget policy stability, rather than continuous adjustments in fiscal policy.) The spending rule would, however, prevent policy makers from enacting an additional stimulus in a weakening economy (in the absence of some extraordinary measures, such as declaring an excessive deficit under the SGP as temporary and thus permissible). A spending rule could be allowed

to adjust for one-time outlays required by natural disasters and other such unanticipated needs (as was the case in the United States), which could provide a counter-cyclical stimulus under those circumstances. (The apparently weakest scenario for a spending rule – a weakening economy where the rule, strictly interpreted and enforced, does not allow judgmental stimulative fiscal policy – is of course the situation in which policy makers are most likely to take the decision into their own hands in any event.)

The track records of spending-based rules thus far have been encouraging. Although at the end of the day the rule is only a part of the total system, both Sweden and the United States did perform well when spending-based rules were in place and observed. In particular the progress of the United States under its rule was striking. Finland and the Netherlands have successful expenditure rules as well. Descriptions of the systems of Finland, the Netherlands and Sweden are appended to this paper.

Questions of judgment arise regarding the preferred properties of a fiscal rule. Would the best rule be one that allows the automatic stabilisers to work at all times and without restriction, but that prevents or at least restricts additional counter-cyclical policy in a weakening economy? Or would the best rule rather be one that sometimes constrains those stabilisers in an economic downturn and never requires their action on an economic upturn, but would with a small pre-existing deficit allow additional expansionary counter-cyclical policy? This is clearly a matter of judgment.

However, arguably, and allowing for consideration of other criteria, giving free rein to the automatic stabilisers on both the upside and the downside of the economy might be the better policy.¹⁰ There is no reason to believe that a spending-based rule would be less conducive to a stable macroeconomy than would a deficit-based rule; in fact, the pro-cyclical tendencies of deficit-based rules would suggest that spending rules would be superior. This judgment depends in part upon the inexact nature of the economic and budget forecasting process.

6.4. Weaknesses of judgmental counter-cyclical fiscal policy

A spending rule would not allow additional judgmental changes in fiscal policy for stimulative counter-cyclical purposes; however, for that reason, it would neither overstep any counter-cyclical fiscal adjustment, nor move in the wrong direction because of false indicators in the macroeconomic data. (It should be noted that, depending on circumstances, the rule could in fact be made to allow such actions. But that is not the topic in this discussion.)

When viewed purely through the lens of stabilisation policy, a fiscal rule driven in some way by a cyclically adjusted deficit measure might seem

superior. However, there are numerous problems in the implementation of judgmental counter-cyclical fiscal policy. For one thing, there are multiple lags in the data development and budgeting processes which result in a substantial delay between the occurrence of economic phenomena and the ultimate implementation of fiscal policy.

Data are collected, processed, and revised with significant lags, which might be called technical lags. As has been made abundantly clear in recent years, economic data can be misread for years, let alone quarters, and so there is no guarantee whatever that even “final” figures will be meaningful at their release.

The Congressional Budget Office summarised the inaccuracies of US real-time economic forecasting – its own, that of the Presidents’ budgets, and that of the private sector consensus – as follows:

As the track record shows, forecasters collectively tend to err during periods that include either turning points in the business cycle or significant shifts in the trend rate of productivity growth. For example, most forecasters overestimated the economy’s growth rate in forecasts they made just before the two back-to-back recessions of the early 1980s. That pattern was repeated in the forecasts they made just before the more moderate recession of the early 1990s. In addition, during the mid- to late 1970s, forecasters continued to assume that the productivity trend of the previous two decades would prevail. In retrospect, however, the productivity trend of the 1970s and 1980s was significantly lower than that of the 1950s and 1960s. Because forecasters in the 1970s expected the previous trend to return, their forecasts of real output in the mid- to late 1970s turned out to be too optimistic. Partly for the same reason, forecasters repeatedly underestimated inflation in the late 1970s.

The years from 1995 to 2000 were a mirror image of the forecasting experience of the late 1970s. Partly because forecasters underestimated the trend rate of productivity growth beginning in 1996, they underpredicted the economy’s growth rate and overpredicted inflation.

