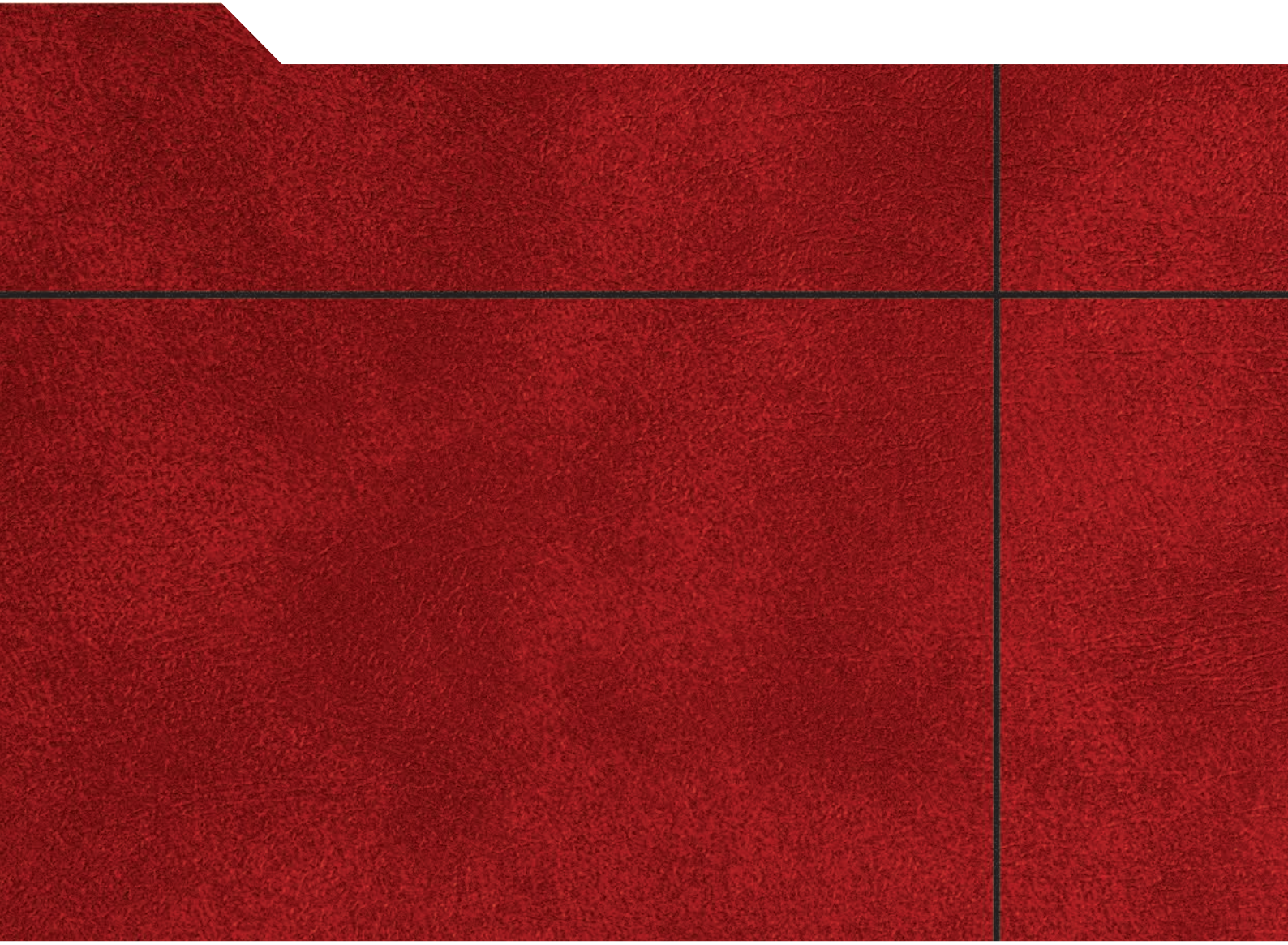
OECD Journal on Budgeting



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Budgeting for federal insurance and retirement programmes: Cash or Accrual

Federal retirement programmes and some federal insurance programmes have long-term effects on the budget. But the federal budget process typically uses cash-based accounting measures that cover a 10-year period, which may be too short to accurately report those programmes' net budgetary effects over the long term. In contrast, using accrual accounting for such programmes would accelerate the recognition of long-term costs and would display the expected costs of new commitments when they were incurred and thus were most controllable. However, such estimates are less transparent and verifiable than cash-based estimates, involve more uncertainty, and can complicate budget reporting.

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Keywords: accrual budgeting, federal budgeting, federal insurance, federal retirement

1. Introduction

The federal budget serves many important functions, including tracking the government's cash flows, serving as a key instrument in national policymaking, summarising how fiscal policy changes over time, and communicating the nature and scope of governmental activities. The net costs of federal activities are estimated throughout the federal budget using two fundamentally different measures—cash accounting and accrual accounting. The principal difference between cash and accrual accounting lies in the timing of when the commitment (or collection) of budgetary resources is recognised. Transactions in cash-based accounting are recorded when payments are actually made or receipts collected. In contrast, accrual measures record the estimated value of expenses and related receipts when a commitment is first made rather than when subsequent cash transactions occur. Accrual measures summarise—as a single number in net-present-value terms—a programme's anticipated cash flows over many years by adjusting (discounting) future payments and income for the time value of money to make that stream of transactions comparable to an equivalent lump sum at a specific time.[1] Currently, most federal activities are recorded in the budget on a cash basis; the major exception is federal credit programmes, which are recorded on an accrual basis.[2]

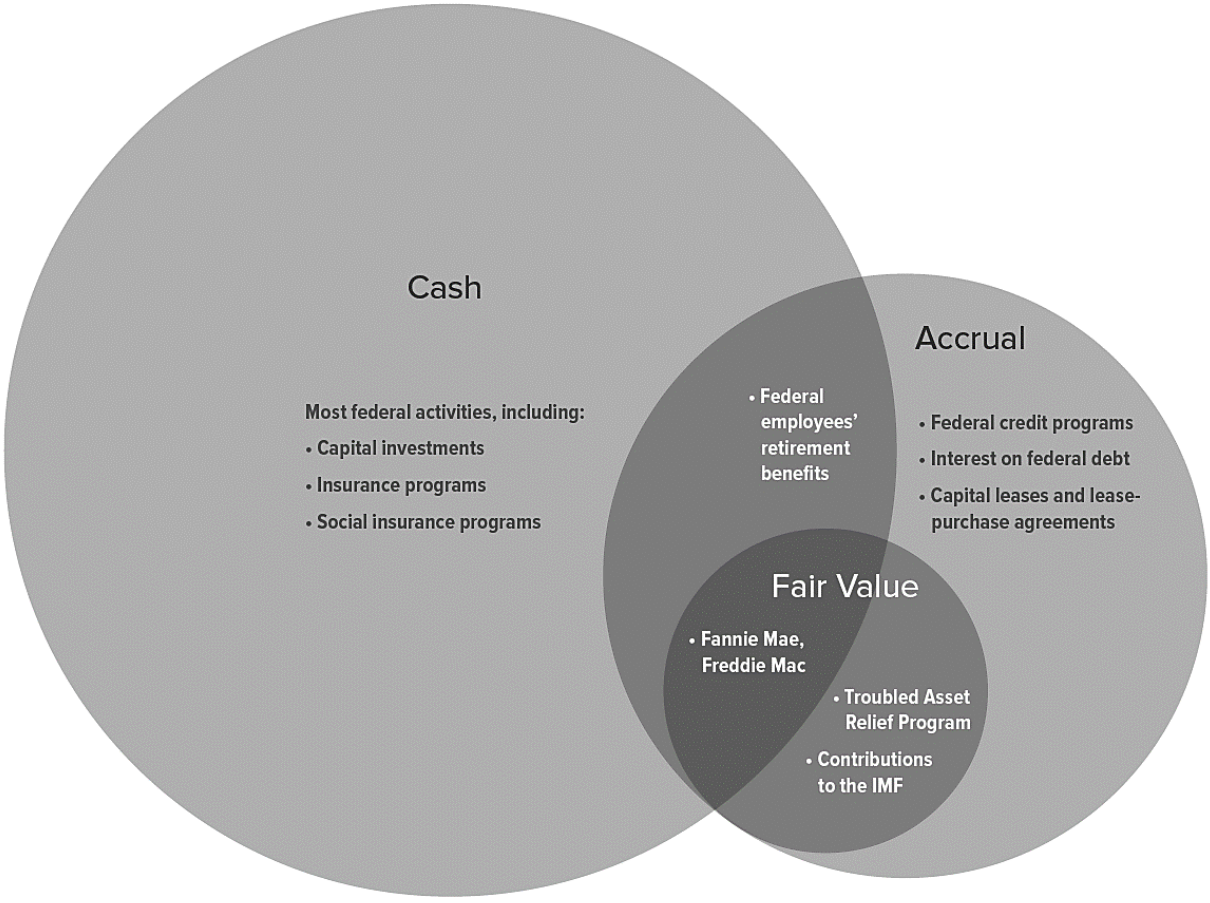
Recognising the full cost of decisions up front is a key pillar of budgeting. Whether programmes are accounted for on a cash or accrual basis can, in some cases, significantly affect the size and timing of their estimated budgetary effects, measures of which are used by policymakers to allocate limited federal resources. Factors for assessing whether accrual measures offer helpful information include whether they provide a complete and relevant picture of a programme's budgetary effects, are practical and accurate enough to use in the budget process, and are appropriate for the various types of federal commitments.

The federal budget process primarily uses cash-based measures of budgetary effects over the next 10 years, but that period may not be long enough to capture the full extent of some effects. Accrual-based estimates that consider long-term effects provide more complete information about programmes that involve longer time frames, such as some federal insurance programmes and federal civilian and military retirement programmes. Those estimates make it easier to compare the costs of programmes that differ in the timing of their cash flows; however, accrual estimates are less transparent and verifiable than cash-based estimates, involve more uncertainty, and can make the budget process more complex.

2. How accrual accounting currently works in the federal budget

Accrual measures are used in the federal budget for a few activities—mainly federal credit programmes (such as student loans and mortgage guarantees), interest on the debt, and capital leases (Figure 1). Those measures help policymakers compare the net costs of programmes despite differences in the timing of their cash flows (CBO 2018a). The largest differences between accrual measures and cash measures occur in federal credit programmes.

Figure 1. Current budgetary treatment of selected federal programmes



Note: Transactions in cash-based accounting are recorded when payments are actually made or revenues received. Accrual measures summarise in a single number the anticipated net financial effects at a specific point in time of a commitment that will affect federal cash flows many years into the future. That is, accrual methods record expenses when the commitment is first made rather than when subsequent cash transaction occur. The fair-value approach reflects the market value of the federal government's obligations
IMF = International Monetary Fund.
Source: CBO

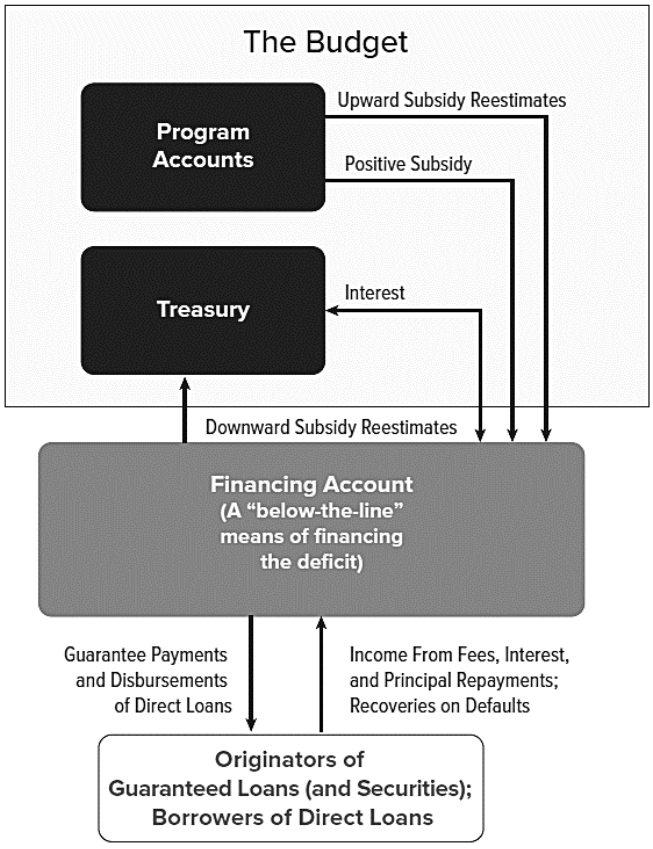
2.1. FCRA-based budgetary treatment

The Federal Credit Reform Act of 1990 (FCRA) specifies that the budget reflect the anticipated net cost (or savings) of a loan or loan guarantee - known as the subsidy cost - on an accrual basis when the loan is disbursed (Phaup 1996). Policymakers made the switch from cash to accrual accounting to more accurately measure the full net cost of credit programmes over the long term, to facilitate comparisons of the net cost of direct loans, loan guarantees, grants, and other programmes, and to improve the allocation of budgetary resources.

For each credit programme, the FCRA approach requires two accounts: an on-budget *programme* account and a non-budgetary *financing* account (Figure 2). The programme account shows (on an accrual basis) the net subsidy costs over the life of the programme's loans, and the financing account reflects (on a cash basis) cash flows between the government and non-federal entities, such as originators or borrowers of federal loans. (FCRA specifies that the administrative costs of those programmes be recorded separately and accounted for in the programme account and the budget on a cash basis.) Whereas the transactions of programme accounts are included in measures of the deficit; cash flows to and from financing accounts

are excluded. (In technical terms, those cash flows are considered a means of financing the deficit.) If the programme has a positive subsidy (that is, anticipated net costs over the life of the loans), the programme account makes an accrual-based payment to the financing account to cover the net present value of expected costs for each credit cohort (all the loans or loan guarantees that the programme obligates in a given year); that payment is recorded as an outlay in the budget. If the programme has a negative subsidy, the financing account makes an accrual-based payment to an on-budget receipt account in the Treasury; that receipt counts as a negative outlay in the budget.

Figure 2 The budgetary treatment of federal credit programmes with positive subsidy cost



Notes: For each programme, credit reform accounting requires two accounts: a programme account and a financing account. (In addition, if the subsidy is negative, an on-budget receipt account is necessary).The programme account shows the net subsidy costs, and the financing account reflects the cash flows that make up those subsidy costs.

The cash flows between the financing account and originators of guaranteed loans (and securities) or borrowers of direct loans are a means of financing the deficit and are excluded from the calculation of the budget deficit — that is, they are "below-the-line" accounts.

If the credit programme has a positive subsidy, the programme account makes a single payment to the financing account for each credit cohort (If the credit programme has a negative subsidy, the financing account makes a payment to a receipt account in Treasury).

Re-estimates of the subsidy costs are annual. A positive (or upward) re-estimate results in payment from the programme account to the financing account. A negative (or downward) re-estimate results in a payment from the financing account to the on-budget receipt account in the Treasury.

The annual interest payments between the Treasury and the financing account can also flow in either direction. If the financing account has been a net borrower, it pays interest to the Treasury. If the financing account holds government securities, then the Treasury makes interest payments to the financing account.

Source: CBO

Under FCRA, agencies prepare accrual-based re-estimates of the subsidy costs for existing credit cohorts each year, reflecting the most recent information about the programme. Like the original estimates of subsidy costs, a positive (or upward) re-estimate results in a payment from the programme account to the financing account. A negative (or downward) re-estimate results in a payment from the financing account to the receipt account. Interest transactions, which can flow in either direction between the financing account and the Treasury take into account the time value of money (the fact that a dollar today is worth more than a dollar at some future date because it can earn interest in the interim). Over time, as credit subsidy re-estimates are made to align initial estimates with the cash flows that actually result and the net budgetary effects of the programme are fully reflected in the programme account, the inflows or outflows of the programme's financing account should net to zero.

2.2 Fair-value budgetary treatment

In addition to the accounting approach taken under FCRA, a related approach, known as fair value, can be used to provide a more comprehensive measure of the costs of federal credit programmes and other types of financial assistance (CBO 2018b, CBO 2019a). FCRA measures do not fully account for the cost of the risk the government takes on when issuing loans or loan guarantees; hence, they make the reported cost of such transactions lower than the cost that private institutions would assign to similar credit assistance on the basis of market prices. The fair-value approach seeks to incorporate a full measure of that risk by reflecting the market value of the federal government's obligations.[3]

The difference between the two approaches lies in their treatment of the cost of that market risk, which is the component of financial risk that remains even after investors have diversified their portfolios as much as possible.[4] Market risk arises from shifts in macroeconomic conditions, such as productivity and employment, and from changes in expectations about future macroeconomic conditions. Loans and loan guarantees expose the government to market risk because future repayments of loans tend to be lower when the economy as a whole is performing poorly and resources are more highly valued.

To incorporate the cost of market risk, the fair-value approach uses market prices to measure the cost to the public of federal loans and loan guarantees; that process generally entails using the discount rates on expected future cash flows that private financial institutions would use. In contrast, the FCRA approach uses the interest rates on Treasury securities to discount future cash flows. Those market-based discount rates are higher than Treasury rates; the difference effectively reflects the market risk inherent in the underlying cash flows.[5]

3. Advantages and disadvantages of cash and accrual measures

In the budget, cash and accrual measures have advantages and disadvantages (Redburn 1993, Khan 2013, Warren 2015).

- Cash measures are transparent and verifiable, and they largely track changes in debt held by the public, which is a key measure of the government's fiscal condition (Schick 2007). They also work well for programmes with short timing lags.
- However, the cash measures used in the federal budget process may provide incomplete information about some programmes with longer timing lags; for those programmes, a significant portion of cash flows stemming from near-term commitments occur after the 10-year budget period (GAO 2019).
- In combination with truncated time horizons, cash accounting introduces opportunities for policymakers to adjust budgetary outcomes through timing shifts—that is, by instituting nonsubstantive policies that simply delay payments or accelerate receipts without materially changing their underlying value (Irwin 2012).

- Accrual measures succinctly convey whether policy changes are expected to increase or decrease the deficit over the long term, thereby facilitating comparisons of the net cost of programmes with cash flows that differ in timing (or exposure to market risk) and potentially improving lawmakers' opportunity to control long-term costs when commitments are initially made (Phaup 2019).
- Accrual estimates, however, are methodologically complex, sensitive to technical assumptions, subject to the uncertainties of projecting programme activity far into the future, and more volatile than cash measures.
- Accrual measures are harder to explain and understand than cash measures, particularly if they incorporate market risk.
- Increasing the use of accrual measures in the budget would pose implementation and transition issues (Khan and Mayes 2009). Formally adopting accrual-based budgetary treatment would require new account structures and re-estimates to reconcile present-value estimates with actual cash flows.

In the context of federal budgeting, accrual measures offer mixed incentives. They strengthen lawmakers' incentives to consider the long-run budgetary effects of legislation by providing a way for proposals that would affect the budget after the 10-year period to be credited with long-term savings (or charged with long-term costs). But broader use of accrual measures might also let lawmakers use expected savings from potentially unsustainable legislative changes - such as significant cuts to federal retirement benefits in the long term - to finance near-term spending increases or tax cuts. In the future, lawmakers might feel it necessary to reduce or reverse the scheduled cuts to benefits. But because the short-term steps that raised spending or lowered revenues would have already occurred, undoing the scheduled cuts would add to the pressures on the federal budget.

Moreover, adding more accrual measures to a largely cash budget could create situations in which activities that might be similar would have different budgetary treatments, giving a programme's advocates an incentive to seek to categorise their programme in whichever manner would result in the preferred treatment.

4. Using accrual measures of federal insurance programmes in the budget process

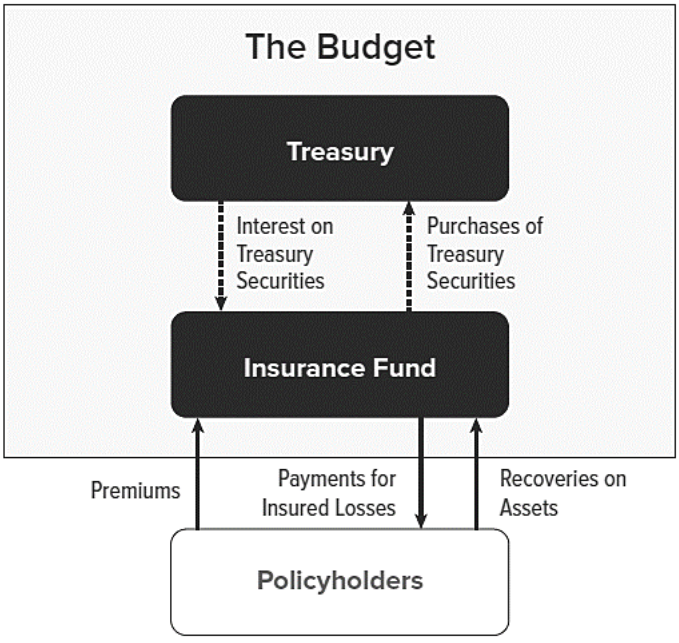
To make well-informed choices about federal insurance programmes, policymakers need accurate measures of the extent to which a programme's income is expected to cover the costs stemming from the risk assumed by the government. But the 10-year cash estimates used in the federal budget process may not span a period long enough to cover the full budgetary effects attributable to some insurance programmes, particularly when long lags occur between commitments and resulting cash flows. That problem may be exacerbated for programmes in which the timing of cash inflows and outflows do not coincide closely. In such cases, accrual measures that summarise anticipated cash flows over many years in net-present-value terms might help to highlight potential fiscal imbalances and options for addressing them (CBO 2018c, Phaup and Torregrosa 1999, GAO 1997, GAO 2007).

4.1. Creating a new account structure for federal insurance programmes

Budgeting for insurance programmes on an accrual basis would require a new account structure, which could be modelled on FCRA budgeting for credit programmes. The key step would be to create an insurance fund (which would function like a financing account for a credit programme) that would serve as a non-budgetary accounting mechanism for tracking a programme's cash flows. For programmes such as deposit and flood insurance, the existing accounting mechanisms used to track cash flows would serve that purpose. Premiums and other income would be credited to the insurance fund, which would disburse

payments for claims and other expenses. Under current budgetary accounting, the transactions of such funds are shown in the budget (Figure 3). With accrual accounting, those cash flows would not be recorded in the budget. Instead, an on-budget accounting mechanism (similar to a programme account under FCRA) would record the estimated subsidy cost of each year's cohort of insurance commitments (Figure 4). That cost would be the net present value of all future cash flows expected to stem from insurance commitments included in that cohort. If the FCRA model was followed, analysts would need to make periodic re-estimates to reconcile the accrual estimates with actual cash flows for each insurance cohort.

Figure 3. Current budgetary treatment of federal insurance programmes

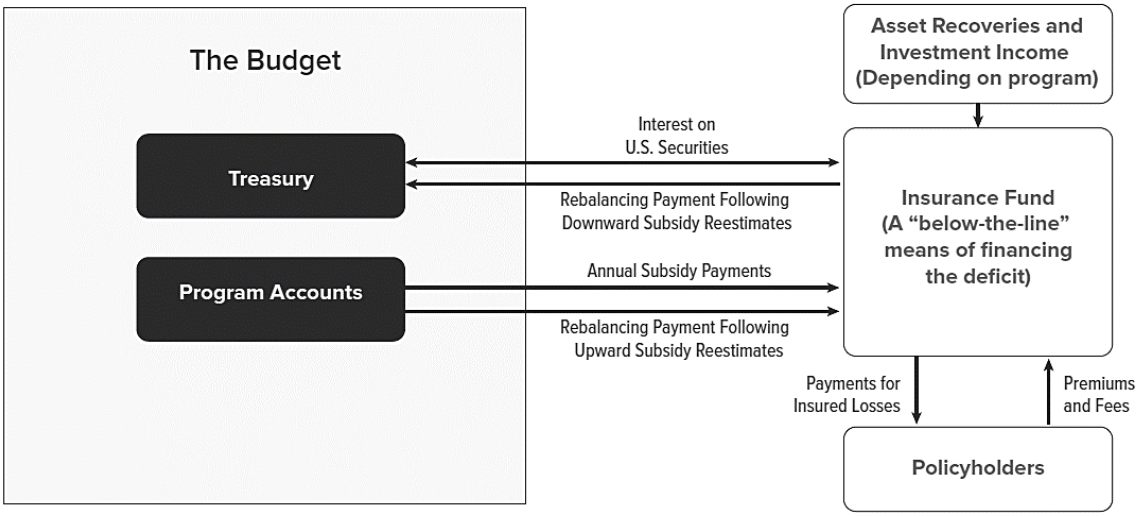


Notes: Dashed lines indicate intragovernmental transactions (amounts paid by one part of the government to another). Administrative costs are not shown.

Annual interest payments between the Treasury and the insurance fund could flow in either direction. If the insurance fund had been a net borrower, it would pay interest to the Treasury. Alternatively, if the insurance fund held government securities, the Treasury would pay interest to it.
Source: CBO

In the transition to an accrual budgetary treatment, policymakers would need to create a clear onetime separation between costs related to past commitments in existence at the time of the transition and costs related to new commitments. Following the approach used when FCRA was adopted, lawmakers could create liquidating accounts to report the cash flows of existing insurance policies and claims. That separation would be particularly important for pension insurance because payouts related to past commitments (for single-employer plans that have already been taken over and multiemployer plans that are currently insolvent) could continue for decades.

Figure 4. An accrual approach to budgeting for federal insurance programmes with positive subsidy costs



Notes: Administrative costs are not shown.

The cash flows between policyholders and the insurance fund, as well as asset recoveries and any investment income on private securities would be a means of financing the deficit and would be excluded from calculations of the deficit (In other words, the insurance fund would be a "below-the-line" account). That treatment matches how financing accounts for credit programmes are treated under credit reform accounting.