(Congressional Budget Office, 2005, p. 3)

In short, and in summary, economic forecasting has been highly accurate except when it mattered. The CBO elaborated on this point in qualifying any optimistic interpretation of the averages of forecasting errors over long periods of time:

As noted earlier, forecast errors tend to be larger at turning points in the business cycle and when there are shifts in major economic trends. That tendency can be clearly seen in the forecasts of real output growth by comparing the large errors for 1979 through 1983 – when the economy went through its most turbulent recessionary period of the post-war era – with the smaller errors recorded for the mid-expansion years from 1985 to 1987. More recently, the recession of 2001 and slow recovery in 2002 account for the overpredictions made by all three forecasters in 2000 and 2001.

(Congressional Budget Office, 2005, p. 4)

There is no reason to believe that the US experience is unique in this respect. Thus, one might argue that reliance on the operation of the automatic stabilisers, rather than on judgmental fiscal policy, would be significantly less error-prone.

Even after the economic data are fully formed, they enter the policy-making process at different points in the budget cycle. And policy decisions are made with varying degrees of rapidity, involving political lags in the recognition of the data and in acting upon them. These lags can add a further measure of delay in the response of judgmental fiscal policy actions.

The European Commission recognised this problem in its 2004 summary report when it noted that requirements for pro-cyclical policy adjustments “...coupled with the traditionally long lags in identifying the growth shortfall and the slowness of the decision-making process in fiscal policy put fiscal authorities under strain” (European Commission, 2004, p. 90).

Given the annual budget cycle and the lags in collecting, processing, and acting upon economic data, the delay from real-world developments until the actual impact of fiscal policy under a deficit rule could easily be two years, or even longer. In the scale of economic cycles, that is a very long time.

For the same reasons, fiscal policy – in contrast to monetary policy – is much more difficult to reverse even should circumstances require. The annual cycle of policy making could be delayed even more. Changing the benefits of spending and tax policies in reverse is difficult politically. Thus, a shift of direction in fiscal policy would be much more difficult than, for example, the reversal of US monetary policy in the face of the international currency instabilities of 1998.

Such lags are among the reasons why economists have come over time to lean more on the monetary authorities for stabilisation policy, with or without a deficit-based fiscal rule.

Because of the problem of lags in discretionary macroeconomic stabilisation, some might argue that changes in fiscal policy could move somewhat faster if the policy-making system allowed less intervention by political decision makers. But that would require a substantial, if not complete, surrender of stabilisation policy judgment to the outcomes of a formula.

Such a quick-reaction deficit rule would require budget policy makers to yield their control over the details of spending and tax policy, so that actual policy decisions could be made in step with a mechanical formula. Policy makers could not take the time to debate the details of counter-cyclical policy choices and still remain timely. Accordingly, proposals for heavy reliance on fiscal policy for counter-cyclical purposes have sometimes suggested that limited options for policy tools be pre-selected, and perhaps chosen purely by formula. Such a mechanised process would be unlikely to yield sound budget decisions. Both economists and public sector decision makers would almost certainly prefer the freedom to exercise some judgment.

Rejecting a cyclically adjusted deficit-based budget rule would not mean that policy makers would forsake the wisdom in calculations of cyclically adjusted deficit estimates. Rather, those models would be used as inputs to policy-making processes instead of as determinants of the outcomes of those processes.

7. Macroeconomic stabilisation, deficit rules, and productivity shocks

As was argued in the discussion on fiscal responsibility, if a productivity or other supply shock should occur, and once it is correctly categorised as temporary or permanent, then under any fiscal rule, the entire outlook and budget policy must be recalibrated. Until the shock is recognised, results under the fiscal rule will be sub-optimal. No fiscal rule is immune from such a problem.

Until an adverse shock is recognised, and until the necessary action is then taken, a deficit rule will be too lenient, in that GDP estimates used to compute the reference deficit limit in currency will be overstated. The reverse will be true with respect to a favourable shock; in this case, the deficit rule will be too restrictive. The excessive leniency in the case of an adverse productivity shock might be thought to be an advantage, if the lower

productivity coincides with a cyclically weak economy, or if the productivity shock should prove not to be permanent.

A deficit rule using a cyclically adjusted output measure would have only limited advantages. Recognition of a favourable productivity shock would give a larger reference deficit limit in currency, which would give more room for fiscal deficits in what would likely be an already strong economy, and thus would provide at least the potential for pro-cyclical policy. Recognition of an adverse productivity shock would reduce the reference deficit limit in currency, and thus might require pro-cyclical budget tightening in a weak economy. Recognition of any shock that proved to be temporary rather than permanent would require difficult policy readjustments in the future.

A spending rule, as in the instance of a cyclical economic movement, would allow the automatic stabilisers to work in real time. Thus, in an adverse productivity shock, the spending rule would allow counter-cyclical spending to grow and receipts to decline. In a favourable productivity shock, the automatic stabilisers would work in the opposite direction, but still counter-cyclical. But again, the spending rule would not allow further stimulative counter-cyclical policy action.

7.1. Fiscal rules, public investment, and other issues of resource allocation

There has been concern that fiscal rules might prevent the provision of adequate funding for public investment (such as human capital building, infrastructure, research, and so on). This might be thought to be a particular problem with a spending rule because it imposes a cap on annual appropriated spending, through which much of public investment occurs. However, that potential problem is readily avoided. First, the spending rule can be given parameters to achieve any given deficit goal, over any given time profile of fiscal consolidation, with higher annual appropriated spending and a requirement for lower spending and/or higher receipts under the pay-as-you-go category. (This approach could use the same technique described earlier – a “debit” on the “pay-as-you-go scorecard” – that could be used to mandate additional deficit reduction.) Second, as was the case for part of the history of the spending rule in the United States, there could be separate appropriations caps for different categories of spending, which could allow more spending for investment purposes and mandate less spending for other appropriations programmes.

Similar techniques could be used to ensure adequate public investment funding under other fiscal rules. Otherwise, some might fear that any fiscal

rule could distort choices of allocation of resources between public and private uses, or among alternative public uses. On the former point, there will always be difficult choices between public spending with positive societal returns, and private spending; and imposing a system of fiscal constraints only makes such choices more explicit. Those decisions can and should be addressed explicitly at the imposition of a spending rule, and the outcomes need be no less desirable than in any alternative process that achieved fiscal sustainability. And as illustrated above with respect to the allocation of resources toward public investment, a spending rule can encourage explicit debate on alternative uses of public resources, which can only be for the good; and the tools exist under a spending rule to achieve the allocation that is desired by decision makers.

7.2. Deficit rules and core government functions

In the standard theory of public finance, the levels of government spending and revenues should be determined by the marginal cost of raising an additional dollar of public funds and the marginal benefit of spending that dollar. And even in practice, spending decisions are often based upon a rough consensus on an appropriate size and role of government, which in turn presumes at least some stability in the availability of funds.

A fiscal rule that relies upon unpredictable annual upward and downward adjustments of spending and revenue amounts, based solely on fiscal projections and without reference to programmatic considerations, would inject an increased measure of uncertainty and instability in public sector decisions – surely much more instability than the most basic public finance principles would welcome. This instability would most likely reduce the efficiency and effectiveness of the core functions of government. Likewise, uncertainty with respect to tax parameters could lead to inefficient and even pro-cyclical decisions in the private sector. For example, if private decision makers perceive that the economy is strengthening and that tax parameters would therefore become less generous, they might accelerate economic activity – with pro-cyclical effect. The converse pro-cyclical impact would result from instances of economic weakening.