If an insurance programme is estimated to have a net cost, the programme account would make a single payment to the insurance fund for each insurance cohort, as shown in the figure. Alternatively if an insurance programme is expected to result in net savings, the insurance fund would make a payment to a receipt account in the Treasury.

Subsidy re-estimates would be made periodically (For credit programmes, subsidy re-estimates are generally prepared on an annual basis for each cohort). A positive (or upward) re-estimate would result in a payment from the programme account to the insurance fund. A negative (or downward) re-estimate would result in a payment from the insurance fund to the receipt account in the Treasury.

Annual interest payments between the Treasury and the insurance fund could flow in either direction. If the insurance fund had been a net borrower, it would pay interest to the Treasury. Alternatively, if the insurance fund held government securities, the Treasury would pay interest to it.
Source: CBO

Policymakers also would need to decide whether accrual measures for insurance programmes should incorporate market risk. Federal insurance programmes expose the government to market risk if their claims are likely to be higher (or their income lower) than usual when the economy as a whole is performing poorly. For programmes that face a significant amount of market risk, such as pension and deposit insurance, accounting for that risk would result in more comprehensive estimates of federal costs (CBO 2005). However, including market risk might involve considerable analytical judgment and would cause those estimates to be more difficult to understand.

4.2. Usefulness of accrual measures for certain federal insurance programmes

Relative to 10-year cash estimates, accrual measures may be particularly useful for some insurance programmes.

- For the Federal Deposit Insurance Corporation's resolutions of troubled financial firms, carried out through the Orderly Liquidation Fund (OLF) and the Deposit Insurance Fund (DIF), annual cash flows may not be a good indicator of the net costs of a given year's transactions—especially during

or after a financial crisis, when losses are large. For any particular year or 10-year period, a snapshot of cash flows may not capture all of the up-front costs of resolving troubled institutions (if those resolutions occurred before the projection period) or all of the offsetting income from fees assessed on the financial industry (particularly if those receipts are expected to occur after the projection period). Accrual measures would largely eliminate timing-related distortions for resolution activities and, if calculated on a fair-value basis, would provide a fuller estimate of expected costs. Alternatively, some of the drawbacks of using cash measures for the OLF and the DIF could be lessened by keeping the cash budgetary treatment of losses and income but excluding transactions that involve working capital from estimates of the budget deficit.[6]

- For federal flood insurance, 10-year cash estimates may be dominated (particularly in the near term) by costs that stem from past events. By focusing instead on expected losses and income related to the insurance commitments made during a given period, accrual measures might help to highlight the programme's structural imbalances.
- For the Pension Benefit Guaranty Corporation (PBGC), 10-year cash measures fail to convey the size of the imbalance between the agency's resources and its liabilities for future claims. Because of the long timing lags that typically occur between inflows and outflows in PBGC's pension insurance programmes, cash-based projections currently show net savings from those programmes. Accrual measures would present a more accurate measure of PBGC's long-term commitments.

4.3. An example: Estimating the cost of federal pension insurance

The rules that govern how pension plans are funded expose the Pension Benefit Guaranty Corporation to the risk of large losses - losses that far exceed PBGC's ability to absorb them. In particular, the rules that specify how plans' assets and liabilities are valued for purposes of determining the minimum amount of funding that employers must provide to pension plans create an incentive for plans' managers to invest in risky securities, such as common stocks. The value of those assets can fluctuate considerably over time, whereas the benefits promised by plans remain fairly fixed. Thus, a drop in the value of those assets can lead to major underfunding of plans, which makes their insolvency more likely. The fact that most pension plans use risky investment portfolios to fund their benefit liabilities exposes PBGC's insurance to a great deal of market risk - in that PBGC is vulnerable to the risk that many plans will become significantly underfunded when returns on those investments are low, particularly when economic conditions are weak.

To illustrate the magnitude of the differences between alternative measures of the cost of pension insurance, CBO prepared three estimates in May 2019 based on the net claims that PBGC's multiemployer programme is projected to face from insolvencies over the next 21 years (CBO 2016; Kiska, Levine, and Moore 2017):[7]

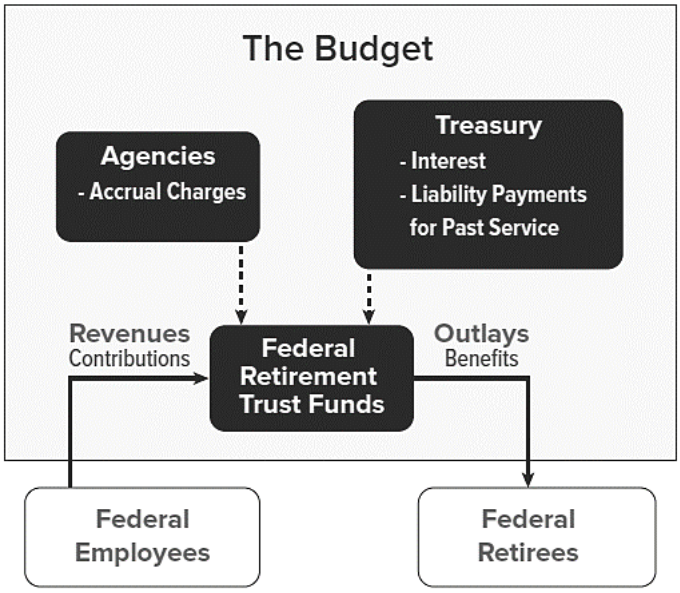
- On a cash basis, CBO projected that claims for financial assistance from multiemployer plans would total USD 58 billion over the 2019–2039 period. But the multiemployer programme's projected resources during that period (USD 8 billion in premiums and interest) would limit the amount of claims that could be paid to USD 8 billion, resulting in unpaid claims of USD 49 billion.[8]
- Using the FCRA approach, CBO estimated that total projected lifetime claims from multiemployer plans expected to become insolvent during the 2019-2039 period have a present value of USD 64 billion. The multiemployer programme's projected income from premiums and interest over that period has a present value of USD 6 billion, resulting in a net-present-value cost of USD 58 billion.[9]
- On a fair-value basis, CBO estimated that total projected lifetime claims from multiemployer plans expected to become insolvent during the 2019-2039 period have a present value of USD 73 billion. That figure is larger than the FCRA-based estimate because of the significant amount of market risk that the multiemployer programme is exposed to. The net present value of income from premiums and interest is the same, USD 6 billion, resulting in a net-present-value cost of

USD 67 billion. That fair-value estimate approximates the amount that a private insurer would need to be paid to assume PBGC's obligations to pay all claims from multiemployer plans expected to face insolvency over the next 21 years.

5. Using accrual measures of federal retirement programmes in the budget process

Federal budget totals reflect the cost of almost all benefit programmes for federal retirees on a cash basis, as the benefits are paid.[10] Thus, the effect of those programmes on the budget deficit is the difference between cash outflows for benefits and related cash inflows (mainly from federal workers' contributions toward their future pensions) in a given year (Figure 5). In many cases, however, individual agencies record those benefits differently. Most agencies' annual budgets are charged for some of the costs of future retirement benefits that their employees earn in the current year. Those charges are calculated on an accrual basis and are credited to the federal retirement funds that will pay the benefits when they become due. Although accrual charges attribute the long-term costs of those benefits to agencies' current budgets, they are recorded as intragovernmental payments (transfers from one part of the government to another) and have no net effect on the deficit. In contrast, agencies' contributions to the Thrift Savings Plan (TSP), a defined contribution pension plan similar to 401(k) plans used in the private sector, are immediately reported as budget outlays.

Figure 5. Current budgetary treatment of federal retirement costs



Note: Dashed lines indicate intragovernmental transactions (amounts paid by one part of the government to another).
Source: CBO

5.1. Creating a New Account Structure for Federal Retirement Benefits

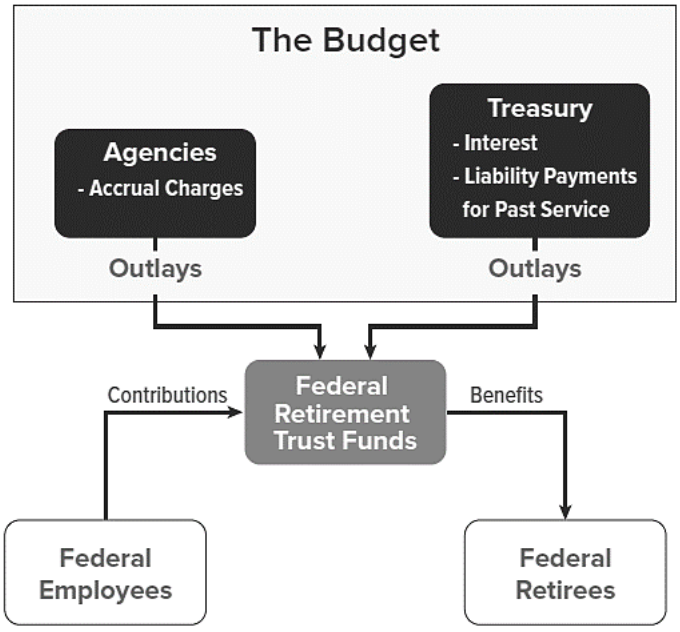
Following the FCRA approach, if retirement programmes were recorded in the budget on an accrual basis, the retirement trust funds used to track cash flows between federal agencies, retirees, and current workers would become non-budgetary ("below the line") accounts for tracking programmes' cash flows—similar to financing accounts for credit programmes (CBO 2019b). New accounts would have to be set up for

retirement benefits that are currently paid from the Treasury's general fund rather than from retirement trust funds. All of those non-budgetary accounts would be excluded from calculations of the deficit.

The budget would record the following transactions with those non-budgetary accounts as outlays (Figure 6):

- Agencies' annual accrual charges, which would measure the budgetary resources being conveyed to the non-budgetary accounts used to track programmes' cash flows;
- The Treasury's net positive or negative outlays for any re-estimates considered necessary, over time, to reconcile the balances of the non-budgetary accounts with plans' liabilities and for payments to gradually fund the cost of benefits earned by past employees before agencies began making accrual payments;[11] and
- Annual interest payments from the Treasury to those accounts on their holdings of Treasury securities.

Figure 6. Potential accrual budgetary treatment of federal retirement costs



Source: CBO

Under an accrual budgetary treatment, those federal payments to non-budgetary accounts would factor into measures of the deficit, which could improve the budget's usefulness in identifying how government spending for federal retirement benefits might affect the economy. Transactions between those non-budgetary accounts and individuals - such as contributions from current workers and spending for benefits to current retirees - would be recorded on a cash basis in the accounts and have no direct effect on the deficit. In the current system, by contrast, those transactions are recorded on a cash basis in the budget.

A more limited approach for increasing the use of accrual measures in accounting for federal retirement benefits in the budget would require agencies to expand the scope of benefits for which they incur annual accrual charges. Agencies already pay most of the accrued normal cost of pension benefits (a measure of the additional liability to pay benefits that a retirement plan accrues during a year because of work performed in that year) for civilian employees to the government's retirement trust funds. However, no

federal civilian agency makes accrual payments for retirees' health care benefits; those costs are charged (on a cash basis) to the Office of Personnel Management rather than to the employing agencies. The Department of Defense's (DoD's) budget already reflects accrual costs for pension benefits and for the supplemental cost of health care for military retirees who qualify for Medicare. But DoD's budget does not cover accrual costs for other health care benefits for its retirees.

Expanding the scope of accrual charges would significantly affect agencies' budgets.[12] Unless an agency received a funding increase to cover the cost of new accrual charges, that change would require the agency to devote more of its annual budget to personnel-related costs, potentially constraining programme spending.

5.2. Advantages and disadvantages of accrual measures for federal retirement programmes

Although cash-based measures are transparent and readily verifiable, accrual measures can improve decision-making and give a clearer picture of the annual change in the long-term sustainability of the government's retirement programmes, for several reasons.

- The cash-based estimates used in the budget to account for federal retirement benefits can provide incomplete and potentially misleading information—mainly because of the sizable time difference between when commitments to provide benefits are incurred and when those benefits are paid, coupled with the truncation caused by the 10-year budget period. The fact that some retirees' benefits may be paid over many decades also contributes to the shortcomings of 10-year cash-based measures. That situation may contribute to a tendency to weight the government's mix of current and deferred compensation more heavily toward deferred compensation (Leonard 1986).
- Accrual measures would recognise the costs of retirement benefits when they were incurred and thus when they were most controllable by policymakers.
- By measuring all forms of current and deferred compensation on a consistent basis, accrual estimates might enable more meaningful comparisons between alternative compensation structures. For example, accrual measures would highlight budgetary trade-offs between current and deferred compensation or between traditional defined benefit pensions and defined contribution TSP accounts (CBO 2017).
- By summarising long-term budgetary effects up front, accrual measures would give policymakers a more accurate sense of whether and how much proposed changes to deferred compensation would increase or decrease the deficit over the long term. That perspective is especially important when considering changes to defined benefit pensions, which involve commitments over long periods of time.
- Accrual measures would make it harder for lawmakers to engineer more favourable budgetary outcomes by shifting the timing of a programme's cash flows (such as by delaying the payment date for monthly pension benefits to the next fiscal year to reduce the reported deficit in the current year).

Using accrual measures for federal retirement programmes would have some drawbacks, however, compared with cash-based measures.

- Accrual measures are more methodologically complex and potentially harder to understand. For example, accrual measures for pension plans are based on actuarial estimates that incorporate forecasts of future interest rates, wages, length of employees' service, and mortality rates.
- Accrual estimates generally have a wider range of uncertainty because of their longer time horizons and their reliance on the technical assumptions used to discount the value of future cash flows. Thus, accrual estimates are typically subject to larger revisions than cash-based estimates. In particular, small changes in discount rates could lead to large re-estimates of accrual measures.

Such updates could cause swings in the deficit, as re-estimates for federal credit programmes do, but the swings attributable to re-estimates for retirement benefits might be larger.

- Transitioning to accrual measures and implementing those changes would pose challenges. For example, policymakers would need to determine how to report the cost of USD 5 trillion of existing federal liabilities for retirement benefits.[13] In addition, new federal accounts would need to be established to reconcile accrual estimates with actual cash flows.

5.3. An example: Estimating the cost of modifying federal retirement benefits

In a recent report, CBO analysed a policy that would replace the defined benefit Federal Employees Retirement System (FERS) for newly hired federal civilian workers with an expansion of the defined contribution TSP (CBO 2017). The option would eliminate the FERS pension, boost the government's automatic TSP contribution to 10% of an employee's salary, and eliminate the government's matching contribution.[14]

CBO examined how the option would change federal spending for civilian workers on a cash basis and an accrual basis (under the assumption that appropriations would be adjusted by an amount commensurate with the accrual estimates). On a cash basis, CBO measured federal outlays (for payments of pension benefits and the government's contributions to employees' TSP accounts) and revenues (from employees' contributions toward their future pensions) in nominal terms over the coming 10 years and as a share of the nation's gross domestic product over 75 years. When measuring costs on an accrual basis, by contrast, CBO estimated the percentage of the salaries of all new employees that the government would need to set aside each year to fully fund those workers' pension and TSP benefits.

For illustrative purposes, CBO compared the cash and accrual costs for federal workers who would be hired in 2018. On a cash basis, the option would impose costs in the near term because it would require larger up-front outlays for the government's TSP contributions. But relative to current law, costs would be lower in the future, particularly when employees affected by the option retired. The accrual estimate captures that effect.

Specifically, CBO estimated that the option would have had the following effects:

- It would have *increased* the government's net retirement costs for employees enrolled in FERS by 17% over 10 years on a cash basis but would have *reduced* net cash outflows by about 3% over 75 years on a present-value basis.
- It would have reduced accrual costs for new employees by 29% because the government's contributions to fully fund those workers' benefits would have dropped from 14.2% of salary to 10.0%.[15]

6. International experience with accrual accounting and budgeting

The Organisation for Economic Co-operation and Development (OECD) reports that since the early 2000s, several of its member countries have expanded their use of accrual measures for financial accounting and budgeting; others have retained cash-based measures (OECD and IFA 2017, van Helden and Reichard 2018). For OECD countries that use accrual-based budgeting to recognise their commitments, the basis used to allocate resources to pay those commitments also varies (Blöndal 2006). For example, New Zealand and the United Kingdom use accrual-based appropriations that are similar to the subsidy-cost appropriations used for federal credit programmes in the United States. In such cases, although laws that provide funding reflect accrual measures, government agencies have access to the full amounts of cash necessary to execute programmes. Other countries use cash-based appropriations, perhaps indicating a preference among policymakers to retain control over the amount of cash provided to agencies.

Some of the OECD countries that have more fully embraced accrual-based budgeting have already seen advantages from expanding the use of such measures for government-funded pensions. Pension obligations for public-sector employees usually constitute a country's largest government liability after sovereign debt, and some nations have concluded that simply controlling government borrowing is not sufficient to ensure long-term fiscal sustainability. Using accrual measures may help countries control their long-term obligations. For example, when accrual budgeting in New Zealand and the United Kingdom made the costs of civil servants' pensions more transparent and the size of the existing commitments clearer, policymakers took steps to reduce pension costs for new employees (Irwin 2012, GAO 2000). New Zealand switched from defined benefit plans to defined contribution plans for public-sector workers. To offset growing liabilities for the pensions of its public employees and military personnel, Australia created a sovereign wealth fund in 2006 that it cannot draw on until 2020 (Moretti and Youngberry 2018, Warren 2015, GAO 2007).

7. Conclusions

Using accrual measures to calculate the costs of some insurance programmes and federal retirement programmes could improve decision-making by providing more complete information about those programmes' long-term effects. The costs of new commitments would be reported when they are incurred and thus are most controllable by policymakers. When market risk is present, fair-value estimates would provide a more comprehensive measure of costs and help policymakers more fully understand the trade-offs between certain policies. For insurance programmes, the more comprehensive information provided by fair-value estimates would allow for more meaningful comparisons of the costs of competing programmes and a greater focus on risk when setting premiums. For federal retirement programmes, accrual measures would facilitate direct comparisons between all forms of current and deferred compensation (such as wages and pensions), making the cost of alternatives clearer to policymakers.

Compared with cash-based measures, however, accrual measures have several limitations. Their longer time horizons and their reliance on technical assumptions make them potentially harder to understand, more uncertain, and subject to larger revisions. Furthermore, implementing accrual measures in the budget would require new account structures and decisions about how to address the cost of commitments that have already been made.

Notes

1. Calculating such a present value depends on the rate of interest (known as the discount rate) used to translate future cash flows into current dollars. For example, if USD 100 is invested on 1 January at an annual interest rate of 5%, it will grow to USD 105 by 1 January of the next year. Hence, with a discount rate of 5%, USD 105 payable a year from today has a present value of USD 100.

2. The budget also reports the federal government's interest costs as outlays when they accrue, not when they are paid; however, the difference between the cash and accrual measures is small for most of the Treasury's debt issues.

3. That approach is used in CBO's baseline projections and legislative cost estimates related to Fannie Mae and Freddie Mac, two government-sponsored enterprises now in federal conservatorship. The Office of Management and Budget, however, does not treat those entities as governmental.

4. For example, individuals can diversify their investments in stocks through mutual funds and stock index funds, such as those tracking the Standard & Poor's 500—an index of 500 of the largest U.S. firms. Those investments minimize the idiosyncratic risk of any single company but still expose investors to overall declines in the stock market.

5. The fair value of an asset is defined as the price that would be received if that asset was sold in an orderly transaction between market participants. Similarly, for a liability such as a loan guarantee, the fair value is the price that would have to be paid to induce a market participant to assume the liability.

6. Working capital refers to the portion of up-front spending used to acquire assets of insolvent institutions that is expected to be offset in future years by receipts from the sale of those assets.

7. PBGC's multiemployer programme insures benefits for about 10 million participants in plans offered by groups of employers, typically in a unionized industry as part of a collective bargaining agreement.

8. CBO estimated that PBGC's multiemployer revolving fund, which holds only Treasury securities, will earn less than USD 500 million in interest over the entire period. Under current law, PBGC is allowed to pay claims for financial assistance only to the extent that its accumulated assets (premium payments and interest income on its investments) permit. CBO projects that the multiemployer programme will be insolvent in 2025. The amount of financial assistance paid, not

the total amount of claims, is recorded in the federal budget as the multiemployer programme's outlays.

9. Accrual estimates of premiums implicitly account for any interest that would be earned on the multiemployer programme's revolving fund. Thus, CBO does not distinguish between premium income and interest income in its accrual projections.

10. The federal government also faces separate long-term commitments to pay benefits to eligible veterans. Almost all of those benefits are reported on a cash basis. Switching to accrual measures for veterans' benefits would involve a number of budgetary challenges (CBO 2019b).

11. Such payments to or from the Treasury might be needed to adjust the accounts' balances for changes in actuarial assumptions and experience. Re-estimates would probably be made at the programme level rather than for every cohort, which would simplify the process and reduce the administrative burden. For pension plans operated by the private sector or by state and local governments, the standard funding practice is for a plan's sponsor to make not only normal-cost payments but also amortisation payments (including for liabilities for past service) to align the pension fund's balance with the plan's liabilities. The Treasury currently makes a series of amortisation payments to the largest federal retirement trust funds.

12. When the Administration, in its 2003 budget request, proposed accruing retirement costs for federal employees, it also proposed increasing agencies' budget authority to cover the newly recognised expense. Otherwise, agencies would need to cut spending for other discretionary expenses or reduce employment to pay the increased accrual charges (CBO 2002).

13. Actuaries estimate that as of September 30, 2018, those liabilities included USD 3.7 trillion in pension liabilities for federal civilian employees and military personnel and USD 1.2 trillion in liabilities for retirees' health care benefits (Department of the Treasury 2019).

14. Under current law, federal employees hired in 2018 contribute 4.4% of their salary to the FERS pension. The government makes an automatic TSP contribution of 1% of salary and matches employees' contributions up to an additional 4%.

15. Those estimates do not reflect the Office of Personnel Management's recent revisions to its actuarial assumptions, which increased the normal cost for most employees as of 1 October 2019. (The normal cost is a measure of the additional liability to pay benefits that a retirement plan accrues during the year because of work performed in that year.)

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Can subnational accounting give an early warning of fiscal risks?

The early detection of state and local fiscal problems can help in resolving them quickly before they turn into crises. Early detection should be easier if subnational governments prepare high-quality accounts. A survey and case studies were therefore undertaken to investigate the nature of subnational accounting in OECD and key partner countries, as well as the use of subnational accounts by national governments that monitor subnational finances. The results show that in many countries subnational accounting has characteristics that should help in the early detection of fiscal problems, including the use of accrual accounts prepared according to largely harmonised standards. Many national governments use a wide range of indicators from the accounts to monitor the financial health of subnational governments. However, there is room for progress including in the monitoring of non-financial assets and reporting of currently off-balance sheet liabilities.

The research and preparation of this report was conducted by Tim Irwin, OECD expert, and Delphine Moretti, Senior Policy Analyst in the Budgeting and Public Expenditure division, under the supervision of Sean Dougherty, Senior Adviser to the Network on Fiscal Relations across Levels of Government. Dave Bean (GASB), Pietrangelo De Biase, Flavia Giannini, Fatos Koc and Scherie Nichol (all OECD), and Hilde Marie Skarvang (Norway) provided comments or other assistance that was most appreciated. The report was prepared for the OECD's Network on Fiscal Relations across Levels of Government and the Senior Budget Officials' Network on Financial Management and Reporting.

JEL codes: H60, H70

Keywords: Subnational accounting, fiscal risks, balance sheets, monitoring

Executive Summary

The importance of state and local governments in many countries means that their fiscal problems can have serious repercussions not only for local public services but also for national public finances. This study looks at accounting practices in subnational governments and the use that national governments make of the accounts when they monitor subnational finances. It draws on a new survey on subnational accounting and the monitoring of subnational finances sent to OECD countries and partners, as well as six case studies.

Concerning accounting frameworks, in a large majority of countries, accounting standards for subnational governments are at least partly harmonised, including in most federations. In three-quarters of the countries, the common standards require accrual accounting – about the same proportion as among national governments (see Moretti, 2016). In virtually all countries annual accounts are published or available to citizens upon request within a given time lag. There is also growing recognition that reliable financial reporting entails not only good accounting standards but also sound external control.

There are, however, significant differences in subnational accounting practices among OECD countries. Standard-setting is often the responsibility of a national government ministry, but is sometimes the responsibility of an independent standard-setter. The standards themselves are sometimes based on standards used by the national business sector, sometimes on international standards, and sometimes on multiple frameworks. There are also many approaches to auditing, ranging from the most conventional (audit by the supreme audit institution) to the least conventional (self-auditing).

Whether problems in the comprehensiveness, timeliness, reliability and comparability of subnational financial information identified in past studies (OECD/KIPF, 2016: Chapter 6) have been addressed is difficult to answer. Anecdotal evidence and case studies prepared for this study suggest that some problems still exist. First, a number of countries are still aiming to strengthen accounting requirements for subnational governments, e.g. by moving from national accrual standards to International Public Sector Accounting Standards. Second, some reports from supreme audit institutions identify a range of problems with the accounts prepared by subnational governments, including incomplete balance sheets or the lack of consolidation of extra-budgetary subnational entities and corporations.

Overall, answers to the survey suggests that countries are facing understandable difficulties in managing a fundamental trade-off in subnational governments' accounting: the need for comprehensive, timely and reliable reporting of financial operations for the identification of fiscal risks requires sophisticated accounting standards and practices, which in turn requires capacities and resources for accounting departments and audit institutions that may be difficult to mobilise at subnational level. While the survey on which this study is based did not include questions on how this trade-off is handled, answers sometimes mentioned noteworthy initiatives.

In certain countries, larger subnational governments' accounts recognise a broad range of assets and liabilities (including those related to pensions, derivatives and public-private partnerships), but for smaller subnational governments the trade-off between quality and cost is handled by allowing smaller subnationals to produce less disclosures in their financial statements. Some countries make timely monitoring easier by having subnational governments report on a quarterly or even a monthly basis, but only for headline-financial indicators. Concerning external control, while some flexibility may be granted concerning the modalities for the audit of individual accounts, the supreme audit institution may be tasked with the preparation of a summary report on the financial situation of subnational governments and their annual financial audits, allowing the identification of any widespread problems.

Concerning monitoring practices, the survey shows that most national governments monitor subnational finances in some way, even sometimes in those countries where they do not have any authority to intervene to solve subnational fiscal problems. In the latter case, the rationale for the monitoring may be a shared responsibility for complying with fiscal rules that apply to the whole of general government or the

public sector. The objective of the monitoring may however vary: sometimes, the national government gathers information to identify early warning signs of financial problems in individual subnational governments, independently from any fiscal rule. It can be said that in such cases that the Ministry of Finance performs an advisory function, rather than surveillance.

National governments consider that subnational accounting currently provides information that is helpful for the detection of fiscal problems and the prevalence of uniform standards makes monitoring simpler. The indicators that are most commonly monitored are debt and the cash deficit, but the availability of accrual data allows the use of new indicators found only in accrual accounts in more than half of the countries surveyed, such as liabilities (defined as including not just ordinary debt but also accounts payable, leases and other items). Some countries mentioned that they specifically monitor pensions, arrears or guarantees.

Nevertheless, the survey's results suggest a few possible remaining gaps in the way monitoring is done. Only a few countries monitor subnational governments' net financial worth or net worth, meaning that the understanding of their financial situation and risks is limited. For example, focusing only on debt and other liabilities does not allow the national government to identify early signs of future problems in relation to losses accumulated by entities owned by subnational governments (unless their accounts are consolidated). It also makes early detection of problems in relation to riskily high levels of investment in infrastructure or deteriorating infrastructure more difficult.

In addition, although the survey did not include any question on the preparation of forecasts by subnationals, it is worth noting that some subnationals do produce financial forecasts, which are an important supplement to historical information. Good monitoring requires subnationals to prepare fiscal forecasts, discuss the factors that could cause outcomes to differ from the forecasts and explain their ability to cut spending or raise revenue if outcomes turn out to be worse than forecasts.

Finally, this study notes that the use of benchmarking and comparative analysis could be developed and is likely to be most useful if there are many subnational governments and if there is sufficient time series data on their finances, circumstances and financial problems. In such cases, it may be possible to develop a statistical model that identifies which indicators have best predicted subnational fiscal problems in the past and to use the model to help predict future problems.

1. Introduction

1.1. The subnational context

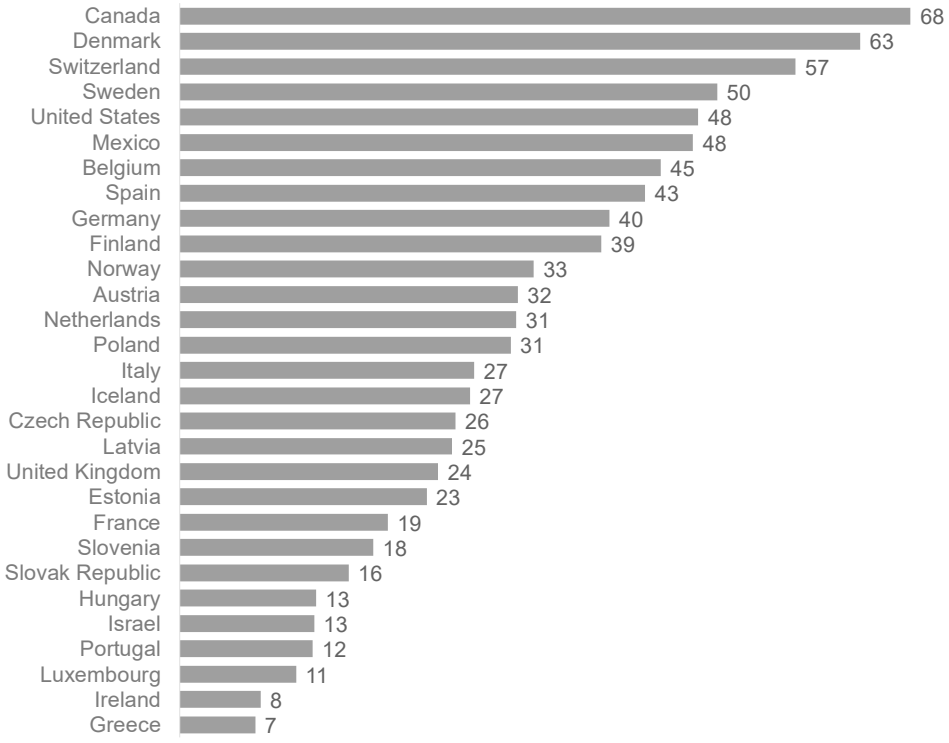
Subnational governments provide crucial public services in OECD countries at the state and local levels. They are usually responsible for local infrastructure, including roads and water supply, and they are often responsible for education, health care and other social services. In federations and decentralised unitary countries such as the Nordics, they may account for as much as 50% of government spending (Figure 1). Their share in government debt is usually lower, but subnational debt is nevertheless more than 10% of GDP in about the half the OECD countries for which data are available (Figure 2). Data on subnational assets are less widely available, but subnational governments' role in the provision of infrastructure suggests they are likely to own a large share of public non-financial assets in many countries. In Australia, to take one example, they own 89%.[1]

The importance of subnational governments in many countries means that subnational fiscal problems can have serious repercussions not only for local public services but also for national public finances. Initially, it is the local population that suffers from such problems. Infrastructure investment and maintenance tend to be cut back, jeopardising the future quality of services. If the problems are severe enough, they can also lead to cuts in staff and operating expenses in areas such as education and health care, creating immediate problems for essential public services. Ultimately, however, subnational problems can become national fiscal problems. For one thing, the national government may feel obliged to step in to remedy the deterioration of public services. It may also have guaranteed the debts of subnational governments. Or it may simply judge that the national costs of allowing subnational governments to default on their debt are greater than the costs of bailing them out.

Although systematic data on subnational fiscal problems are not available, examples are easy to find. Spain's fiscal problems during the European debt crisis of the early 2010s were compounded by those of the autonomous communities of Andalucía, Catalonia and Valencia (Jenker and Lu, 2014). In the United States, the financial crisis caused Illinois to suffer severe financial difficulties, and the city of Detroit to file for bankruptcy. In Brazil, the State of Rio de Janeiro declared a "state of public financial calamity" in 2016, and some other states have since followed suit (Rodrigues, 2019). Similar problems have arisen, at various times and in varying degrees of severity, in many OECD countries (see, *e.g.*, Allers, 2014; Baskaran, 2014; von Hagen et al., 2000; National Audit Office, 2018; Herold, 2018 and 2020; and this article's Annexes). It would not be surprising if the coronavirus pandemic of 2020 also caused serious financial problems for some subnational governments (OECD, 2020).

Figure 1. Spending of subnational governments as a percentage of the spending of general government

OECD countries, 2016



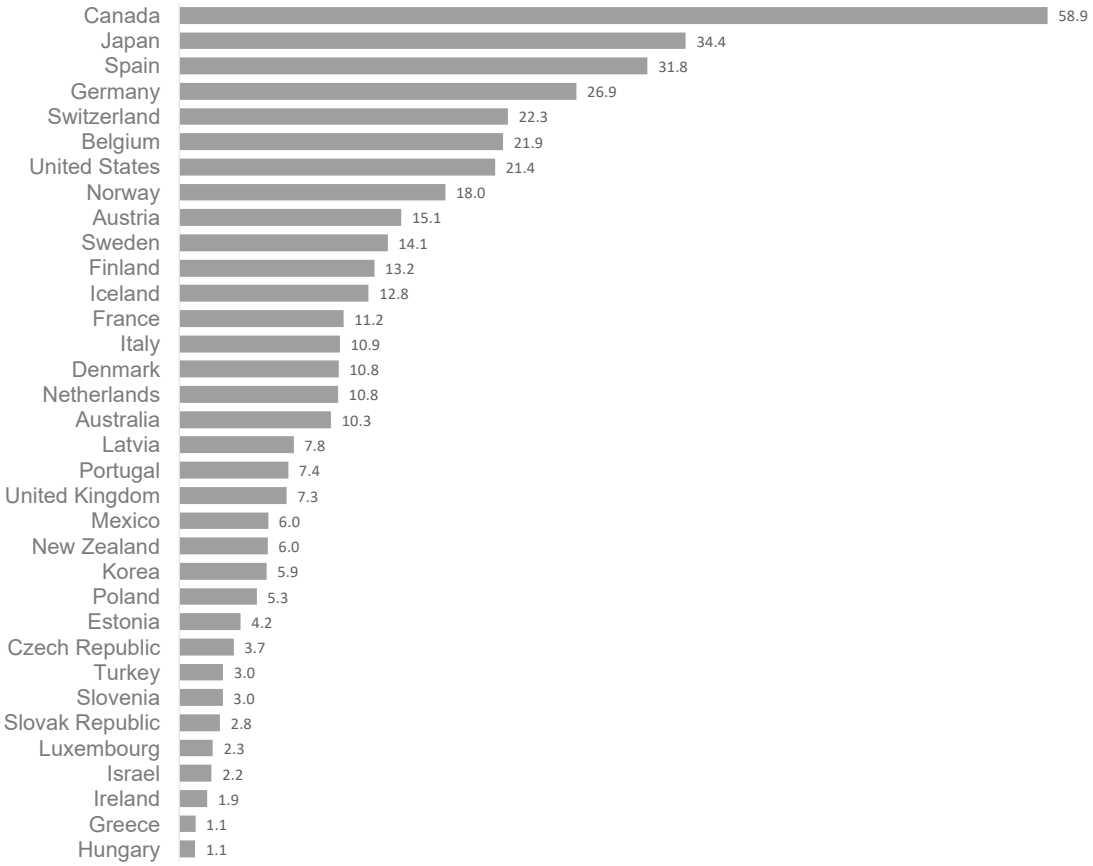
Note: The spending of each level of government excludes its transfers to other governments. Estimates are not available for all countries. For Mexico, the estimate is for 2015. For the United States, the estimate excludes local government: it is spending by state governments as a percentage of spending by states and the federal government.
Source: OECD Fiscal Decentralisation Database, Table 5 (accessed 7 July 2019).

1.2. The role of national governments

National governments can try to mitigate the fiscal risks of subnational finances in at least two main ways (OECD/KIPF, 2016: Chapter 5; Herold, 2018). They can disclaim responsibility for subnational debts and thus minimise moral hazard and encourage citizens, journalists, researchers, lenders, credit-rating agencies and others to monitor subnational finances (the "no-bailout strategy"). Alternatively, they can establish fiscal rules and other constraints that aim to prevent subnationals from accumulating too much debt or otherwise taking on excessive risks and then monitor the subnationals to check compliance with the rules and to look for signs of trouble even when rules are not broken ("the control-and-monitor strategy") (see, *e.g.*, Sutherland, Price and Joumard, 2006). Other strategies are possible, though some run the risk of creating moral hazard without imposing controls strong enough to prevent excessive risk-taking. In addition, the chosen strategy is sometimes complemented by the creation of an insolvency regime for subnationals to reduce the problems created by subnational failures (Herold, 2020, in this volume).

Figure 2. Debt of subnational governments as a percentage of GDP

OECD countries, 2016



Note: Estimates are not available for all countries. For Israel, Japan, Mexico, and New Zealand, the estimates are for 2015; for Switzerland, the estimate is for 2014. For Australia and the United States, the estimates exclude the debt of local government.
Source: OECD Fiscal Decentralisation Database, Table 19 (accessed 11 October 2019).

Under both main strategies, solving subnational fiscal problems before they become crises requires subnationals to prepare high-quality accounts. Specifically, the accounts should be up to date, which means that they should be produced reasonably frequently and with a reasonably short time lag. They should be reliable, which means, among other things, that they should be audited. They should be easy to understand, which is more likely if, among other things, they follow a common set of standards. And they should be comprehensive. Accounting information on subnational governments' debt and cash flows is crucial, but early detection of problems is more likely if the accounts include more than this. A subnational balance sheet, for example, may suggest problems in the maintenance and renewal of assets, while data on accrual expenses may show that cash outflows are being controlled only by delaying the payment of bills. Data on liabilities associated with pensions, public-private partnerships, and subnational enterprises may reveal serious fiscal risks even though the conventional direct debt of the subnational government remains modest. Of course, not even the best accounting can reveal all looming subnational fiscal problems: a banking crisis, major natural disaster, or a pandemic can quickly create fiscal problems for subnational governments even with strong finances. Timely, reliable, understandable, and comprehensive accounting should, however, provide early warnings of some subnational financial problems, and also provide information on the extent to which subnationals have the financial strength to weather sudden negative shocks.

1.3. Objectives of the study

The study draws on a new survey on subnational accounting and monitoring of subnational finances sent to OECD countries and key partners, and includes a closer look at practice in six countries – Australia, Brazil, France, Germany, Iceland and the United States. Together, these countries illustrate a variety of institutional relationships between national and subnational governments and a variety of approaches to the problem of preventing subnational fiscal crises (see Annexes). This survey was answered by 30 OECD countries and 3 partner countries totalling 33 countries.

The study examines the accounts that subnational governments produce and how that information is used by national governments. Section 2 looks specifically at accounting practices. Using the answers to the questionnaire, it considers whether subnational governments follow uniform accounting standards and, if so, who sets the standards; whether the standards are cash or accrual-based and what they are based on; and who audits the accounts and how timely they are. Looking in more detail at a small number of countries, it also considers some of the variety in the details of accrual accounts, including the scope of consolidation and the comprehensiveness of the recognition of assets and liabilities other than conventional debt. Section 3 then looks at the monitoring of accounts by national governments. Using the answers to the questionnaire, it examines whether national governments monitor subnational accounts and whether they have the authority to intervene in case of problems. For those governments that do monitor their subnationals, it then looks at issues such as which agency does the monitoring and which indicators are monitored.

2. Accounting

2.1. Approaches to standard-setting

An advantage of decentralisation is that subnational governments can experiment with different approaches, allowing others to learn from their successes and failures. As US Supreme Court Justice Louis Brandeis observed, a “state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.” Subnationals’ finances can sometimes pose a risk to the rest of the country, however, and when they do there is a strong case for common accounting standards that ensure a high level of transparency and comparability (OECD/KIPF, 2016). Such standards do not, of course, prevent subnationals from experimenting with the additional information they provide.

2.1.1. Accounting standards are generally harmonised

Having uniform standards is easier in unitary countries. Of the 24 survey respondents classified here as unitary countries,[2] 10 have a common set of standards for all governments including the national government, and 12 have a common set of standards for subnationals that differs from the standards followed by the national government (Table 1). South Africa is distinctive in that the national government and the provinces follow one set of standards, while municipalities follow a different set.

Surprisingly, a high degree of standardisation occurs also in the nine federations surveyed. Four of them have common standards for national and subnational governments, and two have harmonised standards for subnationals that are different from the standards for the national government. In most cases, these common standards are adopted on a voluntary basis, and compliance with them may not be universal. Two federations in which there is less standardisation are Belgium and Germany.

Common standards make information easier to understand and compare, but do not ensure perfect comparability. Sometimes accounting standards allow for more than one option in the treatment of an issue, and even when there is only one option there may be different ways to interpret the standard.

Perhaps most important, compliance with the standards may be imperfect, as reportedly in Brazil and Mexico.

Table 1. Consistency of standards across national and subnational governments

Subtotals for unitary states and federations

	Similar for national and all subnational	Similar for all subnational	Not similar
Unitary Countries	**10:** Czech Republic, Estonia, Latvia, Lithuania, New Zealand, Portugal, Slovak Republic, Turkey, United Kingdom, China	**12:** France, Greece, Iceland, Ireland, Israel, Japan, Korea, Luxembourg, Netherlands, Norway, Poland, Sweden	**2:** Italy, South Africa
Federations	**5:** Australia, Austria, Canada, Spain; Brazil	**2:** Switzerland, United States	**2:** Belgium, Germany

Note: For Italy, the harmonisation of standards within subnational government is only partially done.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 2: Is there one set of accounting standards for all governments or all subnational governments or do the standards vary, for example, by region or level of government?

2.1.2. The means for imposing common standards are country-specific

The means for defining common standards vary between unitary countries and federations (Figure 3). In unitary countries, the national government often sets accounting standards for subnationals, with the responsibility typically attributed to the Ministry of Finance (9 countries) or the Ministry of Interior (7 countries). Ministries of finance are more likely to be involved if there is one set of standards for all governments. In three unitary countries – Iceland, Norway and Sweden – standard-setting responsibility lies with an independent body that includes representatives of national government, local-government associations and sometimes auditors.

In most federations, independent standard-setters establish standards that can be adopted by subnational governments. In Australia, the commonwealth government and the states have agreed to follow standards based on International Financial Reporting Standards (IFRS) set by the Australian Accounting Standards Board (an independent government entity). A similar mechanism exists in Canada. In Switzerland, a set of accounting standards was developed cooperatively and is "widely applied" by cantons according to the questionnaire response. In the United States, many subnational governments follow the standards set by the (private) Governmental Accounting Standards Board. Similarly, the national government in Austria (in particular the Ministry of Finance in agreement with the Court of Auditors) has the authority to set accounting standards for subnational governments based on International Public Sector Accounting Standards (IPSAS).

2.2. Accounting basis for subnational accounts

Accounting standards are generally classified as "cash basis" or "accrual basis" (see *e.g.*, Moretti and Youngberry, 2018). Cash-based accounts are easier to prepare because they are simpler and require fewer judgements and estimates. That means they are also easier to understand and less vulnerable to manipulation by means of dubious judgments or optimistic estimates. Reliable cash-based accounts and measures of conventional debt also provide much of the information needed for monitoring subnational finances. They show whether a subnational government is generating enough cash to service its debts, and they allow the national government to establish rules that limit subnational deficits and debt. Where cash accounting also requires the recording of contractual commitments, information on committed future cash outflows is also available.

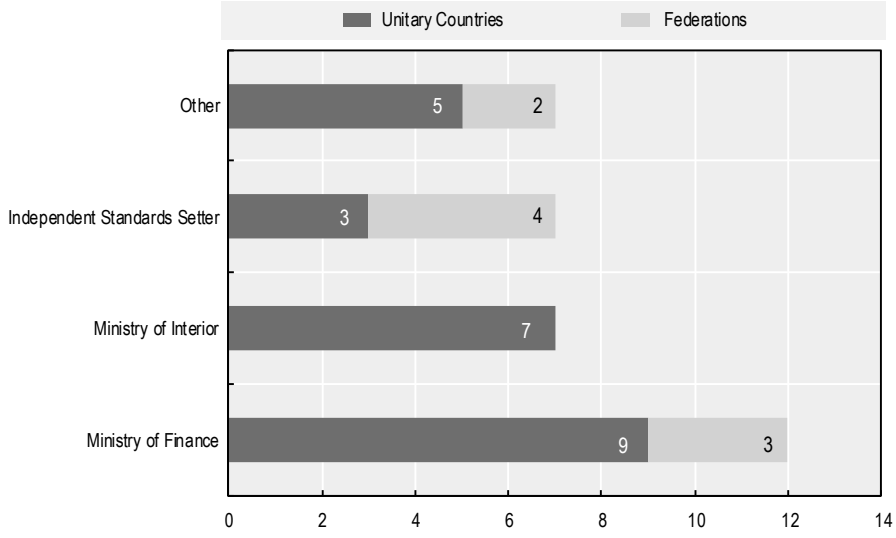
Yet having more information than is provided by traditional cash accounts should allow subnational fiscal problems to be detected earlier. Sooner or later, most fiscal problems show up in cash deficits and in difficulties repaying outstanding debt, but problems may build up well before these things happen. To take one example, a struggling subnational government may respond to declining revenues by delaying payments to suppliers, as happened during the European debt crisis in countries such as Italy and Spain. For a while, the struggling subnational's cash accounts may remain in balance, thereby concealing the looming problem. Accrual-based accounts will reveal the problem earlier since they record spending when the government is invoiced (for instance), and not when it pays.

2.2.1. A large majority of subnationals prepare accrual accounts

The merits of accrual accounting in providing a more comprehensive picture of the finances of local government are recognised in most OECD countries (Figure 4). In a large majority of the countries surveyed, subnational accounts prepared on an accrual basis or subnationals are transitioning to the accrual basis (*e.g.*, Brazil). In addition, in those countries where subnational governments prepare their main accounts on a cash basis, complementary accrual financial statements may be prepared on mandatory (*e.g.*, Portugal) or voluntary (*e.g.*, Japan) bases.

Figure 3. Authority for standard-setting

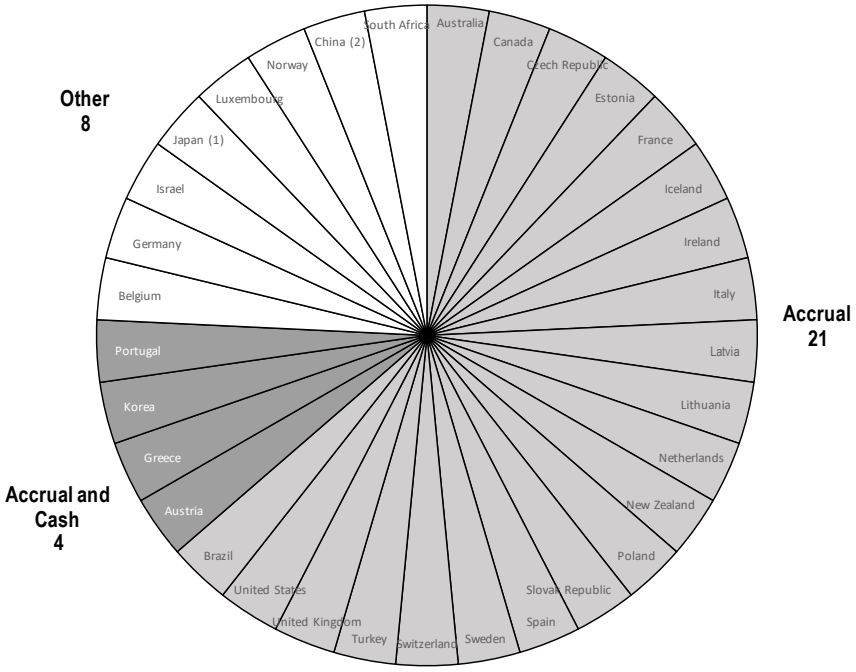
Subtotals for unitary states and federations.



Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 6: Is there an institution in charge of establishing accounting standards for subnational governments?

There are some exceptions. Israel, Luxembourg and Norway use a mix of accrual and cash concepts. This means in most cases that expenses are recognised on accrual basis, but the depreciation of assets is not included in the annual profit and loss. In other countries that do not have harmonised accounting standards for subnationals, the type of accounting basis used depends on the subnational government. In Belgium, for example, Brussels, Flanders and the German-speaking community have accrual accounts, but Wallonia does not. In Germany, Hesse and Hamburg and most local governments have accrual accounts, but most *Länder* and some local governments do not.

Figure 4. Accounting basis for accounts of subnational governments



Note: (1) The Japanese Ministry of Finance strongly recommends that subnational governments prepare accrual financial statements in addition to their cash accounts; (2) China launched pilot exercises for implementing accrual accounting at the subnational level in 2016.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 3: What kind accounting standards do subnational governments follow in your country?

In most of the countries that use the accrual basis for subnational accounts (Table 2), the transition took place more than a decade ago – that is before the 2008 financial crisis. The adoption of accrual standards did not prevent a series of recent problems with subnational government finances. In some cases, the problems may have been hard to prevent with any kind of accounting because the main cause was a deep recession and a credit crunch. In other cases, the quality of the accounting standards may have been part of the problems. For example, in Portugal or Greece, subnationals were required to move from cash to accrual accounting in the wake of the financial crisis. Case studies show that some countries have recently strengthened the accrual-accounting requirements for subnationals (Brazil, France and Iceland).

Table 2. Date of the transition to accrual accounting

	Total	Countries
Before the 1990s	6	France, Iceland, Latvia, Netherlands, Sweden, Switzerland
1990s	6	Australia, New Zealand, Poland, Portugal, Spain, United Kingdom
2000s	7	Canada, Estonia, Greece, Korea, Lithuania, Turkey, United States
2010s	5	Austria, Czech Republic, Ireland, Italy, Slovak Republic
On-going	1	Brazil

Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 4. If subnational governments prepare accrual-based accounts, when did the transition happen and how long were subnational governments given to adopt accrual accounting? (24 answers).

Box 1. Selected past problems with subnational government accounting

Non-debt liabilities

If conventional debt is closely scrutinised or restricted by fiscal rules, subnational governments may be tempted to borrow in unconventional ways. Australia experienced this issue when conventional borrowing by the states was controlled by the Loan Council: states circumvented the restrictions by effectively borrowing by means such as sale-and-leaseback agreements and privately financed but government-guaranteed infrastructure projects (see Annexes).

Subnationals may also enter into derivative contracts that initially reduce net cash outflows but increase them later. In 1994, Orange County, in California, filed for bankruptcy (and was not bailed out by the state) partly because of investments in derivatives and other instruments that had initially seemed promising but later proved costly. During the recent financial crisis, several Italian local governments, including the city of Milan, suffered losses on interest-rate swaps that they had entered into before the crisis in order to reduce their net interest spending (Sanderson et al., 2010). In both countries, controls on derivatives have been improved since these problems arose.

Sometimes, a subnational government's biggest liabilities relate to pensions. In the United States, the magnitude of subnational pensions and how they should be valued in subnational accounts has been a matter of controversy in recent years. Novy-Marx and Rauh (2009) argued that the accounts of US states seriously under-estimated the size of pension obligations, which in gross terms, they estimated, were five times larger than the states' conventional debts (for a different view, see Angelo, 2013, and for a broader discussion of the issues, see GAO, 2014).

Guarantees can also cause problems. In Austria, to take one example, the state of Carinthia suffered severe financial problems during the global financial crisis because it had guaranteed (and also partly owned) the failing Hypo Alpe-Adria Bank. To help resolve the problems, the bank was taken over by the national government (IMF, 2018).