In this respect, a spending rule might be more conducive to the sound operation of the customary functions of government and to greater stability in the expectations held by the private sector. A multi-year spending rule, as was the pattern in the United States, would provide accurate expectations about future appropriations, allowing policy makers and programme managers to plan more effectively, and inducing them to consider the tradeoffs inherent in multi-year allocation decisions. In contrast, a deficit-based rule, which might allow an increase in spending in one year (through

an increase in the allowable deficit in currency) but require a decrease in spending in the next, would make planning much more difficult and might lead government programmes to waste resources in changing course unpredictably. In this regard, as argued above, a spending rule could improve the efficiency of the allocation of resources within the public sector.

Similarly, because a spending rule would allow receipts to fall through the workings of the automatic stabilisers during an economic downturn, the private sector could have reasonable confidence that tax policy would remain stable. In contrast, under deficit-based rules, taxpayers might have to fear tax increases, perhaps shortly after having enjoyed tax cuts, because the economy would weaken and the deficit would rise toward its reference limit. That could lead to pro-cyclical behaviour in the private sector.

7.3. Fiscal rules and monetary policy

The uncertainty in public sector planning (and in private sector planning relative to the tax system), and the potential pro-cyclical bias of a deficit-based fiscal rule, recall why economists have changed their general preference over the last 40 years away from counter-cyclical fiscal policy and toward reliance on the monetary authorities for stabilisation, with spending and tax policy aimed more toward longer-term structural goals. This trend in economic thinking suggests a preference for the greater stability and certainty that could be had in an expenditure-based rule.

The trend in economic thinking toward reliance on the monetary authorities for stabilisation policy would have to be considered in the particular circumstances of the European Union, given its single monetary authority but individualised budget policies. But as was noted earlier, the difference between the United States and the countries of the European Union – and the difference between the European countries' policy flexibility now and several decades ago – though real, should not be exaggerated.

7.4. Outlines of an expenditure rule in a multi-country monetary union

In the instance of a multi-country monetary union such as the EMU, or for other monetary unions that have been discussed in other parts of the world, the following characteristics of a possible expenditure rule would seem pertinent:

- **Coverage:** The PAYGO provisions of the US Budget Enforcement Act (BEA) permit both revenue collections and entitlement programmes to function as automatic stabilisers, but still provide for effective restraint on un-paid-for expansions of entitlement programmes and tax cuts. The US PAYGO appears to be more effective in providing for a counter-cyclical expenditure rule than the Swedish case with minimal – or non-existent – margins for years t and $t+1$, leaving no scope for automatic stabilisers in a cyclical downturn.
- **Time frame:** Three years has been an effective budget horizon for Sweden. Although the United States nominally sets five-year caps, the caps were actually effective for closer to three years, in that the 1991-95 caps were slightly revised and extended in 1993, the 1994-98 caps were increased and extended in 1997, and the 1998-2002 caps were essentially disregarded in their last years. Because of the impending impacts of the retirement of the baby-boom generation, however, a longer time frame might be considered.
- **Country specificity:** All aspects of an expenditure rule could be country specific: the caps; the categories used (capital investments; defence; programmes for the poor; etc.); the deficit/debt targets on which the categories are based; the enforcement procedures (see below); even many of the economic assumptions. This is not to say that some aspects could not be shared by several groups of countries; for example, caps for countries with higher debt or greater demographic problems may be set at different levels than for countries that do not have these problems to the same degree. Similarly, some aspects (treatment of natural disasters and emergencies, for example) may be the same for all countries. The point is that the expenditure rule can provide the flexibility to address most country-specific problems without surrendering the restraints on spending needed to promote long-term fiscal sustainability.
- **Enforcement:** Sweden and the United States provide some lessons on enforcing an expenditure rule even though the characteristics of groups of sovereign countries collectively may be very different from the characteristics for any single country.
 - **Warnings do not work; laws do.** National rules will never be stronger than the political commitment to keep them, because the national legislature can always change the rule. Political support will always be important, but even that will not be enough. Warnings can be ignored too easily, but caps (and

enforcement provisions) that are set in law are difficult to change – procedurally and politically. This implies that caps for each country should be accepted by all the countries in the monetary union, but then also enacted into law by each country individually. The same applies to enforcement procedures. Uniformity of enforcement procedures is less important than having some kind of binding procedure that requires a change in law to ignore or overturn.