Borrowing by related entities

Subnational governments may also be tempted to avoid restrictions on their own borrowing by having borrowing done by entities they own or control. Australia experienced this tendency in the early days of the Loan Council, when borrowing limits applied only to the states themselves. The states responded by having local governments and semi-independent state bodies do the borrowing on their behalf.

Even if borrowing is not done on behalf of the subnational government, it may be difficult for the subnational government to avoid standing behind entities that it owns or control. In France, for example, the commune of Angoulême became financially distressed after property-development companies that it partly owned (and whose liabilities it had guaranteed) became financially distressed – and was bailed out by the national government.

2.2.2. There is no shared definition or framework for accrual accounting

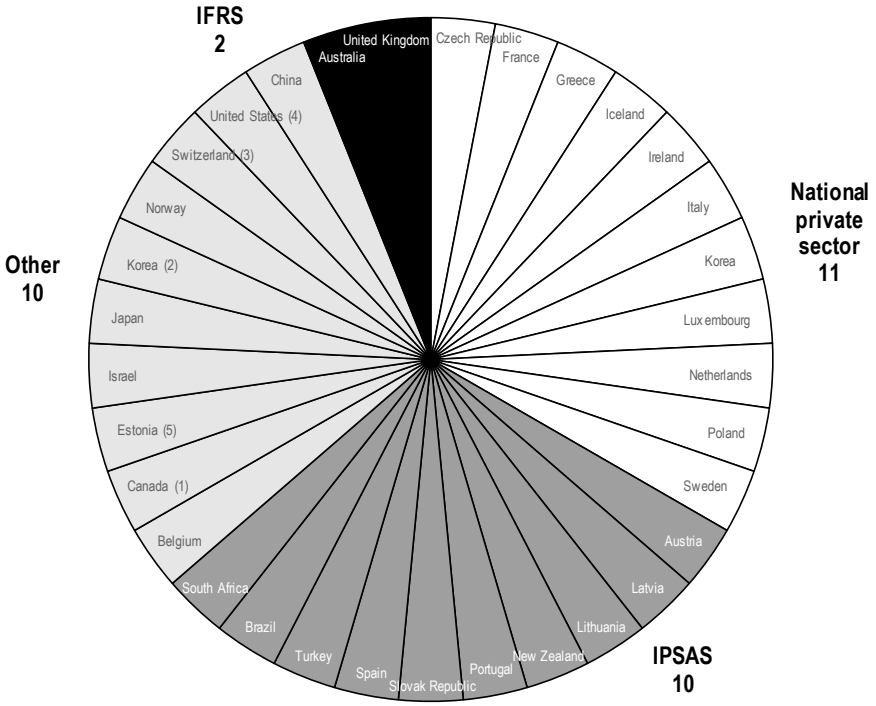
The debate on characteristics for "quality" of accrual accounting standards in the case of the public sector is not settled. However, ensuring that subnationals follow standards that are established by an independent standard-setter with appropriate technical capacities or are aligned with recognised international accounting standards can go a long way towards ensuring that their accounts provide comprehensive and relevant information.

Countries in which accrual-based standards for subnationals were adopted before the 1990s often based those standards on national standards for the private sector (Figure 5). Later, a few countries adopted

standards based on international standards for the private sector, namely International Financial Reporting Standards (IFRS) (*e.g.*, Australia and the United Kingdom). Recently, it has become more common to adopt standards based on International Public Sector Accounting Standards (IPSAS) (Brazil, Slovak Republic and Lithuania). Some early adopters of accrual accounting have also started aligning their framework with IPSAS (*e.g.,* Latvia).

Countries that use IFRS or IPSAS as a reference for their national framework sometimes mention adaptations or exceptions, due for example to the mismatch between the requirements of the standards and available resources and capacities at subnational level. In Portugal, for example, so-called local "micro-entities" are not required to prepare accrual-basis financial statements in addition to their cash accounts. Similarly, in the United Kingdom, "small entities" have simpler reporting requirements.

Figure 5. Reference framework for accrual-basis accounting standards



Note: (1) Canada has launched in 2019 a consultation on its international strategy, including the option to adopt IPSAS; (2) the Korean standards are aligned with those used in the United States; (3) Switzerland answered that the standards are not based on any of the frameworks listed; (4) in the United States, the standards are the pronouncements of the Government Accounting Standards Board; (5) Estonia answered that their standards include references to IPSAS, IFRS and the national private sector framework
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 5: If subnational governments prepare accrual-based accounts, are the standards for these accounts based on other standards?

2.3. Timeliness and reliability of subnational accounts

Early detection of problems requires timely and reliable accounts. To be timely, accounts must be published or transmitted to the national government on a sufficiently frequent basis and within a reasonably short lag after the end of the period.

To ensure reliability, the annual accounts need to be audited. Cash accounts can be manipulated by changing the timing of cash flows without greatly changing the substance of subnational finances. Accrual accounts introduce opportunities to manipulate accounts by making dubious judgments and optimistic estimates. In both kinds of accounts, some form of quality assurance is needed to help detect fraud and

ensure that the accounts reflect the rules. However, the importance of estimates and judgments in accrual accounting increases the onus on auditing to maintain the reliability of the accounts.

2.3.1. Annual reporting is a basic requirement in virtually all countries

Annual reporting to national government is mandatory in almost all unitary states. A large majority of countries do not require that this reporting be done with audited accounts. Where audited accounts are required, the time lag for the transmission of the accounts tends indeed to be longer – for example, more than six months (Greece, Israel and Norway).

Although this information was not required in the survey, a number of countries indicated that in addition to the transmission of the annual accounts, subnational governments are required to report some data on a more frequent basis. That is the case for example in Greece, Estonia, Lithuania, Brazil (monthly) and in Iceland and Israel (quarterly).

In most federations, states and local governments are not required to report financial data to the federal government (except for statistical purposes) (Table 3). They often have the obligation however, to publish their annual accounts, according to detailed rules specified in national or subnational legislation. The publication of accounts by subnational governments is mandatory in most unitary states. The exceptions are Korea, Luxembourg, France and Norway. In the two latter countries, all citizens have however access to this information upon request.

Table 3. Reporting requirements towards national government

Subtotals for unitary states and federations

	Non-audited annual accounts	Audited annual accounts	Time-lag (1)	No such requirements
1/ Unitary States				
Czech Republic	*		M+2	
Estonia	*			
France	*			
Greece		*	M+9	
Iceland	*		M+5	
Ireland	*		M+3	
Israel		*	M+6	
Italy	*			
Japan	*			
Korea	*		M+5	
Latvia		*		
Lithuania		*	M+2	
Luxembourg	*			
Netherlands	*		M+7	
New Zealand				*
Norway		*	M+7 (4)	
Poland	*		M+7	
Portugal	*		M+4	
Slovak Republic				*
Sweden				*
Turkey	*			
United Kingdom		*		
China	*			
South Africa	*		M+9	
Sub-total	15	6		3
2/ Federations				

Australia				*
Austria		*		
Belgium				*
Canada				*
Spain	*			
Germany				*
Switzerland				*
United States		(2)	M+9	
Brazil	(3)		M+6	
Sub-total	2	2		5
Total	17	8		8

Note: In some countries, such as Norway, a first set of non-audited data is communicated to the national statistical agency in the first quarter of the year. Time-lags are specified only when a reporting requirement to national government exists and for countries that provided this information in their answer to the survey. Time-lags are expressed in months; (2) In the United States, all state and local governments that receive more than $750,000 of federal assistance must submit a financial and compliance audit within 9 months after period end; (3) In Brazil, the Fiscal Responsibility Law establishes that the subnational governments have to send their accounting data of the last fiscal year until June 30, in order to the central government consolidate the public sector accounts. (4) In Norway, the accounts have to be submitted to the national government within one month of their adoption by the local government – i.e. at the latest June 30th + 1 month.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 9. Are subnational governments required to submit their accounts to the national government?

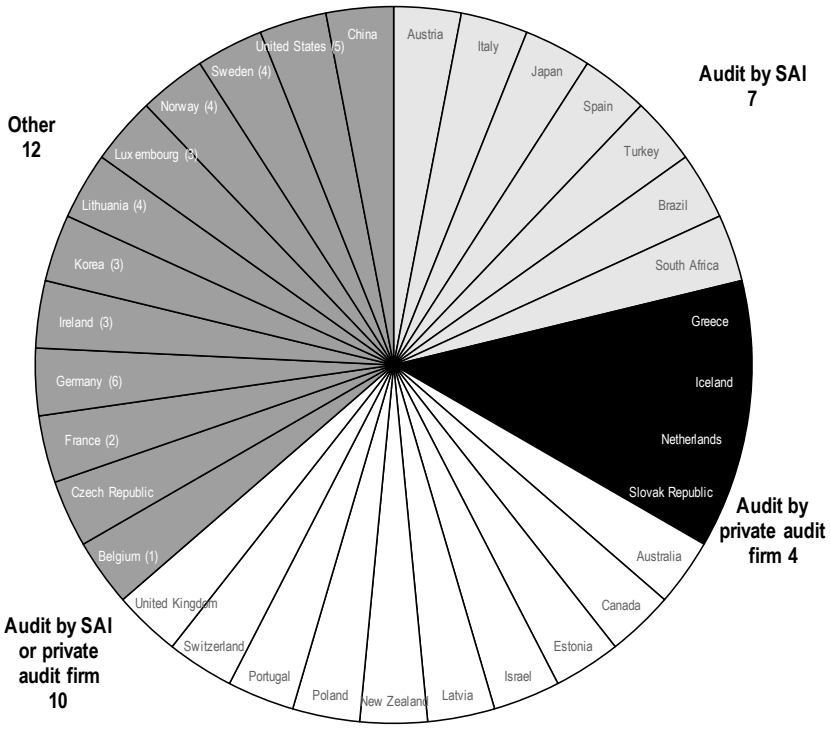
2.3.2. Independent audit is not yet a standard practice

There are many variations in the auditing of subnational accounts (Figure 6). While the audit of the national government's accounts by the supreme audit institution (SAI) is the norm in the OECD, only a small group of countries require that their SAI also audit subnationals' accounts each year (7 of 33 countries). In other countries, there are limits on what type of entities the SAI can audit, for constitutional or other reasons. For example, the SAI may have discretion as to how many individual entities to audit each year, in order for them to accommodate other types of audits within their resource constraints.[3]

The survey answers reveal two dominant practices. In 10 countries, independent external audit is required, and it often involves both the SAI and private audit firms. Under this model, the SAI or a state auditor may provide an audit opinion on the consolidated financial statements of the state, while audit firms may audit the accounts of local governments. In 12 countries, other audit models are used. Audits may be carried out by audit departments, inspections or the like, operating under the auspices of either national or subnational government. In Sweden, politically elected auditors conduct controls and report their findings and recommendations to the audit committee of the municipal council. In Germany, local governments are authorised to self-audit.

Very few countries indicated widespread audit issues with subnational accounts. This is understandable, as discovering such issues could require reviewing hundreds if not thousands of audit reports. In addition, audit qualifications may be difficult to analyse or compare where accounting standards have not been fully harmonised. However, a recent report of the Austrian Court of Audit on the fiscal data of municipalities identified many issues with incomplete data. Two countries indicated that their SAI produces a synthesis of key audit issues identified in the local sector (France and New Zealand; see Annexes). Such reports are useful in that they may help identify common problems and risks that may have gone unnoticed through the usual monitoring mechanisms.

Figure 6. Audit of subnational accounts



Note: (1) In Belgium, state governments are audited by the Court of Auditors and local governments are audited by agencies of the state governments; (2) France is piloting several audit models; (3) in Ireland, Korea and Luxembourg, audits are carried out by audit departments operating under the auspices of the national government; (4) in Lithuania, Norway and Sweden, audits are carried out by local bodies; specifically, in Norway, audits cannot be conducted by a local body which is part of the legal entity of the municipality. Thus, audits are carried out mainly by audit companies owned by one or several municipalities or regions, but also by private audit companies; (5) in the United States, auditors vary by state: they can be conducted entirely by the state auditor, entirely by public accounting firms, or both; (6) in Germany, different types of audit are authorised at local level, including "self-auditing".
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 7. Are subnationals' accounts audited?

3. Monitoring

The accounts that subnationals produce are often monitored by national governments. National governments that pursue the control-and-monitor strategy must of course monitor subnational finances, but governments that pursue the no-bailout strategy may also choose to do some monitoring, while being careful to avoid any suggestion that the monitoring implies responsibility.

3.1. Monitoring systems

The approach that national governments take depends in part on their authority over subnational governments, which tends to depend in turn on whether the constitution is federal or unitary. As a rule, national governments in unitary countries have authority over subnational governments and tend to follow the control-and-monitor strategy, while national governments in federations are less likely to have such authority and more likely to follow the no-bailout strategy. Yet there are several exceptions to this rule, and some governments follow strategies that do not fit neatly into either of the two categories.

In the countries surveyed for this study, 18 national governments reported that they had the authority to monitor subnational governments and take steps to remedy their problems (Table 4). As might be

expected, these countries are almost all unitary. The exception is Spain, which has been described as quasi-federal. In 12 countries, the national government reported that it did not have the authority to monitor subnational governments and take steps to remedy their problems. As might be expected, all the federations apart of Spain fall in this category. However, four unitary states are also in this category: the Czech Republic, Portugal and two Nordic countries that, despite being unitary, have a tradition of autonomous local government - Iceland and Sweden.

Table 4. National governments' authority to intervene in subnational finances

	Authority to monitor and take steps to remedy problems	No such authority
Unitary Countries	**17:** Estonia, France, Greece, Ireland, Israel, Japan, Korea, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Poland, Slovak Republic, United Kingdom; China, South Africa,	**4**: Czech Republic, Iceland, Portugal, Sweden
Federations	**1**: Spain	**8**: Australia, Austria, Belgium, Canada, Germany, Switzerland, United States; Brazil

Note: Answers provided by respondents sometime referred to legislation other than the constitution. Italy, Latvia and Turkey did not answer this question, as they answered a previous version of the questionnaire.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 1: What authority does the constitution give the national government in the area of subnational finances?

The proportion of national governments that monitor subnational finances in some way is higher because some national governments monitor even though they do not have legal authority to intervene to solve subnational fiscal problems (Table 5). In particular, 27 of the 33 countries responding to the survey said that the national government monitored the finances of subnationals. As might be expected, there is again a relationship between whether national governments monitor and the constitution of the country. Monitoring is almost universal in unitary countries, and most of the countries in which the national government does not monitor are federal.

Table 5. National governments' monitoring of subnational finances

	Monitors	Does not monitor
Unitary Countries	**22:** Czech Republic, Estonia, France, Greece, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Norway, Poland, Portugal, Slovak Republic, Sweden, Turkey, United Kingdom; China, South Africa,	**2:** Netherlands, New Zealand
Federations	**5:** Australia, Austria, Canada, Spain; Brazil	**4:** Belgium, Germany, Switzerland, United States

Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), based on answers to question 11: Does the national government monitor the finances of subnational governments?

One exception to the expected pattern is that national governments reported that they monitored subnational governments in four unambiguously federal countries – Australia, Austria, Brazil and Canada – as well as in Spain. In Brazil, the monitoring includes verifying whether subnationals have complied with fiscal rules set at the national level.

Another exception to the expected pattern is that two national governments of unitary countries, the Netherlands and New Zealand, reported that they did not monitor the finances of subnational governments. In New Zealand, the system was said to be "sufficiently robust that active monitoring is not required". The response for the Netherlands did not mention the reason for the approach, but Allers (2014) notes that

subnational governments in the Netherlands sometimes receive bailouts from the national government and that the fiscal rules governing subnationals are weak or do not bind. Nevertheless, Allers argues, the approach works reasonably well because local politicians want to avoid the loss of autonomy that comes with a bailout.

3.1.1. In the EU, some federal countries have developed innovative kinds of monitoring

In the member countries of the European Union, the finances of subnational governments matter to national governments partly because of the countries' treaty commitments to restrict the debt and deficit of general government (*i.e.*, national and subnational government combined, as defined in macroeconomic statistics). As a result, some monitoring of subnational finances is necessary even if the national government does not have authority over subnational governments. In the federations of Belgium and Germany, the problem has been addressed by a form of co-operative monitoring. In Germany, the accounts of both the national government and the *Länder* are monitored by the Stability Council (*Stabilitätsrat*), which was jointly created by the federal government and the *Länder*. In Belgium, the High Council of Finance performs a similar function.

When monitoring is done by the national government, it is almost always done according to laws or guidelines (Table 6). The two exceptions are Canada and Sweden. In unitary countries, it is typically done by the finance ministry or the interior ministry. Often, responsibility for monitoring accompanies responsibility for setting accounting standards (Figure 3). Sometimes, both the finance and interior ministries are involved. In France, the Ministry of the Interior monitors local governments' compliance with a golden rule (current spending cannot exceed revenue), while the Ministry of Economy and Finance looks for warning signs of financial trouble by monitoring subnational governments' debt, expenditure rigidity, self-financing capacity, and ability to increase local taxes. As these examples illustrate, monitoring may need to go beyond accounting indicators to include the economic and legal context.

Independent fiscal institutions also play a growing role in monitoring subnational finances, as mentioned in the questionnaire responses from Austria, Lithuania, Spain and Sweden. Independent fiscal institutions tend to examine not only subnational governments' recent fiscal performance, but also their forecast financial performance, providing an important complement to monitoring that looks only at fiscal outcomes. One of their main tasks is typically to report on compliance with fiscal rules, so when the fiscal rules apply to subnationals, as in the European Union, their monitoring of subnationals is especially significant. In Spain, for example, the Independent Authority for Fiscal Responsibility, established in 2013, now plays a major role in monitoring subnational finances (von Trapp et al, 2017).

Table 6. Monitoring of subnational finances by national governments

Subtotals for unitary and federal countries

	Monitoring department	Law or guidelines?
1/ Unitary Countries		
Czech Republic	Finance	Yes
Estonia	Finance	Yes
France	Finance, interior	Yes
Greece	Finance, interior	Yes
Iceland	Special committee	Yes
Ireland	Interior	Yes
Israel	Interior	Yes
Italy	Finance, interior, audit	Yes
Japan	Interior	Yes
Korea	Interior	Yes
Latvia	Finance and environment and urbanization	Yes

Lithuania	Finance and independent fiscal institution	Yes
Luxembourg	Interior	Yes
Norway	Interior	Yes
Poland	Finance, supreme audit institution, etc.	Yes
Portugal	Interior	Yes
Slovak Republic	Finance	Yes
Sweden	Finance and independent fiscal institution	No
Turkey	Interior, supreme audit institution, environment	Yes
United Kingdom	Finance and interior	Yes
China	Finance	Yes
South Africa	Finance	Yes
2/ Federal countries		
Australia	Finance, central bank, grants commission	Yes
Austria	Finance, fiscal council and co-ordination committees	Yes
Canada	Finance	No
Spain	Finance and independent fiscal institution	Yes
Brazil	Finance	n/a

Note: Includes only those countries in which the national government monitors subnational finances.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), answers to questions 12 and 13: If yes [i.e. if the national government monitors subnationals], which institution of the national government does the monitoring? Are there legal requirements or other guidelines for the monitoring?

3.1.2. The nature of the monitoring varies widely

The term "monitoring" encompasses a broad variety of activities, and the nature of the monitoring varies across countries. In some countries, the main purpose of the monitoring is to determine whether subnational governments have complied with fiscal rules and other legal requirements. If the monitoring suggests non-compliance, the national government is likely to have the ability to intervene. In Israel, for example, local governments' budgets must be approved by representatives of the national government and quarterly data on budget execution are reviewed by the Ministry of the Interior, which can intervene in the budgets if it deems this to be necessary.

In other countries, such as Australia and Canada, the nature of the monitoring is different. The national government gathers information, but it is not verifying compliance with fiscal rules with a view to possible interventions in the budgets of the subnational governments. In some cases, the objective of the monitoring may be to identify early warning signs of subnational financial problems, and this may be separate from the monitoring of compliance with rules. Since financial problems can show up first in indicators not governed by rules, this monitoring generally looks at a wide range of indicators. In the cases of Australia, Canada or France, it can be said that the ministry of finance performs an advisory function vis-à-vis subnationals, rather than a surveillance one.

3.2. Indicators used for the monitoring

3.2.1. Monitoring of debt and cash deficits is often supplemented by monitoring of accrual-based indicators…

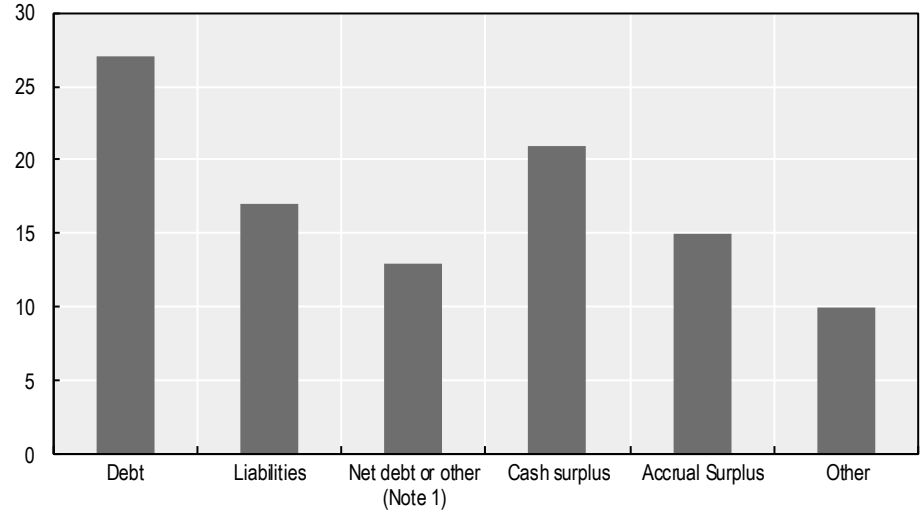
The indicators that are most commonly monitored are debt and the cash deficit (Figure 7). Subnational governments' debt is monitored in all 27 countries in which subnational finances are monitored, and the cash deficit is monitored in 21 of those countries. The fact that the cash deficit is not systematically monitored in all the countries is a possible concern, because although the accrual deficit can pick up early warning signs of problems not apparent in the cash deficit, the cash deficit is also informative. Subnational governments need to be generating enough cash to meet debt-service and other requirements, and a large

unexplained difference in the two surpluses might be a sign that the accrual surplus is being mis-measured (for example, by over-estimating receivables).

In many countries, indicators available only in accrual accounts are also monitored. The accrual deficit is monitored in 15 countries, and liabilities (defined as including not just ordinary debt but also accounts payable, leases and other items) are monitored in 17 countries. Monitoring a broad measure of liabilities is especially useful since subnational governments may borrow in unconventional ways if conventional debt is closely scrutinised or restricted by fiscal rules. Australia, for example, experienced this when conventional borrowing by the states was controlled by the Loan Council (see Box 1, above, and Annexes). Under the heading of other monitored indicators, Brazil mentioned pensions, Greece arrears, and Latvia guarantees.

Figure 7. Indicators monitored

Subtotals for unitary states and federations



Note: Table excludes countries that indicated that national government did not monitor subnational finances. (1) Net debt or other includes net worth and net financial worth.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), answers to question 14: Which indicators does the monitoring focus on?

3.2.2. Progress is still possible

Overall, the survey results are encouraging in the extent to which the monitoring of traditional fiscal indicators is now supplemented by the monitoring of non-traditional indicators. Moreover, almost all survey respondents said that they believed that the data they received was satisfactory. Nevertheless, the results suggest a few possible remaining problems (in addition to the issues discussed in Section 2, including the unavailability of accrual indicators in some countries) and some areas where further progress might be sought.

Only 13 countries monitor subnational governments' net financial worth or net worth. This may prevent identifying early signs of future problems, in relation for example to the losses of entities owned or otherwise controlled by subnational governments. Although serious financial problems in these entities are likely ultimately to show up in the accounts of the subnational government itself, problems may be detected earlier if monitoring encompasses the fair value of the shareholdings as reported in the balance sheet or,

of course, if the subnational governments publish accounts that consolidate all controlled entities. Australia and Iceland are examples of countries in which subnationals publish accounts that consolidate controlled entities, as well as showing accounts for a narrower definition of subnational government (see Annexes).

Another possible problem is that there is little evidence of the monitoring of the subnational governments' fixed assets. This may make early detection of problems of deteriorating infrastructure more difficult – a problem analysed, for example, in New South Wales (see Annexes). Conversely, there may be cases (as perhaps in some subnational governments in Spain before the European debt crisis of the early 2010s) where monitoring would reveal riskily high levels of investment in infrastructure.

Although the survey did not include any question on the preparation of forecasts by subnationals, some answers noted that historical information is necessary but insufficient for good monitoring. It is possible for the accounts of a subnational to be healthy even though its prospects are poor, and conversely, for its prospects to be good even though its accounts suggest that it is in bad shape. What also matters is what will happen to its revenue, whether in the form of transfers from a higher tier of government or in the form of its own taxes, and what will happen to its spending obligations, either because of changes in local conditions or because of changes in its responsibilities. Moreover, the subnational's ability to respond to changes is also crucial. Can it raise taxes or cut spending, or are its hands tied?

It is useful, therefore, if subnational governments publish fiscal forecasts, discuss the factors that could cause outcomes to differ from the forecasts, and explain their ability to cut spending or raise revenue if outcomes turn out to be worse than forecasts. Some subnational governments provide medium-term forecasts. The State of Victoria in Australia, for example, publishes "forward estimates" for the three years following the budget year for various categories of revenue and spending, along with a discussion of the economic outlook, and the risks surrounding the economic and fiscal forecasts.[4] New Zealand's local governments publish audited 10-year plans that include financial forecasts.

3.3. Benchmarking

Most respondents said that monitoring compared subnational financial indicators with benchmarks (Table 7). Specifically, of the 27 national governments that monitor the finances of the subnational governments, 19 said that they monitored against benchmarks, while only seven said that they did not. Most governments publish the results of their monitoring. The Norwegian government said it did not set benchmarks against which to monitor subnational finances, but that it published financial indicators for local governments and compared them to regional or national averages. In many countries, the benchmarks are just the fiscal rules. Only in a few cases, it seems, is the benchmarking used for analysis of the strength of the finances of subnationals that goes beyond checking compliance with fiscal rules.

The use of benchmarking and comparative analysis is likely to be most useful if there are many subnational governments, as for example in France, where there are more than 36 000 communes. If one tier of subnational government contains only a few entities, as with the states and territories in Australia and the provinces in Canada, paying close attention to the special characteristics of each government is feasible and benchmarking is less valuable (On the benchmarking of non-financial performance, see also Phillips, 2018).

The more subnational governments there are, the more attractive is statistical analysis. If there are many subnationals and sufficient time series data on their finances, circumstances and financial problems, it may be possible to develop a statistical model that identifies which indicators have best predicted subnational fiscal problems in the past and to use the model to help predict future problems.

If there are many subnational governments, the form in which their accounts are published or submitted to the national government starts to matter. If there are only a few subnationals, officials in the national government can read the accounts in a form such as a pdf file and enter data as needed into their own

files. If there are many subnationals, however, monitoring is much easier if the accounts are submitted or published in a way that facilitates the downloading of the financial data from each subnational.

If there are only a few subnational governments or only a few years of historical data, developing a reliable model may not be possible. More use must then be made of analysts' judgments. Even in this case, however, it may be helpful to ask expert analysts to assign weights to various indicators as predictors of financial trouble and then to use a spreadsheet model to calculate for each subnational an index of risk that employs those weights. It may also be possible to make use of estimates made in other contexts, such as estimates of the links between credit ratings and debt defaults. If the subnationals have credit ratings, it may be possible to apply these estimates directly. In other cases, it may be possible to estimate the credit ratings they would receive.

Categorising subnationals by apparent risk can help identify which ones merit closer scrutiny. Even if there are too many subnationals for close analysis of the finances of each one to be feasible, a model can be used to identify those that seem most at risk. Then analysts can look more closely at the finances of the smaller group to determine whether they are actually performing reasonably or whether remedial action should be taken.

Finally, national governments pursuing the control-and-monitor strategy can enlist the help of analysts outside government by requiring subnationals to publish their accounts. This allows citizens, journalists, and others to investigate subnational finances if they wish to do so. The justification of fiscal decentralisation is that local citizens are often more knowledgeable and more concerned about what is happening in their area than are officials in the national government. For the same reason, local citizens, journalists, and others may sometimes be better at detecting local problems than is the national government.

Table 7. Benchmarking, publication and satisfaction with monitoring

	Benchmarked?	Published	Satisfactory
Australia	No	Yes	Yes
Austria	Yes	Yes	Yes
Canada	No	No	Yes
Czech Republic	Yes	Yes	Yes
Estonia	Yes	Yes	Yes
France	Yes	No	Yes
Greece	Yes	Yes	Yes
Iceland	Yes	No	Yes
Ireland	No	Yes	Yes
Israel	Yes	Yes	n/a
Italy	Yes	No	Yes
Japan	Yes	Yes	Yes
Korea	Yes	Yes	Yes
Latvia	Yes	Yes	Yes
Lithuania	Yes	Yes	Yes
Luxembourg	No	No	Yes
Norway	No	No	Yes
Poland	No	Yes	Yes
Portugal	Yes	Yes	Yes
Slovak Republic	Yes	Yes	Yes
Spain	Yes	Yes	Yes
Sweden	No	Yes	Yes
Turkey	Yes	Yes	Yes
United Kingdom	Yes	No	Yes

Brazil	Yes	Yes	No
China	n/a	n/a	n/a
South Africa	Yes	Yes	Yes
Total 'Yes'	**19**	**19**	**24**

Note: Table excludes countries that indicated that national government did not monitor subnational finances.
Source: OECD Survey on Subnational accounting and monitoring of subnational finances (2019), answers to questions 15, 16 and 17: Does the monitoring involve comparison of the abovementioned indicators with specified benchmarks (e.g., does it involve comparison of each subnational government's debt-revenue ratio with a benchmark debt-revenue ratio)? Does the national government publish information on the results of its monitoring of subnationals? 1Is the financial information provided by subnational governments sufficient for satisfactory monitoring of their finances?

4. Future directions

The survey undertaken for this study provides high-level evidence on the nature of subnational accounting. For certain finer-grained accounting issues, the article has relied on case studies of a much smaller sample of countries. It would be valuable to analyse survey evidence on the accounting treatment of various details, including the liabilities associated with pensions, guarantees, derivatives, public-private partnerships and subnational enterprises. Related work could consider how best to combine core information on the conventionally defined debt of subnational governments with more comprehensive information on a broader range of liabilities. Similarly useful would be survey evidence on the extent of monitoring by national governments of subnational assets, including their infrastructure assets. More could also be done to assess empirically the success of different monitoring regimes and the statistical value of different indicators in detecting early signs of problems in countries that have a large number of subnationals. Finally, as the coronavirus pandemic has underscored, it would be useful to investigate indicators of subnational governments' financial ability to withstand and respond to large negative shocks.

Notes

1. Australian Bureau of Statistics, Government Finance Statistics 2017-18, Table 7 (estimate excludes non-financial assets not allocated to a particular jurisdiction).

2. Whether a country should be classified as federal or unitary is sometimes unclear. Borderline cases include Spain and South Africa. Following Dougherty and Phillips (2019), this study classifies Spain as federal and South Africa as unitary.

3. Audits conducted by SAIs may include regularity audits (encompassing compliance and financial audits), performance or value for money audits, environmental audits, and forensic audits.

4. See Victorian Budget 19/20, Strategy and Outlook: Budget Paper 2, available at https://s3-ap-southeast-2.amazonaws.com/budgetfiles201920.budget.vic.gov.au/2019-20+State+Budget+-+Strategy+and+Outlook.pdf (accessed 11 July 2019).

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Annex 1.A. Australia

Australia is a federation made up of the commonwealth government; the six states – New South Wales, Queensland, South Australia, Tasmania, Victoria, Western Australia – that founded the country in 1901; and two territories – the Australian Capital Territory and the Northern Territory – that do not have constitutional protection but in practice are treated like states. There are also some 700 local governments that are under the legal control of the state or territory in which they are located (Morris, 2007).

Several aspects of the Australian case are noteworthy in the context of this study. First, although Australia is a federation, it is one in which the central government is considered relatively powerful (Shah, 2007). Second, the states publish accounts based on IFRS but include in those accounts the main classifications of government-finance statistics. Third, there is more fiscal co-ordination than in many federations.

In the area of subnational finances, the most important mechanism for co-ordination has been the Loan Council. Initially, the states were free to borrow as they wished, but in the 1920s the commonwealth and the states jointly created the Loan Council partly to co-ordinate international borrowing so that governments did not compete for funds international funds at the same time. The new set-up however, also gave the commonwealth government the power "to manage and take over state debts, to regulate the borrowing of the states, and to borrow for them". Moreover, the council "was given the sole authority to determine the amounts, terms, conditions, and timing of all loans raised by the Commonwealth and the states" (von Hagen et al., 2000). The states were represented on the Loan Council, but the commonwealth had the largest say in decisions. In the 1980s and 1990s, the rules were progressively changed, and now states have the power to borrow as much as they wish. Nonetheless, the Loan Council still exists as a mechanism for discussion and information-sharing (von Hagen et al, 2000; Webb, 2002).

There are examples of bailout from the early days in the Loan Council, but not recently. In particular, New South Wales defaulted on international borrowing in 1931 and 1932, but each time the commonwealth government stepped in to pay the amounts due to lenders. Later, the commonwealth accepted liability for all state debts.

When state borrowing was limited by the Loan Council, the states exploited accounting weaknesses to circumvent the borrowing limits. At first, states had local and semi-government bodies borrow on their behalf (von Hagen et al, 2000). When this loophole was closed, states later effectively borrowed by entering into leases (Webb, 2002), sales-and-lease-back arrangements (Craig, 1997), and what would now be called public-private partnerships. In the early 1990s, for example, New South Wales guaranteed the revenue of a privately financed project to build a tunnel under Sydney harbour. The state's auditor-general concluded that, for accounting purposes, the tunnel and associated liabilities should be treated as the government's, and the government's financial statements received a qualified audit (see Irwin, 2007, which cites the auditor-general's 1994 report, Private Participation in the Provision of Public Infrastructure: The Roads and Traffic Industry).

The rules introduced in the 1990s emphasise transparency. The commonwealth and the states have agreed to follow a common set of accounting standards set by the Australian Accounting Standards Board, an independently operating body of the commonwealth government (see www.aasb.gov.au/About-the-AASB/Frequently-asked-questions.aspx). The standards are based on IFRS but include special provisions for reporting by governments, including Accounting Standards Board (AASB) 1049: Whole of Government and General Government Sector Financial Reporting. Because they are based on IFRS, the accounting standards require states to recognize assets and/or liabilities in relation to derivatives; certain public-private partnerships; defined-benefit employee pensions; and physical property such as land, building, and infrastructure. They must consolidate all controlled entities.

A notable feature of the financial statements of the commonwealth and the states (though not local government) is the use of classifications from government-finances statistics. Thus the operating statement includes lines for the net operating balance and net lending/borrowing, and the main classification of assets is between those that are financial and those that are non-financial. Moreover, although the financial statements consolidate all controlled entities line by line, they also show, as a kind of segment, the accounts of the general-government sector.

The state and commonwealth governments publish their audited accounts within three to six months of the end of the financial year. Each state's financial statements are audited by the state's auditor-general. The commonwealth Treasury monitors the finances of the states (but not local government) using the state's accounts and information sent by the states to the Australian Bureau of Statistics. Although the focus here is on national governments' monitoring of the first tier of subnational government, also worth mentioning is the an interesting example of state monitoring of local governments (see Box 1.A.1)

Annex Box 1.A.1. Financial Sustainability Assessments of Local Government Units

In response to fiscal problems facing the local government sector, the state of New South Wales recently developed a framework to assess the finances of its local governments. The framework used a range of indicators, based on audited accrual-based accounts, and assigned a weight to each indicator to arrive at a score for each local council's financial sustainability.

The analysis and ratios used in the assessment included both accrual- and cash-based measures. Examples include a Capital Expenditure Ratio, defined as the ratio between annual capital expenditure and annual depreciation, which was used to indicate the extent to which a council is forecasting to expand its asset base; a Building and Infrastructure Renewals Ratio, defined as the proportion spent on infrastructure asset renewals and the asset's deterioration measured by its accounting depreciation; and the Cash Expense Cover Ratio, measuring the number of months a council can continue paying for its immediate expenses without additional cash inflow, and defined as the ratio between current year's cash and cash equivalents and 12 times the total expenses less depreciation and interest costs.

As councils were assessed they were grouped into categories ranging from very strong to very weak in terms of financial sustainability. The results of the analysis were used by the state government in assessing individual local governments as part of initiatives to understand infrastructure spending in NSW and to inform policy on the possible amalgamations of different local governments.

Source: Moretti and Youngberry (2018).

Annex 1.B. Brazil

Brazil is a federation made up of the federal government, 26 states, the federal district, and (at a recent count) 5 570 municipalities (Rezende, 2007: 75; IMF, 2017: 14). At least two features of Brazil's federation make it distinctive. The first is an unusual mix of centralisation and decentralisation. The second is the recognition of municipalities in Brazil's constitution and the federal government's consequent direct relationship with them.

Brazil's democratic constitution of 1988 reversed the centralisation of the previous military dictatorship (Ter-Minassian, 1997: 438). In 2014, subnationals accounted for slightly more than half of public spending net of intergovernmental transfers (IMF, 2017: 14). Rodden (2003) describes the country as the most decentralised country in the developing world. Shah (2007: 6) classifies the federal government's influence over subnationals as being 'weak', putting Brazil in the same category as Canada and Switzerland, below the United States, which in turn is below Australia.

Yet the federal government exercises more direct control over subnational finances than in many other federations. The Fiscal Responsibility Law of 2000 (*Lei de Responsabilidade Fiscal*) imposes fiscal rules and fiscal reporting requirements on subnational governments – something with no equivalent in federations such as Australia and the United States. Among other restrictions, the states cannot have net debt of more than 200% of their net current revenue, and municipalities cannot have net debt of more than 120% (Afonso and Araújo 2006: 406–09; IMF, 2017: 62). There are also separate limits on spending on personnel and on public-private partnerships (IMF, 2017).

The Fiscal Responsibility law also empowers the federal government to set accounting standards for states and municipalities, though the accounting standards the federal government sets are not necessarily those used for monitoring compliance with fiscal rules. At present, subnational accounting is partly cash based, but the governments of all three tiers are required to adopt accrual accounting largely based on IPSAS (*Normas Internacionais de Contabilidade Aplicadas ao Setor Público*). The adoption is expected to be complete in 2025 (Secretary of the National Treasury, 2015).

All subnationals are required to publish quarterly data on their finances (IMF, 2017), and the federal government publishes

- summary information on their finances (Secretary of National Treasury, 2018);
- monthly data on their debt (see www.tesouro.fazenda.gov.br/indicadores-fiscais-e-de-endividamento and also IMF, 2017); and
- consolidated information on the finances of the Brazilian non-financial public sector.

Criticisms of the financial reporting of subnationals include the fact that compliance with the existing rules is imperfect. Not all subnationals meet their obligations to publish data and, although there is a common set of accounting standards, accounting practice is not fully standardised (IMF, 2017: 62–63).

One purpose of the Fiscal Responsibility Law was to end federal government bailouts of subnational governments. Rodden (2003) notes that Brazil had experienced three subnational debt crises since the 1980s. "In each of the crisis episodes thus far, the states – already facing precarious fiscal situations with high levels of spending on personnel and dangerous levels of borrowing – were pushed into debt servicing crises by unexpected exogenous shocks. In each case their first reaction was to demand bailouts from the central government, and in each case the federal government responded by taking measures to federalize state debts" (see also Ter-Minassian, 1997: 451–54). The Fiscal Responsibility law was passed just after the completion of the last of these bailouts, in which the federal government took over the debts of 25

states and 183 municipalities (Afonso and Araújo 2006: 406). The law prohibited new lending by the federal government to subnationals or the renegotiation of the existing debt-restructuring agreements.

The law was successful for a time. Afonso and Araújo (2006: 406) write that it made it "possible to combine autonomy and responsibility [for subnationals] for the first time in the history of the Brazilian federation", and they note that with few exceptions subnationals met their obligations to repay the federal governments (p. 407). Brazil also gained a reputation for a high degree of fiscal transparency.

The new policy was, however, pushed to breaking point by the deep recession of 2015–17. The state of Rio de Janeiro experienced particularly severe problems and, in 2016, it missed payments to the French Development Agency and the Inter-American Development Bank (IMF, 2017: 61). It declared a state of fiscal calamity (an *estado de calamidade pública em âmbito financeiro*). The federal government developed a plan to help states solve their problems (a *plano de recuperação fiscal dos estados*) and entered into an adjustment programme with the state. Since then, five other states have made similar declarations, though they will not necessarily receive federal aid (Rodrigues, 2019).

Annex 1.C. France

France is a unitary state with three levels of local government. There are 18 regions, 101 departments and (at 1 January 2019) 34 970 communes. Compared to the other countries considered in this appendix, the notable features of France include the large number of local governments, the changes over time in the extent of the central government's control owing to the principle of free administration of local governments, and the influence of the European Union.[1]

Tocqueville (1856) famously observed that centralisation was one of the elements of continuity that united pre and post-revolutionary France, and for many years the central government exercised strong control over local government. Yet calls for decentralisation are also long-standing (Rosanvallon, 2004, Chapter 6; Liu, Gaillard, and Waibel, 2013). Recent decentralisation began, or at least accelerated, in the 1980s, when the central government loosened many of its controls. As shown in Figure 1, spending by its subnational governments is now greater than in several other unitary states. Moreover, by the mid-2000s one observer could write, "Now, French subnational governments enjoy an extremely high degree of autonomy. They do pretty much what they want with their taxes, their expenditures, their debt, their regulations, and their employees. Constraints and mandates are minimal" (Prud'homme, 2006: 88).

Yet the central government does exercise control over local governments' finances and financial reporting. Local governments have long been subject to a golden rule, compliance with which is monitored by the Ministry of the Interior. If the rule is not respected, the central government's representative in the relevant department, the Préfet, can as a last resort take over the local government's budget, as happened in the commune of Hénin-Baumont in 2009 (Lévêque, 2013). More recently, the central government has introduced an indicative expenditure-growth limit for the local-government sector (Moretti and Kraan, 2018: 18).

In recent years, moreover, central monitoring has increased. The supreme audit institution, the Cour des comptes, now publishes an annual review of the finances and financial reporting of local governments (*e.g.*, Cour des comptes, 2018). Furthermore, with a view to detecting and resolving emerging financial problems in local governments, the Ministry of Economy and Finance monitors indicators of the financial strength of local governments, including their debt, self-financing capacity, ability to increase local taxes, and the rigidity of their expenditures.

One likely cause of the increase in monitoring was the financial problems suffered by a few local governments in the early 1990s. Notably, the commune of Angoulême issued many guarantees for local projects in the 1980s and when the projects turned out to be unsuccessful, it declared that it would cease making payments to its creditors (Les Echos, 1991; Lévêque, 2013). Since then, there have been problems in the communes of Pont-Saint-Esprit, Bussy-Saint-Georges, and the above-mentioned Hénin-Beaumont. The central government's regular transfers to local governments may have helped prevent more problems (Lévêque, 2013).

Another possible cause of the increase in monitoring was the increasing salience of the European Union's fiscal rules, which apply to general government (*i.e.*, consolidated local and central government). The EU's rules mean that, unless a member country is complying with the rules by a comfortable margin, its national government must monitor and influence the aggregate finances of local governments. France has been subject to the European Union's "excessive deficit procedure" for many of the past 15 years, and in some years even relatively small changes in the aggregate deficit or surplus of the local-government sector could have determined whether or not the country was in compliance with the deficit rules.

The Ministry for the Economy and Finance and the Ministry of the Interior have established accounting standards and budgetary rules for local governments for many years. Those standards are similar for all tiers of local government, though not identical. Accounting by local governments is accrual based, but the standards they follow differ from those followed by the central government. The reason is that local governments have preferred to maintain a system in which budgetary rules (based on an modified accrual system) and accounting principles are very closely linked, which results in numerous accounting entries designed to offset certain transactions recorded under income or expenses in order to keep the budget balanced.

After an experimental audit of the accounts of 25 local governments in 2017, the Cour des comptes (2018: 15) identified several problems in the accounting of local governments, including the following:

- Confusion is created by the existence of separate budgetary and accrual-based accounts (p. 130).
- Reconciliations between fixed assets on the balance sheet and registers of physical assets are not standard (p. 143).
- Accounting for inventory is often poor or absent (p. 144).
- Some 90% of the sample of local governments made inadequate provisions for the impairment of financial assets (p. 145).
- Similarly, 90% of the sample had no procedures for capturing all their off-balance-sheet obligations (p. 146). This last problem is perhaps especially significant because the accounting standards do not require local government to consolidate all the entities that they control, so obligations that would be on-balance-sheet under some standards are off-balance-sheet in the local governments' accounts.

The Cour des comptes (2018: 15) concludes that accounting by local government has a way to go before it presents a true and fair (*fidèle et sincere*) picture of their finances. To address these challenges, the standard-setter, the Conseil de normalisation des comptes publics (Public Sector Accounting Standards Council), is publishing new norms that will further standardise the accounting and bring it into line with that of the central government (Cour des comptes, 2018: 128). A number of other initiatives have been recently launched to improve the quality of financial reporting (e.g., pilots for "single financial accounts" containing financial statements (balance sheet, income statement and notes) and budget outturn data).

Annex 1.D. Germany

Germany is a federal parliamentary republic, with laws and key institutions of state grounded upon a constitution (*Grundgesetz*). It is composed of three main levels of government: the federation (*Bund*), 16 states (*Länder*), which include three so-called city-states (Bremen, Hamburg and Berlin) and about 11,000 cities and communities.[2] The constitution defines the responsibilities of the different tiers of government. The *Länder* are responsible for schools and education, the administration of justice, police and health services, while the communes manage local utilities and may deliver supplementary welfare benefits.

Germany is interesting in the context of this study because it is a federation with autonomous states that has had to work out new ways of monitoring state finances because of the country's EU obligations. The constitution states that "the Federation and the *Länder* shall be autonomous of one another in the management of their respective budgets" (article 109) but adds that they shall perform jointly the obligations of the Federal Republic of Germany resulting from the corrective arm of the European Union's Stability and Growth Pact. Cities and communities have a right to local self-governance according to the constitution. On fiscal matters, however, this self-governance is limited in practice as all borrowing and deficit financing is to be approved by the *Länder* and such approval has often been denied.

The budgets of the federation and the *Länder* are prepared according to shared general principles, laid out in the Budgetary Principles Act (*Haushaltsgrundsätzegesetz*). The accrual basis and the cash basis are both authorized for budget preparation. In the accrual basis is used, *Länder* are required to follow the German accounting standards for the public sector, which are based on the standards applying to local firms. If the cash basis is used, they are required to follow a common cash-basis chart of accounts. The Budgetary Principles Act also requires the provision of detailed data for national accounts and finance statistics (section 49b), prepared according the European System of Accounts (ESA 2010). These statistics are prepared on modified-accrual basis, meaning that investment is nonfinancial assets is expensed as it occurs.

Various fiscal policy co-ordination mechanisms have been used to reconcile the principles of administrative autonomy and joint fiscal responsibility. Since 2009, a Stability Council composed of the federal ministers of finance and economic affairs, as well as the *Länder* ministers of finance, has been tasked with monitoring the budgets of each *Land* and the federal government. The Council is advised by Germany's independent fiscal institution.

This monitoring is done against the fiscal rules of the Stability and Growth Pact and a national fiscal rule, the "debt brake", which requires that budgets for each *Land* and the federation be balanced in structural terms. For the federation, "balance" allows borrowing up to 0.35% of GDP, but the *Länder* have no such latitude. If the Stability Council identifies a "budget emergency", it must agree on a budget rehabilitation procedure. This procedure, however, has no direct enforcement mechanism: each government must implement it "on its own responsibility" and report progress to the Council every six months (OECD, 2015).

The surveillance is based on a set of indicators, forecasts and thresholds agreed by the Stability Council. These indicators are the structural fiscal balance per capita; the credit financing ratio (net borrowing as a percentage of expenditure); debt per capita; and the interest-to-tax ratio (interest expense as a percentage of tax revenue). The indicators are measured according to ESA 2010 data.

All levels of government have been innovative in circumventing debt restrictions, for example by reclassifying current expenditures as capital (investment) expenditures, setting-up entities whose operations are kept off-budget and face less tough debt restrictions and using innovative debt instruments, such as private-public partnerships for infrastructure projects (Seitz, 1999).

In 1988, two states, Saarland and Bremen, turned to the Federal Constitutional Court asking the Court to force the federal government to support both *Länder* in coping with their high public debt. The *Länder* Bremen and Saarland have experienced budgetary difficulties in past decades, which have been considered by the German Constitutional court to be caused by economic hardship rather than budgetary mismanagement. They benefited from a federal bailout in the 2000s, when their debt level increased. They have been the subject of a consolidation programme under surveillance of the Stability Council (Herold, 2018).

As at today, only the *Länder* of Hesse and Hamburg have fully developed accrual accounting, based on the German accounting standards for the public sector. Bremen uses a mixed system. All other *Länder* have cash-based accounting, with some of them including some accrual information in their cash accounts (*e.g.*, North Rhine-Westphalia, Baden-Wuerttemberg).

Annex 1.E. Iceland

Iceland is a unitary country, composed of two administrative levels of government: the state and local authorities. Iceland is interesting for this study in that it is a unitary state with a long tradition of self-government at local level that nevertheless had to adapt its approach because of the financial problems many municipalities faced during the economic and financial crisis that began in 2008.

There are around 70 municipalities in Iceland, of greatly varying size. Reykjavik is by far the largest with 122 thousand inhabitants, which is almost half of the total Icelandic population.[3] Municipalities are at the heart of Iceland's democratic system and were first mentioned in *Grágás* (Icelanders' book of statutes) in the 12th century. Local leaders originally got together to discuss issues of common interest at the *Althingi* (the Parliament), the oldest continuously meeting legislature in the world.

Municipalities' right of self-government regarding their own affairs, subject to the requirements of national law, is grounded in the Icelandic Constitution. The more recent 2011 Act on Local Authorities stipulates that no matter involving the special interests of a municipality shall be finally determined without their opinion.

Municipalities play a key role in the delivery of public services in Iceland, including the operation of preschools and construction and maintenance of local infrastructure. Municipalities often run local companies delivering utilities to citizens, such as water utilities, heating utilities, social apartments and harbours. These companies have independent revenues and finances, but often receive transfers from the municipality.

In the years of economic growth leading to the 2008 financial crisis, some municipalities in Iceland saw their revenue increase and expanded significantly their spending. In 2004 to 2008, their public consumption grew 60% faster than that of the central government and local government expenditure reached nearly one-third of general government expenditure. This happened while the system of monitoring was relatively weak, with only a non-mandatory balanced budget requirement for annual budgets and virtually no sanction for non-compliance (Aizenman and Gunnarsson, 2015).

The accounting of municipalities was already done on accrual basis. One interesting, long-standing feature of Iceland's municipal accounting is that it combined stand-alone accounts for the "core" municipality and consolidated accounts of all entities owned by the municipality.

The 2008 crisis was very severe in Iceland and largely caused by a banking crisis. The crisis caused difficulties for local authorities, mostly due to a sharp decline in their revenues, but also due to certain financial operations (PPPs and borrowing in foreign currency) that made them vulnerable to a shock.