- **Statistics matter.** The data on which the caps and enforcement mechanisms are based should be of high quality and consistent across countries. The sovereignty of each country can be protected through the establishment of small, nonpartisan, independent national budget agencies¹¹ in each country to make regular public reports of budget implementation and forecasts. Although created by law in each country, these agencies should be obliged by law to use the concepts, procedures, and definitions on budgetary matters set forth by a central authority, such as the European Commission. Also, these national bodies should be scrutinised by a central authority, to ensure that the data are accurate.

8. Conclusion

In sum, both in abstract analysis and in the practical record, there seems to be little identifiable advantage in the use of deficit rules for fiscal behaviour. If anything, the balance would seem to lean toward spending rules that are simpler and less prone to malfeasance.

The balance between deficit-based rules and spending rules is summarised in Table 1. It weighs the pros and cons of the various options, and highlights the following differences:

- With respect to fiscal responsibility, deficit-based rules that set only (in effect) a maximum limit on the deficit might be thought to encourage countries to run the largest deficits permitted, creating risks of excessive deficits under unexpected adverse conditions. In contrast, a spending rule would provide firm guidance to policy makers whether the economy and the budget are strong or weak.
- With respect to macroeconomic stabilisation, deficit-based rules provide no incentive for counter-cyclical policy in strong economies, and can limit even the operation of automatic stabilisers in the budget in weak economies. In contrast, spending rules allow

the automatic stabilisers to work in full at all times and in any economic conditions.

- Violations of a spending rule are transparent and incontrovertible. In contrast, non-compliance with a deficit rule, including either a reference deficit limit or required progress toward close-to-balance-or-in-surplus status, can be hidden behind optimistic economic assumptions or unlikely plans for future spending and revenue discipline.
- The performance of the core functions of government – its ability to achieve all of the traditional objectives of the public sector – can be adversely affected if the availability of resources is subject to unpredictable decreases or increases based only upon cyclical developments, as can be the case under deficit rules. Spending rules make the availability of resources more predictable, notably with respect to annually appropriated funding for those core functions of government.
- Funding for public investment can be protected under a spending rule, by requiring additional fiscal restraint through mandatory spending or taxes, or by setting a separate appropriations limit for investment.
- In contrast to the unpredictable fiscal constraints imposed by deficit rules, the more predictable fiscal behaviour encouraged by spending rules can lead to easier co-ordination with monetary policy, and to greater confidence and steadier behaviour within the private sector.

Based on this analysis, and in the judgment of the current authors, policy analysts should consider this alternative approach to fiscal policy making carefully.

Table 1. Alternative fiscal rules

	Deficit rule	Cyclically adjusted deficit rule	Spending rule
Fiscal responsibility:			
Expansion	Encourages larger deficit	Encourages larger deficit	Requires that surplus be saved
Recession	May require a smaller deficit	May require a smaller deficit	Allows deficit to grow
Macroeconomic stabilisation:			
Expansion	Pro-cyclical	Pro-cyclical, but less so than unadjusted deficit rule	Counter-cyclical, through automatic stabilisers
Recession	Pro-cyclical	Pro-cyclical, but less so than unadjusted deficit rule	Counter-cyclical, through automatic stabilisers
Administrability	Verification more difficult	Verification more difficult	Verification easier
Credibility	Status more contentious	Status more contentious	Status more transparent
Public investment	Can be protected	Can be protected	Can be protected, possibly better than under deficit rules
Core government functions	Volatile funding	Volatile funding	Predictable funding
Monetary policy	Co-operation difficult	Co-operation difficult	Co-operation easier