The crisis led to an overhaul of the governance regime for municipalities. In 2011, a new Act on Local Authorities laid out detailed requirements concerning municipalities' accounting standards, financial reporting and audit. It required that accounting standards be established by a Municipal Accounting and Information Committee made up of five members, two of which are appointed by the Association of Local Authorities and one on the recommendation of Statistics Iceland. Under the current accounting framework, municipalities follow accrual accounting policies that are aligned with the national accounting standards for private firms and close to international standards, including reporting on nonfinancial assets.

The 2011 Act on Local Authorities also stipulates the framework for the monitoring of local authorities' finances, which is done by a Monitoring Committee of three members, appointed by the Minister of Local Authorities (two members) and Association of Local Authorities (one member). The legislation stipulates that one of the Monitoring Committee's member shall be a chartered accountant.

The Monitoring Committee is tasked with realising an overall assessment of the financial situation of each municipality. Specifically, the Monitoring Committee verifies compliance of each municipality with two fiscal rules, a balanced budget rule and a debt ceiling. The first rule is that local authorities are prohibited from running operating deficits within a rolling period of three years. The second rule is that municipalities are subject to a maximum debt-to-revenue ratio of 150%. Debt is defined as borrowing, as well as all other liabilities on the balance sheet, such as operating-lease liabilities.

In case of a perceived degradation of the financial situation of a municipality, the Monitoring Committee suggests remediation actions, having taken into account municipal self-government. Municipalities are classified into one of three categories based on whether, and by how much, they are in breach of the rules. Both the autonomy and the degree of external monitoring to which a municipality is subjected vary depending on its category (Aizenman and Gunnarsson, 2015.

Annex 1.F. United States

The United States is a federation with 50 states and over 90 thousand local governments, including cities, counties, and various special-purpose agencies. There is also the federal District of Columbia and various territories such as Puerto Rico. The local governments are creatures of the states. One of the distinctive features of the United States in the context of this study is the pursuit by the federal government and some states of the no-bailout strategy. Another is the widespread adoption of standardised subnational accounting despite the absence of any federal requirement to do so.

In the early nineteenth century, the federal government frequently bailed out financially troubled states, but the expectation of bailouts was overturned in the 1840s when several states defaulted and the federal government refused, despite pressure, to rescue them. Henning and Kessler (2012) write that "whereas no bailout request had been denied by the federal government prior to 1840 …, no such request has been granted since, with one special exception …." That exception was a bailout in the 1990s of the District of Columbia, which, significantly, is not a state. During the global financial crisis, states such as California and Illinois had serious fiscal problems, but those problems have not led to special federal assistance. The federal government was also famously lobbied to rescue New York city during the 1970s and refused, leading to the headline in the *New York Daily News* "Ford to New York: Drop Dead". President Ford's own words were, "I can tell you now that I am prepared to veto any bill that has as its purpose a federal bailout of New York City to prevent a default" (van Riper, 1975).

The absence of bailouts does not mean that the federal government does nothing to help states in difficulty. Federal taxes and spending effectively redistribute resources among states, as tax collections from struggling states fall, while federal spending on defence and social security may remain stable or increase. Routine federal budgetary transfers to the states also aid states in trouble, and during the financial crisis, the federal government's stimulus package included grants to state governments.

State bailouts of local governments also appear to be rare. Inman (2003) identifies only one: New Jersey's rescue of the city of Camden in the early 2000s. A more recent study by the Pew Charitable Trusts (2013) suggests a less clear-cut picture. Certainly, many states do provide assistance in some form to struggling local governments. California, however, declined to bail out three financially distressed cities during the recent financial crisis, just as it had declined in the 1990s to bail out Orange County when its investments in derivatives proved costly. Avoidance of state bailouts of local governments is facilitated to some extent by the existence of a national bankruptcy regime for local governments, though the regime does not operate in all states and its use is not common (De Angelis and Tian, 2013; Herold, 2018).

The no-bailout approach relies in part on monitoring of government finances by markets, which is easier in the presence of high-quality financial reporting. The federal government has not imposed any accounting requirements on the states, but many states and local governments follow local generally accepted accounting principles (GAAP), which primarily consist of the standards issued by the Governmental Accounting Standards Board (GASB) (Ruppel, 2010: ch. 1). GASB is a private organisation that was created in 1984 (though it had various predecessors). Although compliance with GASB standards is not required by any federal law, the standards are influential:

> *At the state or local government levels … many governments' charters, constitutions, enabling legislation, and so on do require the issuance of GAAP-based financial statements. … In addition, there may be instances where states or state comptrollers prescribe the accounting requirements for municipalities and other types of local governments within a state. … There may well [also] be practical requirements … to prepare GAAP financial statement. The best example would be the issuance of debt. Ruppel (2010).*

Many governments prepare two sets of accounts. One is the accrual-based "comprehensive annual financial report" that follows GASB's standards, which are similar in many respects to the standards set by the Financial Accounting Standards Board for the private sector (and thus quite similar to IFRS and IPSAS). The other is a set of "fund" accounts that present near-term resources for governmental funds and accrual-basis accounts for proprietary funds (governmental business enterprises).

The scope of consolidation includes the government itself (the "primary government") and its component units: "organisations for which the primary government is financially accountable" and "other organisations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete" (GASB Statement 14: i). The criteria for determining whether the primary government is financially accountable for another organisation relate to the extent of the primary government's control over the entity and whether the organisation is can provide a financial benefit or impose a financial burden on the primary government.

The accrual-based accounts recognize assets and/or liabilities for derivatives, defined-benefit pensions for employees, certain public-private partnerships, and various non-financial assets including land, building, and infrastructure. The valuation of pension liabilities has, however, been the subject of considerable controversy in recent years. Novy-Marx and Rauh (2009) argue that the pension liabilities are undervalued because future payments are not discounted at a rate that reflects their risks (see also Munnell, 2012: Chapter 3). Angelo (2013) discusses the controversy and defends the approach to valuation taken in the accounts.

Notes

1. The principle of free administration of local governments is defined under the provisions of Article 72 of the French Constitution and is governed by legislative provisions, which specify the conditions for the control of the acts of local governments by the State representative (control of the lawfulness of the acts of local governments and the related budgets).

2. See www.oecd.org/regional/regional-policy/profile-Germany.pdf.

3. See www.oecd.org/regional/regional-policy/profile-Iceland.pdf

Designing and implementing gender budgeting – a path to action

Gender inequality is an important and visible issue for OECD countries and the costs are borne at both social and economic levels. In line with the 2015 OECD Recommendation on Gender Equality in Public Life, gender budgeting ensures that gender equality considerations are taken systematically into account in tax and spending decisions. Effective implementation of gender budgeting has the potential to improve gender equality, ensure a sense of fairness and contribute to inclusive economic growth. This paper draws on the experiences of OECD countries and aims to provide insights into how the budget process can develop as a tool to support gender equality goals; the different ways in which gender budgeting can be implemented; and the factors that help provide an enabling environment for gender budgeting. Arising from this analysis, this paper proposes initial guidelines for designing and implementing gender budgeting to assist countries in putting in place an effective and sustainable approach. It also presents a first pass at a composite index for gender budgeting which assesses the extent to which OECD countries gender budgeting efforts are characterised by a strong strategic framework, effective tools of implementation and an enabling environment.

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Executive summary

Gender equality is a keystone of a prosperous modern economy, yet gender gaps persist in OECD countries in all areas of social and economic life. Action is needed to close remaining gender equality gaps. The *2013 OECD Gender Recommendation* and the *2015 OECD Gender Recommendation in Public Life* propose concrete measures that member countries and other adherents can implement to advance gender equality. A measure set out in the *2015 Recommendation* that is gaining traction among OECD countries is gender budgeting – which seeks to help redress gender inequalities through the tax and spend decisions of government. Half of OECD countries have now introduced gender budgeting, with more countries having plans to introduce it in the near future.

Given the "power of the purse", governments increasingly realise that the Central Budget Authority (CBA) has considerable ability to influence government-wide policy-making so that it better targets national goals. This is one of the reasons that we are seeing the emergence of gender budgeting alongside other initiatives such as "green budgeting", "wellbeing budgeting" and "SDG budgeting". Indeed, when gender budgeting is implemented effectively, it can bring about a reprioritisation of resources to help close gender gaps. This paper draws on the experiences of OECD countries to date and seeks to provide insights on how gender budgeting can be designed and implemented so that the budget process becomes a powerful tool for delivering on national gender goals.

The elements which are important for an effective and enduring gender budgeting practice can be brought together into three key areas:

1. A strong **strategic framework**: Gender budgeting efforts require political commitment, strong leadership and clarity of the roles and responsibilities of different actors across government so that a whole-of-government approach is in place. This approach is also most effective where actions are guided by a national gender equality strategy which outlines overarching gender goals.
2. Effective **tools of implementation**: To successfully implement gender budgeting, countries should select an approach that builds on existing elements of their budgeting model. A more advanced approach to gender budgeting benefits from the incorporation a gender perspective at all of the different stages of the budget process (including the *ex ante*, budget approval and the *ex post* phases).
3. A supportive **enabling environment**: Gender budgeting will be most effective where there is a supportive enabling environment. This includes systematic collection of gender disaggregated data, training and capacity development for government staff, structured engagement with civil society and oversight by accountability institutions such as parliament and the Supreme Audit Institute.

The OECD's first pass at a composite indicator for gender budgeting measures the extent to which gender budgeting efforts across OECD countries have these key elements in place. It categorises gender budgeting efforts as "threshold", "introductory", "mainstreamed" or "advanced". Almost half of OECD countries that have implemented gender budgeting are found to have an "introductory" practice (Belgium, Chile, Finland, Germany, Israel, Italy, Ireland and Portugal), with the remaining countries having a "mainstreamed" practice in place (Austria, Canada, Japan, Korea, Iceland, Mexico, Norway, Spain, and Sweden). No country yet qualifies as having an "advanced" practice.

1. Introduction

1.1. Gender equality: an uphill battle

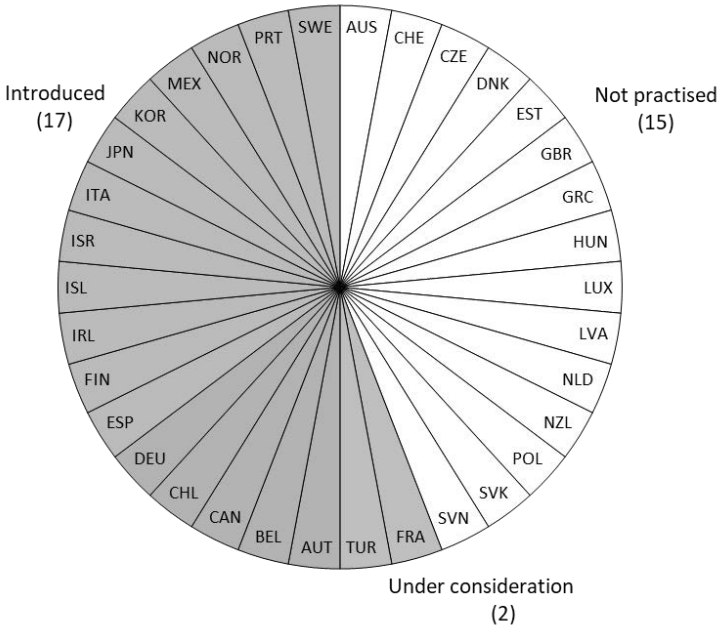
Gender equality is not only a fundamental human right. It is also a keystone of a prosperous, modern economy that provides sustainable inclusive growth. Gender equality is essential for ensuring that men and women can contribute fully at home, at work and in public life, for the betterment of societies and economies at large.

In the past five years, countries have made very little progress in reaching gender equality goals (further illustrated in Box 2). Gender gaps persist in all areas of social and economic life and across countries, and the size of these gaps has often changed little (OECD, 2017[1]). While movements such as *#metoo* and *#timesup* have helped raise awareness of women's rights in recent years, OECD governments must take greater action if they wish to close remaining gender equality gaps.

1.2. Redressing the balance

The *2013 OECD Gender Recommendation* and the *2015 OECD Gender Recommendation in Public Life* propose concrete measures that member countries and other adherents can implement to advance gender equality. In particular, the *2015 Recommendation* states that governments should integrate a gender perspective within the budget cycle (OECD, 2016[2]). This theme is developed further in *Gender Budgeting in OECD Countries* (Downes, von Trapp and Nicol, 2017[3])) and *The Pursuit of Gender Equality: An Uphill Battle* (OECD, 2017[1]). The latter report notes that "the practice of gender budgeting is gaining momentum in OECD countries". Data from the *2018 OECD Budget Practice and Procedures survey* indicates a growth from 12 countries practising gender budgeting in 2016 to 17 in 2018 (Figure 8). The survey also indicates two countries – France and Turkey – having plans in place to introduce it in the near future.

Figure 8. OECD countries that practise gender budgeting



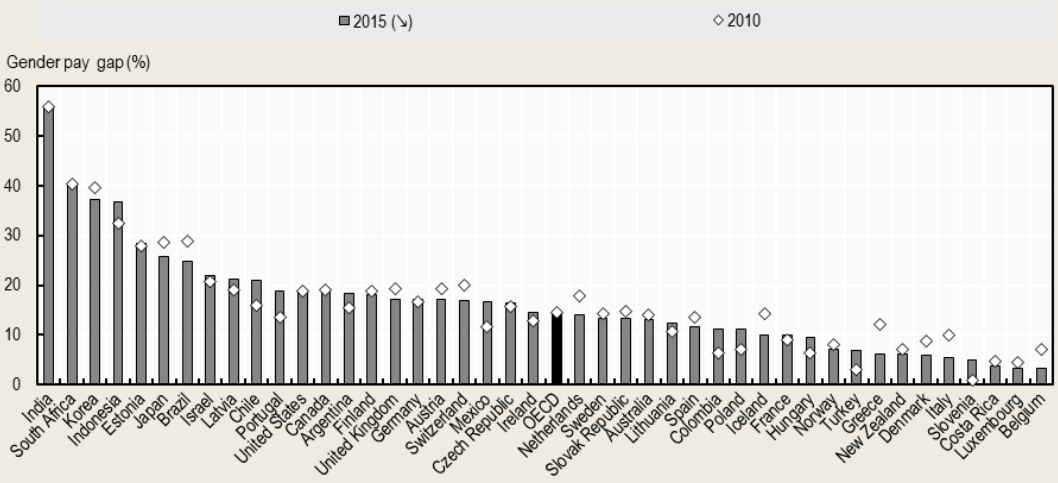
Notes: Data for the United States are not available.
Source: OECD (2018), OECD Budget Practices and Procedures Survey, Questions 32 and 36, OECD, Paris.

Box 2. Gender equality gaps across the OECD

Despite incremental improvements over the decades, gender disparities are still persistent today. Girls and young women surpass boys and young men in educational attainment and yet gender gaps in employment, entrepreneurship and public life still exist (OECD, 2017[1]). For example:

- In the labour market, women are less likely than men to engage in paid work, more likely to work part-time, less likely to become managers and entrepreneurs.
- The median full-time female worker earns 15% less than her male counterpart, on average across the OECD.

Gender gap in median monthly earnings,[a] full-time employees, 2010 and 2015 or latest available year[b]



Note: The gender gap in median monthly earnings is defined as the difference between male and female median monthly earnings divided by male median monthly earnings, for full-time employees. Full-time employees are defined as those individuals with usual weekly working hours equal to or greater than 30 hours per week.
-Data refer to weekly earnings for Australia, Canada, India, Ireland, the United Kingdom and the United States, and to hourly wages for Denmark, Greece, Iceland, New Zealand, Portugal and Spain.
-Data refer to 2014, not 2015, for Argentina, Belgium, Brazil, Estonia, France, Germany, Indonesia, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, New Zealand, Poland, Slovenia, Spain, Switzerland and Turkey. They refer to 2013 for Sweden, 2012 for India and South Africa, and 2011 for Israel. Data refer to 2011, not 2010, for Brazil, Chile and Costa Rica.

- In public life, only 34 % of the highest-ranking civil servants were comprised of women across the OECD in 2015. In terms of the number of women holding public office, significant differences are seen across countries where Sweden (44%) and Mexico (42%) lead women's representation whilst Hungry and Japan barely maintain 10% share of women in parliament (OECD, 2019[4]).

Source: OECD Employment Database (http://www.oecd.org/employment/emp/onlineoecdemploymentdatabase.htm) for OECD countries, Colombia and Costa Rica; and OECD Secretariat calculations based on the Encuesta Permanente de Hogares (EPH) for Argentina, the Pesquisa Nacional por Amostra de Domicílio (PNAD) for Brazil, the National Sample Survey (NSS) for India, the National Labour Force Survey (SAKERNAS) for Indonesia, and the General Household Survey (GHS) for South Africa.

Against this background, this paper seeks to expand on the rational for gender budgeting and to provide insights – based on the country experiences – on the key elements that underpin implementation of an

effective and sustainable practice. It then presents as assessment of the extent to which OECD countries have these key elements in place in the OECD's first pass at a composite indicator for gender budgeting.

2. Is the budget the right place to deal with gender equality issues?

The skills-sets of the Central Budget Authority (CBA) are not necessarily attuned to complex gender equality issues; and these ministries often have an inherent culture of conservatism which, while well-suited to the rigours of sound fiscal management and delivery of the annual budget, are in tension with the requirements of deep-seated social change. However, the budget is the central policy document of government. Given the central role that the budget plays in determining how resources are allocated to deliver outcomes, it is appropriate that cross-cutting priorities such as gender be considered as part of the budget process.

The *OECD Recommendation on Budgetary Governance* recognises a role for modern budgeting to move beyond a traditional technocratic exercise, stating that it can help *"show how annual and multi-annual objectives will be prioritised and achieved"* (OECD, 2015[4]). This is one of the reasons that we are seeing the emergence of gender budgeting, as well as other initiatives such as "green budgeting"[1], "wellbeing budgeting"[2] and "SDG budgeting"[3]. Governments increasingly realise that the budget process is a powerful tool for delivering on national policy goals. Applying this in support of gender equality, and reconciling this modern role with the traditional priority of effective budgetary management, is a key challenge of gender budgeting. But given the "power of the purse", dealing with horizontal policy objectives such as gender equality as part of the budget process offers considerable opportunity to influence government-wide policy-making and deliver on outcomes in a way that might not otherwise be feasible.

Nevertheless, the budget process alone cannot, and should not, try to assume onto itself the responsibility for solving all the problems of society. A whole-of-government approach involving the contribution of all government ministries and agencies is essential in areas such as understanding societal needs, setting of priorities, as well as policy development and implementation.

3. Designing and implementing gender budgeting

3.1. The strategic dimension

Principle 2 of the *OECD Recommendation on Budgetary Governance* calls for close alignment of budgets with the medium-term strategic priorities of government; a call which is echoed in the *OECD Good Practices for Performance Budgeting* (OECD, 2019[6])). Organising and structuring the budget allocations in a way that corresponds readily with national objectives helps facilitate the achievement of results, given the inter-dependencies between the budget process and the achievement of government-wide policies.

In the context of gender budgeting, a **gender equality strategy** plays an important role in identifying **overarching gender equality goals** towards which resources can be directed. To stand up to scrutiny, goals should be SMART (Specific, Measurable, Achievable, Realistic and Time-bound). They may also be linked to an **indicator framework** which helps tracks progress across a broader range of related indicators. An example of an indicators framework is provided by Canada (Box 3).

Box 3. Canada's Gender Results Framework

In 2018, Canada introduced a government-wide Gender Results Framework to track how the country is performing against key gender equality indicators. This provides a whole-of-government tool to measure progress in Canada in relation to gender equality, and to help identify where the greatest gaps remain. Under this framework, the federal government has identified six key areas where change is required to advance gender equality:



Each goal has a number of objectives and indicators that sit under it. During the preparation of the budget, the Gender Results Framework provides a useful framework for policy discussion and helps guide Ministerial decision making in relation to resource allocation.

Source: (Government of Canada, 2019[7])

The *OECD Toolkit on Mainstreaming and Implementing Gender Equality* outlines the importance of a whole-of-government approach in building any strategic framework (OECD, 2016[8]). This ensures that the framework has inputs from government stakeholders that will be affected by it, and will be responsible for implementing it, and gives it political validity.

A key challenge is also building a strategy that has societal validity. Engaging with expert groups in the development of a strategy is a critical element of this and helps ensure that the development of the strategy benefits from their knowledge. The *2017 OECD Recommendation of the Council on Open Government* notes that this sort of participative approach renews trust in government and the policies with which they make. This facilitates good governance, strengthens democracy and sets the condition for more inclusive growth. (OECD, 2017[8]).

3.2. Active engagement with civil society

In the same way that governments are unlikely to devise an optimal strategic framework for gender equality without input from civil society, government stakeholders are also unlikely to be able to devise optimal policies and budget proposals to tackle deep-seated gender equality alone.

Budgeting is a unique "nexus" that brings together the various dimensions of public policy analysis and that determines where the money goes. It is important that this nexus is open to a broad range of inputs

and viewpoints, ***especially* critical viewpoints**. OECD countries have made stronger efforts in recent years to help citizen's understand and engage with the budget process (OECD, 2019[8]). Heightened engagement with societal stakeholders is a major trend in modern public governance. It is considered "critical to building citizen trust and is a key contributor to achieving different policy outcomes in diverse domains" (OECD, 2017[9]).

An open government approach can ensure that the policies and programmes advocated in the budget proposal respond to the needs of citizens in relation to gender equality, and helps ensure that gender budgeting does not lose contact with its feminist-inspired origins and critical perspectives. Citizens and civil society organisations involved in gender advocacy often have the most direct experience and insights into the potential impacts of budget decisions on individuals and vulnerable groups. There is potential therefore for the quality of policy-making to be improved by including these voices within the policy-development and budget cycles. It also prevents the government from having to "reinvent the wheel" when developing gender equality policy, given that many gender advocacy groups have already given considerable thought to these matters.

Consultation may be undertaken as part of a formal **gender equality needs assessment**. These assessments help to examine the extent to which existing government policies meet and affect gender equality needs in a sector by identifying implicit forms of gender discrimination – such as the way with which language is used within the judiciary (OECD, 2016[8]). In this process, citizens and advocates should not be viewed as mere commentators, but as active participants in policy design and debate. An example of active engagement with civil society in relation to gender issues is provided by Spain's Council for Women's Participation (Box 4).

Box 4. The Spanish Council for Women's Participation

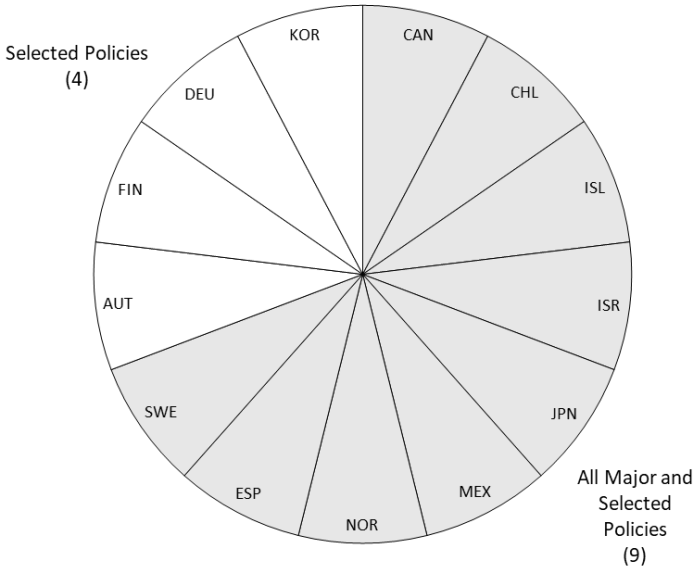
In Spain, the Council for Women's Participation was established by article 78 of the Constitutional Act 3/2007 of 22 March. The Council is made up of representatives from central, regional and local government as well as women's advocacy organisations. Its role is to channel women's participation in public policy development in relation to the principle of equal treatment and opportunities for women and men. The Government of Spain consults with the Council during the development of the Equal Opportunities Strategic Plan. The Council sets up working groups which focus on different elements of the draft Plan and agree specific amendments aimed at its improvement.

Source: Authors, 2019

3.3. Building evidence to inform policy development

A broader range of stakeholder engagement adds to the evidence base for public policy-making. In line with the *2015 OECD Recommendation on Gender Equality in Public Life*, government policy is more likely to achieve overarching gender equality goals when policies take full account of the different circumstances, needs and challenges of women and men. ***Ex ante* gender impact assessments** are a key tool of gender budgeting, and can be undertaken for new tax and spend proposals included in the budget. Two thirds of OECD countries that implement gender budgeting conduct assessments on all major and selected policies, as shown in Figure 9 (OECD, 2018[11]).

Figure 9. OECD countries which undertake *ex ante* gender impact assessments



Notes: Data shown only for the OECD countries which have introduced gender budgeting.
Source: OECD (2018), OECD Budget Practices and Procedures Survey, Question 34, OECD, Paris.

Undertaking this type of assessment during the policy-making phase can help inform policy design and changes can be made to ensure the final proposal is more gender-equal. At times, assessments are at risk of being part of the bureaucratic process - becoming a 'tick box' exercise. To address this, some governments have worked to make sure the correct incentives are in place ensuring assessments are well thought-through and of high-quality. Canada's *ex ante* gender impact assessment tool, GBA+, serves as one example which illustrates this (Box 5).

Box 5. *Ex ante* gender impact assessment in Canada

The Government of Canada has been analysing the gender-specific policy impacts on women and men before making decisions on policies, legislation, and programmes since 1995.

Gender-based analysis plus (GBA+) is the analytical tool that is used by departments and agencies for assessing the gender-specific impacts of policies, legislation, and programs on women and men. When integrated into the policy development process, gender-based analysis allows decision makers to consider gender differences. The "plus" in GBA+ acknowledges that GBA goes beyond biological (sex) and socio-cultural (gender) differences. Implementing gender-based analysis can help integrate social, life, economic, and gender differences into policy development and help the federal government achieve its obligations and commitments to gender equality.

Since 2017, the Minister of Finance has set out in the annual budget circular that GBA+ assessments must be presented alongside new budget proposals. This has helped ensure that assessments are carefully reviewed and of sufficient quality – disincentivising public managers to treat this as a bureaucratic 'box ticking' exercise.

In addition, the Department of Finance has taken further measures in recent years to drive improvement in the quality of GBA+ assessments being put forward with budget proposals. This includes highlighting examples of GBA+ undertaken for Budget 2018 where there is "room for improvement" and publically committing to publishing GBA+ of all budget items starting from Budget 2019.

Source: (Office of the Auditor General of Canada, 2016[12])

However, it is important that gender budgeting efforts do not focus entirely on incremental budget measures, which often account for a small proportion of the overall budget. Effective gender budgeting should also take stock of the gender impact of existing policies that are "baked in" from earlier budgets through tools such as **gender equality baseline analysis.** Examples of this type of analysis in practice are provided by Iceland and Sweden (Box 6).

Box 6. Gender equality baseline analysis

Iceland

Implementation of gender budgeting in Iceland began in 2009 on a pilot basis. Each ministry was tasked with setting up a pilot project to look at the gender impact of existing policies. Among these 17 projects: an analysis of the transferability of individual tax reductions between members of a couple (Ministry of Finance); research on the status of Icelandic household debt (Ministry for Foreign Affairs); and analysis of the gender breakdown of unemployment benefits and hospital waiting lists (Ministry of Welfare).

These baseline analyses highlighted some initial orientations for fiscal policy. For example, women were disadvantaged for farm subsidies, waiting lists for cardiac imaging, and availability of retirement home places. Corrective measures were implemented through the budget act to help redress these inequalities.

Sweden

In Sweden, the analytical tool – JÄMKAS – is used to assess how the activities of agencies/departments impact gender equality. JÄMKAS is an abbreviation of the Swedish words for Gender Equality Survey Analysis and Conclusions. There are three stages to a JÄMKAS assessment:

1. Making an inventory: this involves analysing activities and assessing how they help achieve gender equality policy objectives. Activities that are strategically important for gender equality are identified.
2. Surveying and analysis: this involves examining the activities that have been identified as strategically important from the perspective of women's and men's situations and needs and analysing the facts that emerge.
3. Formulating objectives: this involves listing the changes that could enhance gender equality. Measures that will alter the outcome from a gender equality perspective are then selected, and time and resources are allocated for implementation. Consideration is also given to how the outcomes for gender equality can be measured.

Source: Authors, 2019

3.4. Taking action in the budget to close gender gaps

Where information on the impact of the baseline budget on gender equality and the potential impact of new budget proposals on gender equality is available, this provides useful insights for the CBA on how they might use the budget to close gender gaps and facilitates a **gender perspective in resource allocation**.

There are a number of countries where gender impact assessments of new budget proposals are available, but where the information is not used by the CBA as part of budget decision-making. This may be because the quality of the impact assessments is insufficient, or because the CBA does not have an understanding of the key policy priorities in relation to gender equality, or senses a lack of political appetite for measures in this area. Canada provides an example of a country which is working to overcome these challenges, and seeks to use information on the gender impact of new budget measures in selecting which budget proposals to take forward (Box 7).

Box 7. Gender perspective in resource allocation in Canada

In Canada, the Minister of Finance explicitly references the need for clear and rigorous GBA+ in all budget and off-cycle funding proposals in letters to Ministers. The core requirements relating to this development were outlined in instructions distributed to departments explaining the nature of the supporting analysis that should be provided. Departmental stakeholders report that these changes have already encouraged them to think in a more structured way about the design and conduct of GBA+ and more profoundly about the potential gender impact of new policies and budget proposals.

The information provided in the GBA+ accompanying new budget measures, together with the Gender Results Framework provides a useful framework for policy discussion during the budget preparation process and helps guide Ministerial decision making in relation to resource allocation. The Department of Finance seeks to ensure that the budget proposal includes measures that will help meet goals identified in the Gender Results Framework.

Source: (OECD, 2018[14])

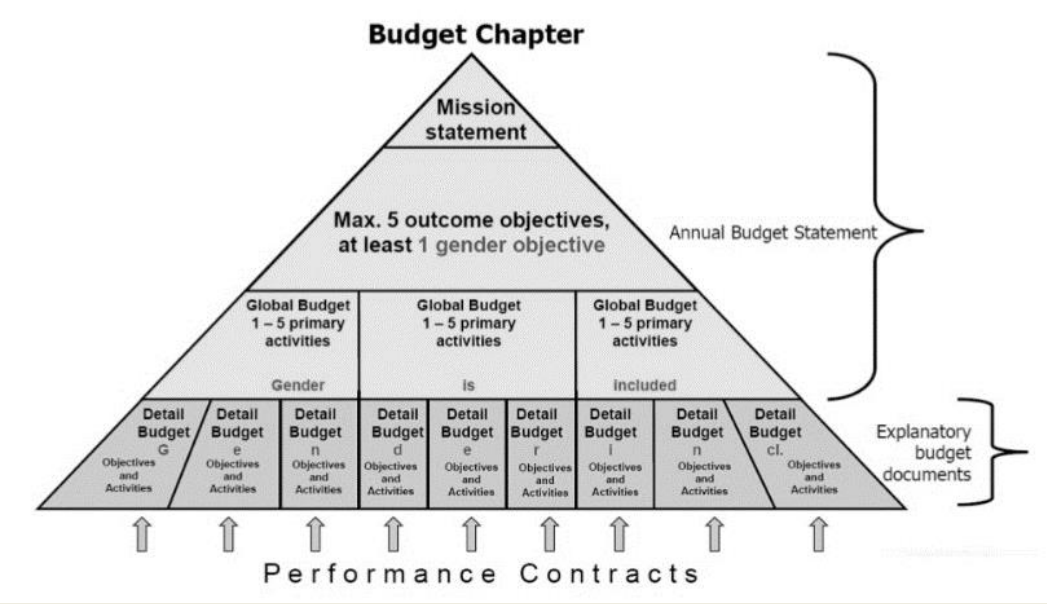
3.5. Tracking progress towards gender goals

Performance frameworks are useful tools for policy development and resource allocation as they provide information on the extent to which policies and programmes are achieving their intended results. Performance targets accompanying budget measures should ideally be aligned with national objectives, including gender objectives. This creates a framework for accountability by allowing stakeholders such as the legislature and civil society to track the action the government is taking to achieve national outcomes and the progress being made. This oversight helps makes sure that new measures take into account lessons from past performance and facilitates the improvement of public services, in line with Principle 8 in the *OECD Recommendation on Budgetary Governance* and the *OECD Good Practices on Performance Budgeting*.

Integrating a **gender perspective in performance setting** can be a useful tool for gender-responsive policymaking. On the one hand, it encourages policy makers to think about what they are trying to achieve in relation to gender and what programmes and funding they need in order to achieve it. On the other hand, it ensures that information is collected on the extent to which policies and programmes are achieving outcomes in relation to gender equality. More than half of OECD countries that engage in gender budgeting apply a gender perspective in performance setting[4]. An example is provided by Austria (Box 8).

Box 8. Integration of a gender perspective in performance setting in Austria

Austria's distinctive system of gender budgeting is well integrated within the performance budgeting framework. According to the Federal Budget Law 2013, the outcome objectives specified for each Budget Chapter must include at least one objective related to gender equality; and in turn, each of the "global budgets" and "detailed budgets" must include at least one gender-related output target. In this way, each line ministry is obliged to consider how its activities relate to gender equality, and to design objectives and indicators to promote gender equality in the context of the budget.



Reporting on the gender-related objectives is covered in the Performance Reports prepared by the Federal Chancellery. Therefore the Austrian system of policy-making is designed to require all ministries to consider gender equality both in their high-level goal-setting and in more detailed specification of outputs and objectives and account for their achievements in gender equality goals and objectives via the annual performance reports.

Source: (OECD, 2018[14]).

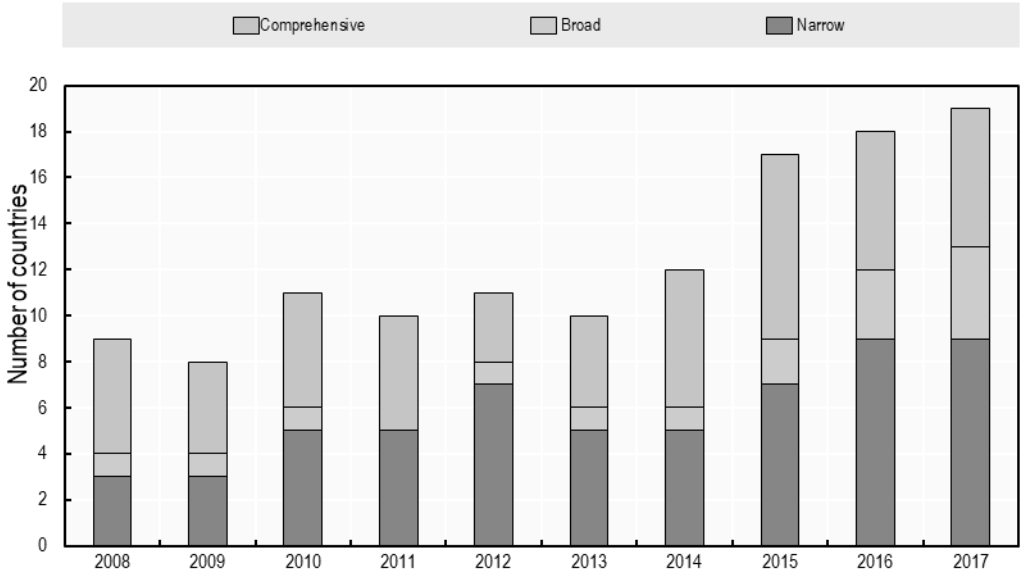
To ensure consistency and coordination of approach, gender indicators within departmental performance frameworks should have upstream linkages to the overall gender equality strategy.

As more gender performance objectives become embedded in the programmes of government, a **gender perspective to evaluation and audit** - which assess the effectiveness of policies and programmes at achieving their objectives - becomes automatic. *Ex post* evaluations and audits allow for learning about the extent to which gender objectives are being met or, if needed, inform why they have not been met. Lessons from these evaluations can inform improvements in future processes to improve outcomes.

OECD countries are also employing greater usage and variety of spending reviews in recent years (Figure 10). It is another exercise which is increasingly used by OECD governments to assess and re-prioritise existing spending. Governments, by large, utilise spending reviews to carry out budget consolidation and reprioritise expenditure to ensure greater efficiencies in spending and alignment to policy priorities. The application of a **gender perspective to spending review** has the potential to ensure that spending reprioritisation has a positive impact on gender equality goals. This is particularly pertinent in the

face of evidence that fiscal consolidation post financial crisis targeted sectors in which women were over-represented (the public sector, social services, etc.) (Périvier, 2018[16]). A gender perspective to spending review can help ensure that re-prioritisation of spend by governments does not exacerbate gender gaps, as it has in the past. The German federal government has plans to implement a gender perspective to spending review in coming years.

Figure 10. Prevalence of different types of spending reviews



Notes: Data for Israel and the United States are not available.
Source: OECD (2018), OECD Performance Budgeting Survey, Question 39, OECD, Paris.

3.6. Making actions and progress open to scrutiny

Making the practice of gender budgeting open to scrutiny is in line with Principle 5 of the *OECD Recommendation on Budgetary Governance* which states that governments should provide for "*an inclusive, participative and realistic debate on budgetary choices*". Providing information on gender budgeting to the public provides for systematic oversight, accountability, and engagement. This information can help civil society understand the extent to which tax and spend measures align with, and help contribute towards, overarching gender goals.

Budget tagging is one way through which governments can make public the resource flows targeted to different government objectives, such as gender equality. It involves the identification of budget programmes which have gender as a principal or significant objective.

Budget tagging can be a relatively "blunt tool" given that it may not be appropriate to count the full value of spending across certain programmes as spend targeted at gender equality objectives. Moreover, the volume of spending aimed at "gender positive" policies may not be the correct target for government action, and risks providing an easy alternative to the more thorough-going policy appraisal that may be needed to get to the heart of persistent gender inequalities. However, tracking the level of resources allocated in support of gender equality provides the public with an indication of the degree to which gender considerations are embedded across different areas of the budget, and how this changes over time. An example of gender budget tagging in practice is provided by Italy (Box 9).

Box 9. Gender budget tagging

Italy

In Italy, a national gender budgeting pilot introduced in 2016 involved budget expenditures being reclassified in light of their different impact on men and women. Expenditures fall into one of the following categories:

- Neutral expenditures: These have no direct or indirect impact on gender, for example: interest and debt repayments, depreciation, royalties and utilities.
- Sensitive expenditures: These relate to measures which have a different impact on men and women, for example, compensation of employees or expenditure on school education.
- Expenditure aimed at reducing gender inequalities: These relate to measures directly attributable to, or aimed at, reducing gender inequalities or promoting equal opportunities, for example, women's entrepreneurship funds, female employment incentives, work-life balance measures.

Information on expenditures in each of these categories within line ministries and other public administrations was provided in the Report to Parliament on Gender Budget 2016.

Source: (Government of Italy, 2017[18])

The information from budget tagging is sometimes presented in a consolidated **gender budget statement.** Where this statement is published as part of, or alongside, the draft budget proposal, it can help the public input into budget deliberations. Such a statement may include different types of information, which may have different applications and value in supporting the task of public scrutiny. For example:

- A **gender allocations report,** which clearly identifies the budgetary resources allocated to policies that promote gender equality, and allocations that affect women and men differently. Such a factual report can promote transparency and awareness of gender equality linkages.
- A **general gender budget statement** summarising in broad narrative terms how the range of measures introduced in the budget are intended to support gender equality priorities and goals.
- A **gender equality progress statement** which provides a more detailed exposition of how the budget measures advance the government's gender equality agenda, by reference to established objectives and indicators.
- **Gender impact analysis** which provides a distributional assessment of how specific measures (both revenue and expenditure) or the budget as a whole affect men and women in different ways, and serves to promote gender equality.

Eight OECD countries publish gender statements as part of, or alongside, the budget proposal. These various types of gender statement are most likely to contain information on general gender objectives, total spending allocated to gender equality projects and gender impact analysis of specific budget measures. Just three OECD countries provide a gender impact of the budget as a whole (Table 8).

Table 8. Information presented in gender statements across OECD countries

OECD Country	General gender budget statement	Gender allocations report	Gender impact analysis of specific budget measures	Gender equality progress statement	Gender impact analysis of budget as a whole
Canada	●		●	●	●
Iceland			●		
Japan	●	●			
Korea	●	●	●	●	
Mexico	●	●	●	●	●
Portugal	●	●			
Spain	●	●	●	●	●
Sweden		●	●		
Total	6	6	6	4	3

Note: Data shown only for the OECD countries which have introduced gender budgeting.
Source: OECD (2018), OECD Budget Practices and Procedures Survey, Question 34, OECD, Paris.

3.7. Engaging accountability institutions

Accountability institutions, such as the parliament and the supreme audit institution, are responsible for holding the government to account publicly for its policies and their implementation. Ideally, these institutions would seek to hold the government to account for their actions on gender budgeting, for example, through examining any gender budget statement published as part of, or alongside, the draft budget. Effective oversight of this information promotes the integrity, quality and credibility of national budgeting, in line with Principle 10 of the *OECD Recommendation on Budgetary Governance*.

An example of parliamentary scrutiny of an equalities statement presented alongside the budget is provided by the Scottish Parliament (Box 10).

Box 10. Parliamentary scrutiny of the equality impact of the budget in Scotland

The Equalities and Human Rights Committee at the Scottish Parliament scrutinises the Scottish Government's Draft Budget as well as the Equality Budget Statement that accompanies it. To do this, it puts out a public call for written evidence and also holds committee hearings with civil society organisations, including gender equality advocacy groups. The Committee provides a summary of its findings, together with recommendations, in a Report to the Finance Committee. Its 2017 Report on the Scottish Government's Draft Budget called for improvements to the Equality Budget Statement, describing it as "central to our scrutiny of the Scottish Budget". The recommendations in this report are considered by the Finance and Constitution Committee as part of its centralised response to the Scottish Government on the draft budget proposal.

Source: (Scottish Parliament Equalities and Human Rights Committee, 2017[14])

Parliamentary scrutiny of the budget can be strengthened through the involvement of a Parliamentary Budget Office (PBO) or scrutiny unit. The independent authority and expertise of these offices and units lends itself well to also supporting scrutiny of gender information presented alongside the budget. An example is provided by the Austrian PBO (Box 11).

Box 11. Scrutiny of gender budgeting by the Austrian Parliamentary Budget Office

The Austrian Parliamentary Budget Office was established in 2012 during a period of substantial reform to the budget law. Its main tasks include:

- Supporting the Budget Committee by providing analysis of the budget
- Responding to information requests from Members of the Budget Committee
- Supporting other parliamentary committees in relation to the impact assessment of new legislation
- Supporting parliament in its analysis of performance and gender budgeting

Specifically, the PBO provides analyses to parliament on government documents related to gender budgeting and gender equality. This helps stimulate the parliamentary debate on gender issues.

In undertaking this role, the PBO provides clear guidance for Members of Parliament on all the gender-related performance objectives, measures and indicators shown in the different budget chapters. Its budget analyses always include a comprehensive section on gender budgeting. These analyses discuss key issues such as, the quality of the information provided, the level of ambition of the objectives, the suitability and the development of relevant indicators (also international comparison), the availability of gender-disaggregated data, and levels of coordination between ministries. The PBO also submits proposals for how reports presented by the government might be improved through greater presentation of sex-disaggregated data (e.g. the grant report).

This legal budget framework and the PBO's support to parliament has resulted in higher awareness of gender budgeting and gender equality, and has brought about intensive discussions of gender objectives in the budget committee and in the plenary sessions. Gender issues are thus becoming an essential part of the budget debate, which is at the heart of parliament's work.

Source: Austrian Parliamentary Budget Office, 2018

Supreme Audit Institutions (SAI) also play a critical role in providing oversight and accountability for all government programs and policies. In line with Principle 10 of the *OECD Recommendation of Budgetary Governance*, SAIs help to promote the integrity of the budget process by allowing for rigorous quality assurance and independent auditing. There are two obvious areas where the SAI can have an important role in relation to gender budgeting.

First, as part of the move from a more traditional focus on financial audits to looking at aspects of performance or value for money, many SAIs now undertake performance audits. Data from the *2014 OECD Mini-Survey on Supreme Audit Institutions and Performance-related Budgeting* indicate about 38% of countries in the OECD conduct audits on the achievement of performance objectives often or always. (OECD, 2015[20]))

Performance audits can greatly enrich public accountability and enable the SAI to make practical contributions to improving the efficiency and effectiveness of the public administration. These are important tools for democratic accountability and control.

As gender-related performance objectives become embedded in the programmes of government, SAIs should ideally be able to integrate a **gender perspective in performance audit.** An example of a SAI which undertakes such an approach is provided by the Austrian Court of Auditors (Box 12).

Box 12. Gender dimension to performance audit by the Austrian Court of Auditors

The Austrian Court of Audit is the supreme audit institution for Austria, responsible for both financial and performance audits.

Internal guidelines specify that each performance audit should consider complementary questions in the area of gender equality. This includes questions such as:

- Is the gender objective relevant?
- Is there sufficient gender-specific data?
- How appropriate is the level of ambition for measures and indicators?
- What is the impact on society?
- Are women and men appropriately represented in the governing bodies?

For example, an audit of "Agricultural Investment Subsidies and its Outcomes" as part of Austria's rural development programme found that gender equality was not systematically covered by the programme, just 30% of the monitoring committee members were women (despite rules of procedure aimed at gender balanced representation), gender specific investment needs were not analysed despite women predominantly having smaller farms than men, and programme data was not systematically reported and analysed from a gender perspective.

Other recent ACA audits with a gender perspective include: Gender Health in Austria (2015), Compensatory Allowances under Pension Insurance (2015), The Introduction of Outcome Orientation in Selected Federal Ministries (2016), and Gender Aspects in Income Tax Law (2017).

Source: Austrian Court of Audit, 2018

Second, SAIs can also play an important role by undertaking a **gender equality systems audit**, which assesses how gender equality policy processes are working. These audits have the potential to ensure that gender budgeting tools, such as *ex ante* gender impact assessment, are being implemented effectively and efficiently. An example of this type of audit being undertaken by a SAI is provided by the Office of the Auditor General in Canada (Box 13).

Box 13. Gender equality systems audit by the Office of the Auditor General of Canada

The Office of the Auditor General of Canada (OAG) has undertaken two audits in relation to gender based analysis (GBA), the main tool employed by the Government of Canada to assess the gender impact of policies and programmes.

Its first audit was conducted in 2009 and sought to determine whether selected departments could provide evidence that they are conducting, and the central agencies can provide evidence that they are reviewing, GBA to adequately support decision making on policy and programme spending initiatives. After this audit, , the Standing Committee on Public Accounts requested that Status of Women Canada, Treasury Board Secretariat and, the Privy Council Office presented to Parliament a government-wide Departmental Action Plan on Gender-Based Analysis. This plan was intended to provide the blueprint for implementing and sustaining the practice of gender-based analysis across all federal departments and agencies.

A second audit was conducted in 2015 and examined whether the selected departments performed adequate GBA to inform government decisions, and whether Status of Women Canada and the relevant central agencies appropriately supported the implementation of GBA throughout the federal government. This audit also examined the government's progress on the 2009 recommendations.

Source: (Office of the Auditor General of Canada, 2016[12])

3.8. Broader public and societal accountability

Apart from traditional budgetary accountability, broader societal dimensions of accountability can also be provided by civil society, and facilitated by transparency on the part of the government with regard to its gender budgeting, for example through the tabling of gender budget statements, as previously mentioned.

Where adequately resourced and equipped with necessary skill sets, gender equality advocacy groups may also be in a position to present their own **social audit of the budget**. This type of civil society scrutiny can be particularly useful in providing an independent "challenge" function as to whether public policies are really addressing core issues than can lead to persistent gender inequalities, especially in cases where the government does not produce any gender-specific information alongside the budget (see Box 14 for the example of Australia).

Box 14. Social audit of the gender impact of the budget in Australia

The Government of Australia was considered a "pioneer" of gender budgeting when it included a Women's Budget Statement as part of the 1984/85 budget documents. By the late 1980s the Women's Budget Statement became part of an integrated approach, which included the development of a National Agenda for Women. However, over subsequent years, political and administrative championing of the Women's Budget Statement fell away, and the document was dramatically downsized in budgets 1994–95 and 1995–96. Following the election of a new government in 1996, the Women's Budget Statement was effectively discontinued.

As the government deprioritised gender budgeting, civil society stepped in, and the National Foundation for Australian Women (NFAW) produced its first gender assessment of the 2014-15 budget in 2014. NFAW is a feminist non-politically affiliated organisation of volunteers and it has continued to produce gender analysis for subsequent budgets. Its reports make recommendations across a range of policy areas, and also in relation to the machinery of government and data collection. NFAW calls on both Government and Opposition to respond to the recommendations set out in its report.

Sources: (Sharp and Broomhill, 2013[16]) and (Morrissey, 2018[17])

4. The final missing pieces of the jigsaw

Gender budgeting presents significant social and economic opportunities for OECD countries. However, implementing an effective and sustainable gender budgeting approach can be challenging. Sustaining it over the long-run requires an enabling environment which supports the use of gender considerations in programs and policies – particularly at times when political momentum loses traction. The following sections outline essential elements to help successfully embed a gender perspective within budgeting. Many of these elements are equally the desiderata of good budgeting and good policy formulation and so

a budget process which effectively incorporates gender budgeting should converge with international good practices on budgeting. Furthermore, in line with the *2015 OECD Recommendation of the Council on Gender Equality in Public Life*, these elements are linked an effective functioning gender mainstreaming framework. Despite the growth in gender budgeting practices across the OECD, these efforts are unlikely to be effective or enduring without the requisite enabling environment in place to fully embed the practice.

4.1. Political leadership

High level political commitment is important for gender budgeting, particularly at the start to help drive the change in culture within government. Political commitment adds weight to gender budgeting reforms, which might otherwise be difficult for government staff to mobilise, particularly if they are already stretched in their jobs. An example of strong political leadership for gender budgeting is provided by the Ministerial Committee for Equality in Iceland (Box 15).

Box 15. Ministerial Committee for Equality in Iceland

In 2017, with the renewed political commitment to gender equality in Iceland, the Prime Minister of Iceland and the Cabinet re-established the Ministerial Committee on Equality. The main role of the Committee is to coordinate equality issues among ministers and within the government. These issues include, but are not limited to, parental leave (paternity and maternity leave); the elimination of the gender pay gap (implementation of the law on the Equal Pay Standard); the rights of LGBTQ+ people; combating sexual violence; and ratification of the Istanbul Convention.

The Ministers represented on the Committee are the Prime Minister; the Minister of Social Affairs and Equality; the Minister of Justice; the Minister of Health; and the Minister of Education and Culture. Other ministers participate in the meetings of the Committee on the basis of need and in accordance with the decision of the Prime Minister who chairs the meeting of the Committee.

Source: Government of Iceland 2018

4.2. Legal foundations for gender budgeting

While political leadership is important at the start, **legal foundations for gender budgeting** can help ensure its sustainability in the longer term. Australia was a pioneer for gender budgeting in the 1980s when it included a Women's Budget Statement as part of the budget. However, through this time, the Statement was seen as an internal bureaucratic exercise not-synced to the normal budgeting process, and of little relevance to the women's movement. Oftentimes, spending and taxing decisions were already made by the time the Women's Budget Statement was completed (Sharp and Broomhill, 2013[17])). As such, after the election of a new government in the 1990s, the Women's Budget Statement was effectively discontinued.

Legislation that is fully tested and debated in parliament may help embed gender budgeting as a valued and enduring feature of public policy making and insulate it, as far as possible, from fluctuations arising from the economic or political environment. Of the 17 OECD countries that have implemented gender budgeting, ten countries have legal provisions (either in the budget law, or another legal provision) underpinning the practice (Austria, Belgium, Canada, Iceland, Italy, Korea, Mexico, Norway, Portugal, and Spain) (see Box 16 for examples). In other OECD countries, the basis for gender budgeting is most often high level political commitment or administrative practices, as shown in Figure 11.