Notes

1. See, among others, European Commission (2003, p. 52), and Gros *et al.* (2004).
2. Blinder (1982) highlights this concern; Canzoneri *et al.* (2002) give this consideration less weight.
3. The failure of the United States to follow its own rule in recent years should not be seen as an inherent flaw of the rule, any more than should the SGP necessarily be indicted because the larger member countries have flouted it. Rather, the current analysis seeks to evaluate the alternative rules for their relative merits, understanding that “Although all rules, including those prescribed by legislation, are intended to apply strictly and permanently – over successive governments – they are, in practice, open to some interpretation and conceivably can be revised, suspended, or repealed through subsequent legislative action” (Kopits and Symansky, 1998, p. 8).
4. Kopits and Symansky (1998, p. 4) and Kopits (2001, p. 6) would characterise the US budget rule not as a fiscal policy rule, but as a procedural rule. Readers who prefer the latter characterisation may construe this paper as a comparative analysis of a deficit fiscal policy rule and a spending procedural rule. The current authors see no reason to conclude pre-emptively that either rule is necessarily superior or inferior on the basis of such a characterisation.
5. Even this picture may understate the degree of uncertainty in the 2001 US budget outlook, and similarly in all other years. The US federal government, by convention, does not revisit its estimates of budgetary consequences of its policy changes; the original estimates stand into the indefinite future. Then, after accounting for the previously estimated policy effects and for the effects of errors in economic forecasts, all remaining errors in budget predictions are assigned to a residual “technical” category. Notwithstanding that policy effects are not re-estimated officially, it is generally the case that economic weakness would reduce the “true” budgetary effects of most tax cuts (certainly those based on reductions in tax rates) in an accounting sense. This is simply because the cost of a tax rate cut would be less if there were less income to tax. It is not because of any presumed effect of tax cuts on the supply of factors of production, or on productivity. Note that the relationship between the cost of entitlement spending programmes (even those with counter-cyclical purposes) and the state of the economy *ex post*

is probably not so systematic and strong. Thus, if the actual budget path in Figure 2 were recalculated today, using currently known information, the cost of the policy steps would likely be lower and, as a direct result, the adverse economic and technical re-estimates would be larger, in equal dollar amount; and the “baseline” budget outcome, without the policy decisions, would have been even worse than depicted in Figure 2.

6. An additional use of cyclical adjustment by the SGP is to assess the required 0.5% of GDP minimum fiscal adjustment for countries out of compliance with the SGP, making references to the existing concept of cyclically adjusted balance (CAB). This application of cyclical adjustment is fully legitimate, though it does not address the other problems of deficit rules raised here.
7. The United States once attempted to enforce a deficit rule for a fiscal year in progress to achieve the actual budget outcome mandated in the targets, based on estimates at the beginning of that year. The US process used only automatic, across-the-board spending reductions; in general, such enforcement could occur through tax increases as well. In practice, such enforcement could require spending cuts that would be painful and impossibly large. Because some major spending items, such as medical care and old-age pensions, could not practically be subject to substantial short-term reductions, the base for cutting spending to enforce the rule would likely be relatively small. And even annual appropriations can be difficult to cut over a time span of several months, given that some of the annual appropriations concern the fulfilment of contracts, some of which are long-term. Therefore, it is easily possible that such spending cuts would be obviated by legislation, eroding the credibility of the budget enforcement process. In practice, all of the significant attempts to enforce the US budget rules through automatic spending cuts were overridden by subsequent legislation, with only the smallest cuts enforced.
8. The generic term “productivity shock” is used to denote any potentially enduring change in the rate of growth of potential output. One-time shocks to the budget, whether favourable or adverse, present a much simpler choice under any fiscal rule: their effects must be either offset or accepted (or some arithmetic compromise between the two).
9. To avoid ambiguity, the current authors do not use the word “discretionary” (which in the United States refers to all annually appropriated spending, but elsewhere is often used to denote decisions made on fiscal policy). Instead fiscal policy decisions are described as “judgmental”.

10. “...even governments enjoying a solid reputation may want to refrain from pursuing discretionary countercyclical fiscal policy in view of the associated implementation lags, irreversibility, and political constraints. In fact, accumulated evidence on the ineffectiveness of discretionary activism suggests that they should rely simply on a fiscal rule that allows for the operation of automatic stabilizers” (Kopits, 2001, p. 8).
11. See Gros *et al.* (2004), and European Commission (2004, p. 113).

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Appendix

Expenditure rules in Finland, the Netherlands, and Sweden

Finland

In addition to the rules that come with being a member of the EMU, Finland has introduced further national expenditure rules. Expenditure ceilings were introduced in Finland in the late 1980s and early 1990s. The initial aim was to strengthen the budget process; in recent years the problems of an aging population have resulted in increased support for the ceilings. The Budget Law mentions in general terms that the government is to set frames for expenditures; however, the ceilings are not just a political commitment but also a customary practice of Finland's government.

The ceilings are set for four years on a rolling basis. They are set in real terms and for central government only, although they include transfers to sub-national governments. Cyclical expenditures – such as unemployment benefits and accommodation subsidies, interest on central government debt, and expenditures that are matched by revenues from the European Union – are excluded. All in all, around 75% of central government expenditures are under the ceiling and account for around 20% of GDP.

When the current government took office it stated a number of fiscal policy objectives, including reducing the central government debt to GDP ratio, securing balanced central government finances in national account terms, and controlling growth of central government spending in real terms. Controlling central government spending is a key feature. The ceiling is stated in real terms and adjusted to nominal terms according to price development for different expenditure items every year.

The Finnish system also includes a “brake” to avoid excessive deficits, stating that the government will take actions, even in conditions of weak economic development, if the deficit according to forecasts will be higher than 2¾% of GDP.

Furthermore, there have been recent discussions about expenditure control for sub-national governments. In a country like Finland, with a high degree of sub-national decision making enshrined in the Constitution, it may be hard for the central government to impose binding rules with sanctions.

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The Netherlands¹

In the Netherlands, after a dramatic increase in deficits in the early 1980s, the government embarked on a new policy to bring deficits down. After some success, however, a high structural deficit limited the scope for allowing automatic stabilisers to work, and required the government to take judgmental measures to meet the targets. From 1989 to 1994, budget projections were frequently overtaken by downward revisions in economic activity, forcing the government to introduce new fiscal packages with greater budget savings than the original budgets. This system of “continuous budgeting” resulted in major decisions on an *ad hoc* basis and at the last minute. As a result, it was recognised that the framework for budgeting had to be reformed.

In 1993, the minister of finance appointed a study group on the budget that recommended a new budget formulation system focused on the **level of expenditures**, rather than the **level of the deficit**,² and on cautious economic assumptions. This created more stability, as any extra revenue would not automatically translate into extra expenditures, and the cautious economic assumptions would help compensate for uncertainty.

In new coalition agreements between different political parties, separate caps on expenditures were to be established for each of the three sectors of the Dutch budget: the “core” budget sector; the health care sector; and the social security and labour market sector. The coalition agreements would also incorporate the multi-year expenditure projections of each ministry as the basis for sub-caps for each minister within the “core” budget sector. Caps were to be established in real terms, which serve to prevent the coalition agreements from having to be re-opened during the course of the government’s term of office. Transfers were to be permitted between sectors and between sub-caps established within the “core” budget sector. Surpluses in one area, however, could be used only to fund **existing** policies that are experiencing higher costs than projected. The consent of the entire cabinet would be required to finance **new** proposals.

Budget over-runs must be offset in the area of the over-run. In exceptional cases, the cabinet may decide that more than one ministry should contribute to financing an over-run. There are strong “firewalls” between revenue and expenditures. If the budgetary situation turns out more favourable than anticipated, then some of the extra revenues may be used to cut taxes, depending on the size of the remaining deficit.

The new budget process has been the key to the successful turnaround of public finances in the Netherlands. The coalition agreements have proven to be an excellent instrument for control, both before and after the Netherlands joined the European Monetary Union.

Sweden

In the early 1990s Sweden experienced a recession and the most severe fiscal crisis since the Second World War. A weak budget process was identified as part of the problem.³ A reform was initiated that led to significant changes in the budget process in the second half of the 1990s. The introduction of a nominal expenditure ceiling for the central government in 1997 was an important part of the reformed budget process. The ceilings on expenditure were accompanied by a top-down budget process and a surplus target for the general government sector of 2% of GDP over the business cycle. In 2000, a balanced budget requirement was introduced for local governments. Although the expenditure ceilings are not explicitly derived from the overall surplus target, the surplus target is taken into account when setting the expenditure ceilings.⁴

Annual nominal expenditure ceilings are set three years in advance as part of the budget process, and are considered to be binding. The ceilings apply to central government primary expenditure, including transfers and grants to local governments, plus expenditures by the old-age pension system outside the central government budget. Each year, as part of a rolling budget framework, an additional ceiling is applied to expenditures three years out.⁵ The ceilings for years $t+1$ and $t+2$ could in principle be altered, but this has not happened since the system was adopted in 1997 (except for technical adjustments). The ceilings are set with a margin over projected expenditures to allow for some policy flexibility and, more importantly, for increases in cyclical spending during an economic downturn. An attempt by parliament to change a proposed budget has to be presented in the form of a complete package that respects the previously determined expenditure frames and ceilings. This requirement has strengthened the hand of the minister of finance in the budget process and has made it more difficult for the budget to be defeated or amended in parliament.

Nominal expenditure ceilings have been an effective means of achieving the surplus target in Sweden. In fact, the ceilings together with a prolonged economic upswing, where revenue collections continuously exceeded projections, produced surpluses that exceeded 2% of GDP between 1999 and 2001. As a result of the expenditure ceilings, fiscal headroom produced by this boom was saved or used for tax cuts rather than for expenditure increases. However, the margins for cyclical fluctuations have been fully used during economic upturns even though they were intended to be only a safety cushion during unexpected downturns. As a result, the ceilings came under pressure following the 2002-03 downturn, forcing the government to scale back some expenditure commitments. The habit of using all headroom under the ceiling for expenditure increases and using the ceiling more as an expenditure target is worrisome and has contributed to a general government surplus lower than 2% of GDP since 2002, but still the ceiling has been important in reducing the expenditure ratio for the central government in the late 1990s and after that keeping it at a stable level.

Apart from the tendency to use up the margins for expenditure, Sweden's fiscal framework has two potential weak spots. First, expenditure restraint has been less evident at the local level, where most government consumption takes place, than at the central government level. Second, the government has resorted to the limited use of tax expenditures to introduce new policies without breaching the ceiling or requiring balancing measures.

Notes

1. This section is drawn from Jón R. Blöndal and Jens Kromann Kristensen (2002), “Budgeting in the Netherlands”, *OECD Journal on Budgeting*, Vol. 1, No. 3, pp. 43-80.
2. 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 Barry Anderson (1999), “Budgeting in a Surplus Environment”, PUMA/SBO(99)3/FINAL, OECD, Paris.
3. For a more thorough description of Swedish fiscal rules, see, for example, Urban Hansson Brusewitz and Yngve Lindh (2005), “Expenditure Ceilings and Fiscal Policy: Swedish Experiences” (paper presented at the Banca d’Italia Workshop on Public Finance, held in Perugia, 31 March-2 April) or Willem Heeringa and Yngve Lindh (2001), “Dutch Versus Swedish Budgetary Rules: A Comparison” (paper presented at the Banca d’Italia Workshop on Public Finance, held in Perugia, 1-3 February).
4. Or using the words of the 2005 Spring Fiscal Policy Bill: “One fundamental factor in the Government’s deliberations on expenditure ceilings is the determination to keep expenditures at a level that is compatible with the public finances surplus target, while also ensuring margins for conducting an active labor market policy and meeting unforeseen expenses, such as costs associated with climate-related and other natural disasters.”
5. Between 1997 and 2001 the ceiling for $t+3$ was set by parliament in the spring (March-May). Since 2002 it is instead proposed in the Budget Bill and decided in the autumn (September-November). In autumn 2004 no ceiling was set for 2007. Instead, the government planned to propose ceilings for both 2007 and 2008 in the Budget Bill for 2006 (in autumn 2005).

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