Box 16. Legal provisions for gender budgeting in OECD countries

Austria

The key foundation for gender-responsive budget management in all public authorities lies in the Austrian Federal Constitution which commits public administrations to aiming for equal status of women and men in budget management, and more specifically in outcome orientation. In addition, the Federal Budget Law 2013 has detailed regulations on outcome oriented administration including the consideration of the objective of effective equality of women and men.

Iceland

The principle of equality is set out in the Constitution of the Republic of Iceland which states that "Men and women shall enjoy equal rights in all respects". Gender budgeting has been legally binding in the Act on Public Finances (No. 123/2015) since January 2016. It states that the Minister of Finance and Economic Affairs should, in collaboration with the minister in charge of gender equality, draw up a gender-responsive budgeting plan to be consulted when the national budget is prepared, and that the draft national budget should report the impact that these considerations have had on achieving gender equality.

Spain

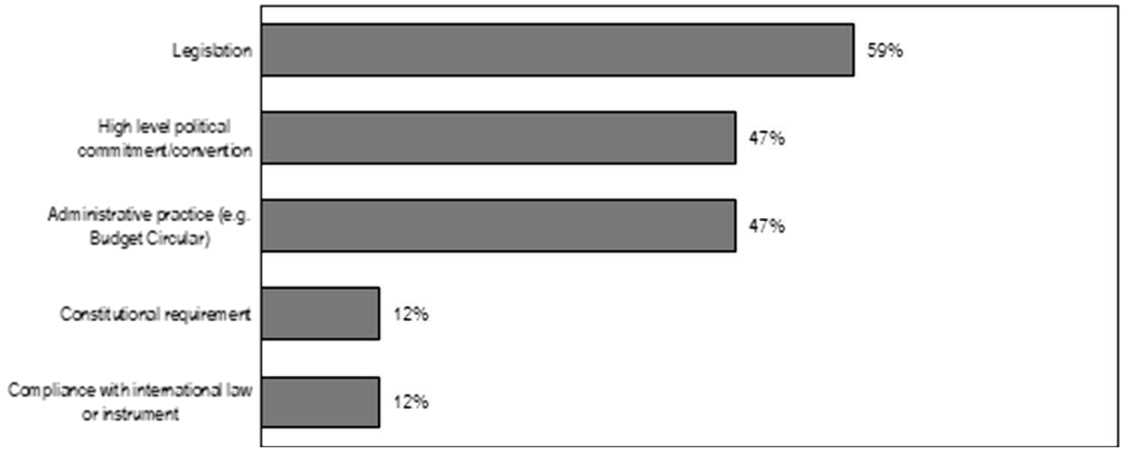
The Spanish Act from 1978 states that there should be no discrimination between men and women. Law 30/2003 of 13 October sets out that all draft bills must include a gender impact assessment report. In addition, Royal Decree 1083/2009 of 3 July established that the annual Draft Budget Law must be accompanied by a Gender Impact Report.

Korea

The 2006 National Finance Act made the submission of gender budget statements and balance sheets mandatory from the 2010 fiscal year onwards. Provisions require the Government to submit a gender budget statement that analyses the impact of budgeting on women and men, and a gender budget balance sheet that assesses whether women and men equally benefit from the budget.

Source: Authors, 2019

Figure 11. Legal basis for Gender Budgeting



Note:
Source:

4.3. Clear roles and responsibilities and strong coordination mechanisms

The CBA has a central leadership role in relation to gender budgeting. However, to embed gender budgeting throughout the budget cycle requires the collective effort of a number of government and non-government stakeholders. A particularly important stakeholder is the Ministry for Equality or Equality Institution (sometimes referred to as the national equalities machineries). The CBA often works hand-in-hand with their equality counterparts in implementing gender budgeting. As part of the leadership role of these institutions, clear responsibilities for the different actors involved (including departments, the national statistical office and citizens) should be set out.

Additionally, strong co-ordination mechanisms (for example, an inter-agency working group) can be a valuable element of any approach to gender budgeting that involves different stakeholders. This facilitates a comprehensive approach, as well as exchange of good practices among different stakeholders. According to the *2018 OECD Budget and Procedures Survey*, almost half of OECD countries who have implemented gender budgeting (41%) report that they have an inter-agency working group such as this. An example is provided by Iceland's Gender Budgeting Committee (Box 17).

Box 17. Iceland's Gender Budgeting Committee

Iceland's Gender Budgeting Committee has been set up, and is led by, the Ministry of Finance and Economic Affairs in a formal cooperation with the Ministry of Welfare. The Committee includes representatives of all the ministries and the Centre for Gender Equality. It is responsible for preparing the implementation programme for gender budgeting. Similarly, steering groups in all the ministries are responsible for implementing gender budgeting within each ministry.

Source: Authors, 2019

4.4. Collection of gender-disaggregated data

An important development along the path of gender-responsive policy making is the **collection of gender-disaggregated data**. Gender-disaggregated data supports gender assessments and audits and is pivotal in enabling governments to develop effective gender-sensitive and evidence-based policies. Departmental data collection should be augmented by other data collecting institutions, such as the national statistics bureau, also collecting gender-disaggregated data.

The *2016 OECD Survey on National Gender Equality Frameworks and Public Policies* points to a systematic lack, across many OECD countries, of the necessary gender-disaggregated data. It may be that the non-availability of this data reflects assumptions that the "default" allocation of resources is gender-neutral, and that gender-disaggregation should only be sought where there are *prima facie* grounds for believing that a non-gender-neutral policy issue is in question. This poses problems as systemic issues – gone unnoticed – will likely perpetuate inequalities seen across many areas of public and economic life. Gender budgeting helps to address this by providing an opportunity to test and bring attention to these assumptions and providing a framework to keep governments accountable to overcoming these challenges. Other factors may also be hindering better availability of gender-disaggregated data, such as: limited human resources; limited capacity of the statistical offices; limited capacity in line ministries/departments/agencies to determine the need for gender disaggregated data; lack of understanding of how to disaggregate household data, limited skills of producers of statistics to incorporate a gender perspective into their work; limited coordination mechanisms to determine the kind of data that need to be collected; lack of indicators to guide the collection of disaggregated data; and poor quality of existing data.

Accordingly, there is a case for a more systematic and thorough-going approach to collecting data on a gender-disaggregated basis. An example from Israel points to an appreciation of the importance of such data availability as a key element in a national gender equality strategy (Box 18).

Box 18. Gender disaggregated data in Israel

In Israel, in 2008 the Statistics Law was amended to require that every data collecting institution must analyse and publish statistics by gender. Subsequently, since 2014, line ministries have had to conduct gender analysis of the budget. In the field of science (scholarships and funds), the exposure of data on gender (ex post) initiated a process of a more balanced allocation of resources. In sports, the data on gender has sparked widespread public debate about how government money is spent in this sector. Despite this, some ministries have continued to have difficulty obtaining the necessary data as shown in an independent study of the Ministry of Industry, Trade and Labour.

Source: (Downes, von Trapp and Nicol, 2017[3])

4.5. Training and capacity development

Training and capacity development can be crucial factors in order to increase openness towards gender-responsive policies throughout the public sector. Training is available in over half of the OECD countries that have implemented gender budgeting (63%). For example, government officials in Korea must have to attend a specific training to learn how to prepare a Gender Budgeting Statement (a document that contains information on gender targets and the gender impact of government spending) in order to help them provide information that feeds into it in the correct manner. In Canada, the government takes forward its commitment to gender impact assessment, named GBA+, through training to strengthen capacity across

departments and organisations. An implementation survey found that 57% of organisations had mandatory GBA+ training in 2017, and almost 75% of organisation used the GBA+ course as mandatory or recommended training for policy analysts (OECD, 2018[14]; Government of Canada, 2018[23]). In Mexico, Gender Units are in place across the public administration to help train in gender policies and this helps develop capacity in relation to gender budgeting (Box 19).

Box 19. Gender Units in Mexico

In Mexico, Gender Units were created to support the public administration in incorporating a gender perspective into different fields of work, and to promote the advancement of women in the public sector. By 2017, 27 Gender Units had been set up, with their main activities including; assessing the work environment, helping design public policies with a gender perspective, providing training in gender policies, tracking and evaluating the incorporation of a gender perspective and ensuring the use of inclusive language.

Source: (Government of Mexico, 2017[24])

4.6. Review and evaluation of the impact of gender budgeting

A whole-of-government vision for gender budgeting steers and aligns planning, implementation, evaluation and the application of key learnings to the forward stages of the policy cycle. Given this, it is important to have a measurement framework in place that is capable of **assessing the impact of gender budgeting** and the extent to which it is delivering the intended results.

Measuring the impact of gender budgeting can have its challenges. For example, it may be difficult to identify the influence of gender budgeting on policy as it will not show up as a discrete step in the policy development process and it will be difficult to control for the impacts of political leadership and direction. However, any information that can be presented on the impact of gender budgeting will help stakeholders better understand its merits and support cultural change within public policy making. Results can also help inform improvements to the approach to gender budgeting, ensuring that it is impactful.

The effectiveness of gender budgeting can be measured in a number of different ways. Examples include:

1. Development and application of gender related indicators that feed back to higher-level strategy
2. Structured feedback/dialogue with civil society bodies and other stakeholders
3. Regular reporting to parliament on the impact of gender-responsive policies
4. Surveying stakeholders/target groups for their perception of the impact of gender- related policies
5. Regular/ongoing monitoring of progress by reference to key indicators/benchmarks of gender equality
6. Engagement of local or international experts to periodically review gender budgeting efforts
7. Collection of case studies which provide insights into how gender budgeting is influencing policy development, overall resource allocation and gender outcomes, as well as the barriers it is facing

An example of a country that has put in place a framework to measure the impact of gender budgeting is provided by Sweden (Box 20).

Box 20. Measuring the impact of gender budgeting in Sweden

The Swedish Government have given the Swedish National Financial Management Authority (ESV), a government agency, responsibility for measuring the impact of gender budgeting reforms that have been carried out by the government. The agency will look at the impact of gender budgeting reforms as well as other budget reforms that may have had an impact on gender equality. It is hoped that the assessments will provide improved awareness of the wide range of budgeting factors which can contribute to or reduce gender equality. This will put the Swedish Government in a better position to put measures in place that correct these inequalities.

Source: Government of Sweden, 2017

5. Bringing it all together

The budget is a central policy document of government, showing how annual and multi-annual objectives will be prioritised and achieved. It is not surprising, therefore, that initiatives to promote gender-responsiveness in public policy have included attempts to incorporate a gender-sensitive dimension into the budgeting process itself.

This paper has aimed to provide insights into how the budget can develop as a tool to support gender equality goals, the different ways in which gender budgeting can be implemented and the factors that help provide an enabling environment to ensure an effective and sustainable approach. As part of this, it has highlighted elements which are important for an effective and enduring gender budgeting practice. Through an effective practice, gender budgeting can help ensure that tax and spending is better targeted to meet overarching gender goals. These elements can be brought together into three key areas:

1. Strategic framework
2. Tools of implementation
3. Enabling environment

5.1. Core elements of gender budgeting

5.1.1. Strategic framework

A **national gender equality strategy** that sets out **overarching gender equality goals** is the centrepiece to a strong strategic framework for gender budgeting. Using gender budgeting as a tool to help deliver on this strategy relies on strong **political commitment** that give momentum to gender budgeting reforms and help drive a change in culture across the government. Building a **legal framework** provides a foundation to allow gender budgeting to become embedded in existing budgeting processes and ensures practices withstand changes in political priorities. Gender budgeting efforts are most effective when there is **strong administrative leadership** by the CBA, in close cooperation with the national equalities machineries. Those in charge should ensure the provision of clear **guidelines on applying gender budgeting** and set out **institutional roles and responsibilities**, so that there is a well-coordinated and cohesive approach to gender budgeting, adapted to the country's governance structures. Instituting an **inter-agency working group** ensures a wide range of stakeholders are engaged through the process, and gives opportunities to share good practice.

5.1.2. Tools of implementation

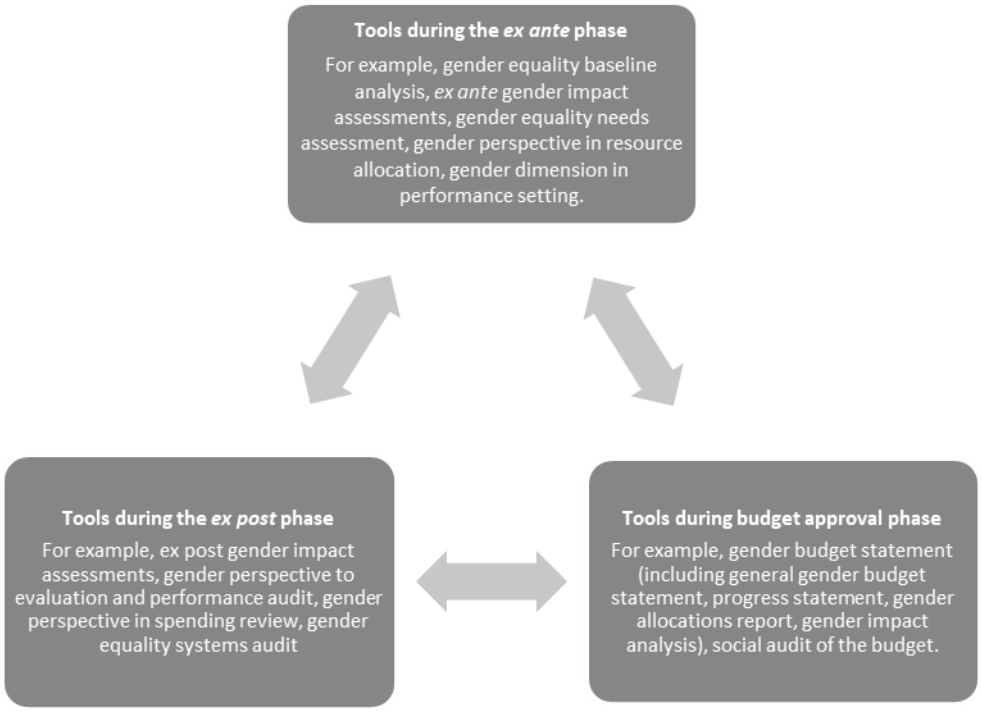
To successfully implement gender budgeting, OECD countries have adopted a variety of operational tools across different stages of the budget process (Figure 12).

Before the budget proposal is laid before parliament – during the *ex ante* phase – a **gender equality baselines analysis** and ***ex ante* gender impact assessments** of new budget measures can help the CBA gain an understanding of how different policies are/can impact gender equality. Information from these – taken together with a **gender equality needs assessment** which outlines the main gender gaps across different policy areas - helps underpin the application of a **gender perspective in resource allocation**. This allows for the CBA to put forward a budget proposal containing measures which are understood to help close priority gender equality gaps. A **gender dimension in performance setting** also facilitates an understanding of how budget measures relate to different gender equality goals, and enables civil society to track progress.

When the budget proposal is being tabled at parliament, a **gender budget statement** can be a useful tool in highlighting the measures that the government has taken to achieve gender equality outcomes. This statement may include a **general gender budget statement** summarising how measures in the budget are intended to support gender equality priorities, together with a **progress statement** outlining the government's progress in supporting and resourcing high-level priorities and goals in relation to gender equality. It may also include a **gender allocations report**, informed by **budget tagging** of spend related to gender**,** which helps stakeholders identify the quantity of financial flows allocated to policies promoting gender equality. And it may include a **gender impact analysis** of specific measures, or of the whole budget, which provides an assessment of the distributional effect of the budget between genders. Where information is missing from the gender budget statement, or no statement is provided, gender equality advocacy groups may choose to present **social audit of the budget** which assesses whether the budget is addressing the core issues bringing about gender inequalities.

After the budget has been spent – during the *ex post* phase – ***ex post* gender impact assessments** and a **gender perspective to evaluation and performance audit** help identify whether the intended results of different budget measures were achieved. A **gender perspective in spending review** also helps ensure that any decisions to reallocate expenditures from one area to another take into account the potential for these decisions to impact on gender inequality. Assessments, such as the **gender equality systems audit**, help identify how well the gender budgeting initiative, and the elements underpinning it, are functioning.

Figure 12. Gender budgeting tools at different stages of the budget process

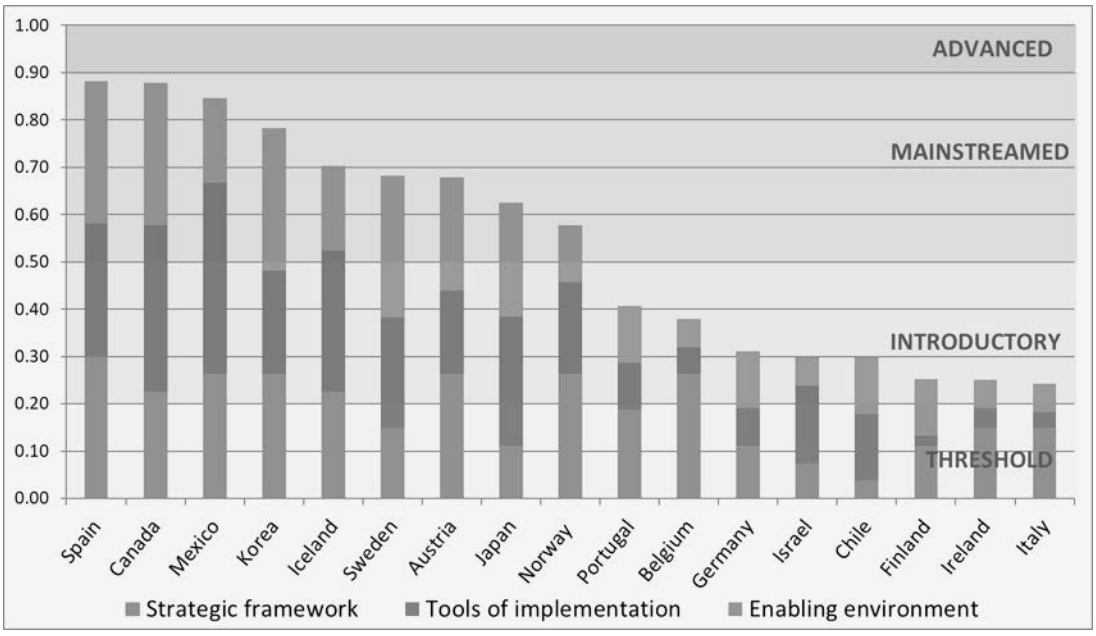


Gender budgeting initiatives are being pursued in various forms across OECD countries. The OECD has refrained from adopting an "ideological" preference with regard to the tools of gender budgeting that should be used. Countries should select an approach that builds on existing elements of their budgeting model. However, a more advanced approach to gender budgeting benefits from the incorporation a gender perspective at all of the different stages of the budget process.

5.1.3. Enabling environment

Finally, successful implementation of gender budgeting relies on a strong enabling environment. Building upon the strategic context of political commitment, legal frameworks, and strong and accountable institutions, practising gender budgeting requires a wide range of supporting factors to ensure its success. Having a sufficient base of information is critical to informing assessments, impacts, and decision-making. As such, systematic collection of **gender disaggregated data** is pivotal in enabling governments develop effective gender-sensitive and evidence-based policies. To increase openness and understanding in relation to gender budgeting through the public sector, **training and capacity development** can help to institute practices over the long-run, as do details and **instructions on the application of gender budgeting in the annual budget circular**. Other factors, such as engaging and consulting citizens and experts, for example, through **structured engagement with civil society** or setting up an **expert/consultative group to advise on gender budgeting**, can become important to inform ongoing gender budgeting efforts and ensure it remains open to a broad range of inputs and viewpoints, especially critical viewpoints. Equally important is for gender budgeting to be subject to **oversight by accountability institutions** such as parliament and the supreme audit institution, so that the government is held to account publically for its implementation.

Figure 13. First pass at a composite indicator on gender budgeting



Note: Only shows scores for OECD countries that have introduced gender budgeting. Information used for this index reflects data represented in the *2018 OECD Budget Practice and Procedures Survey*. Data for Canada has been updated to reflect the introduction of the Canada Gender Budgeting Act in December 2018. Information for countries will continue to be updated as new information is collected.
Source: (OECD, 2019[24])

The OECD's first pass at a composite indicator on gender budgeting will be further refined over time in order to ensure it captures the elements that underpin a comprehensive gender budgeting framework.

Note

1. "Green Budgeting" refers to an approach of using the tools of budgetary policy-making to help achieve climate and environmental goals. The term was coined by the Paris Collaborative on Green Budgeting, a group of countries convened by the OECD which seek to develop new tools and methodologies that are sensible and effective in aligning national policy frameworks and financial flows with climate change targets set in the Paris Agreement, as well as the Aichi Biodiversity Targets and the United Nations' Sustainable Development Goals.

2. "Wellbeing budgeting" refers to an approach to budgeting, popularised by New Zealand in 2019, to tackle a broader set of priorities of wellbeing, such as child poverty, developing a sustainable economy, mental health, and improving the livelihood of indigenous communities. Wellbeing budgeting aims to develop an evidence-based approach which fosters greater inter-ministry cooperation and thinking of longer-term intergenerational approaches to policymaking.

3. "SDG budgeting" refers to the practice of showing the link between the national performance framework and spending to the achievement of the Sustainable Development Goals (SDGs).

4. Including: Austria, Canada, Chile, Iceland, Ireland, Japan, Korea, Mexico, Spain, and Sweden.

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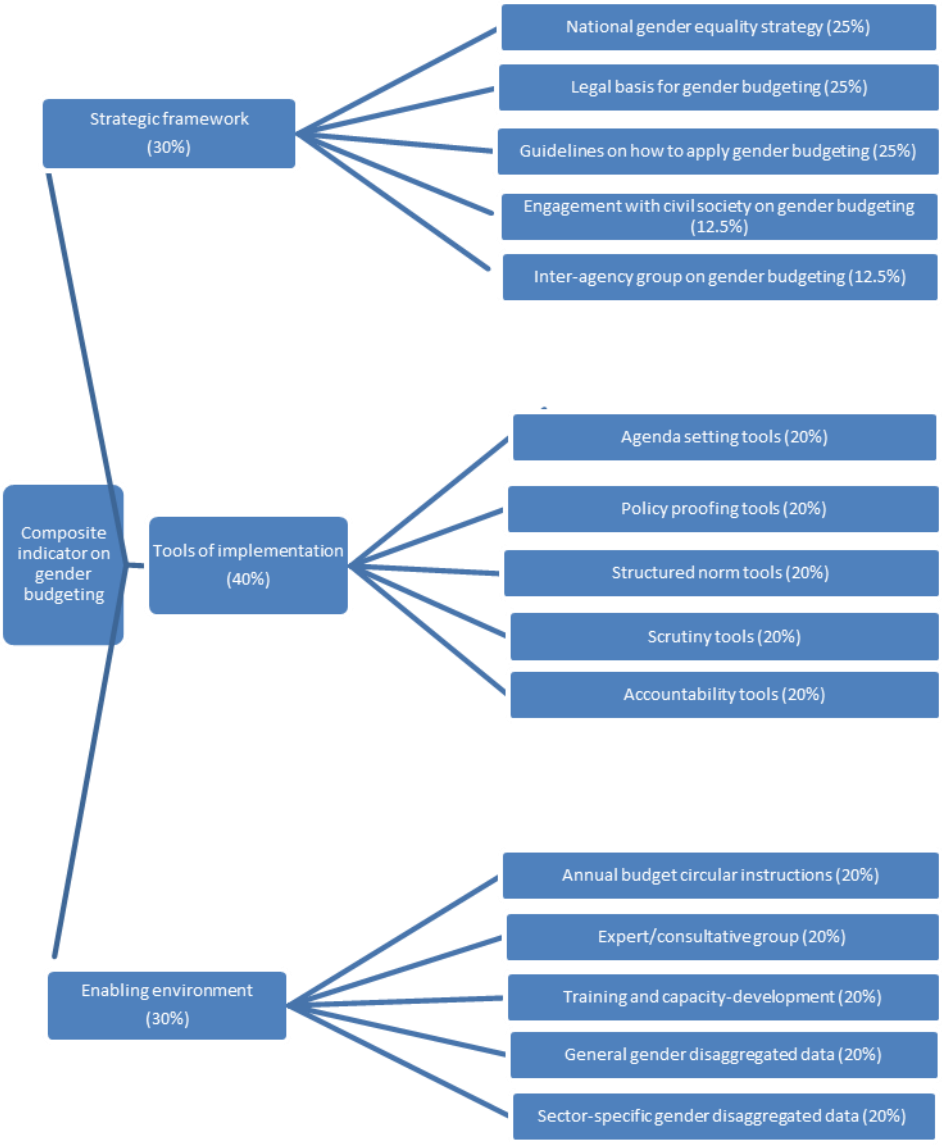
Annex 1.G. First pass at a composite indicator on gender budgeting: variables and weights



Insolvency Frameworks for State and Local Governments

Insolvency frameworks stipulate rules and procedures to resolve debt in a prompt and orderly way. Such frameworks may serve to facilitate debt restructuring and the fiscal recovery even of subnational entities, including states and municipalities. They may even prevent subnational governments from sliding into insolvency. This paper identifies the benefits of setting up an insolvency framework for subnational governments, complementing existing budget rules and procedures. It analyses different design options of subnational insolvency frameworks by drawing on existing regimes for municipalities in Colombia, Hungary, South Africa, Switzerland and the United States as well as proposals for sovereign bankruptcy procedures in the literature. The paper also explores the main challenges for implementing subnational insolvency regimes and presents possible solutions.

This paper was prepared by Katharina Herold while on secondment to the OECD Network on Fiscal Relations across Levels of Government from the German Ministry of Finance. It incorporates feedback from delegates at the 2017 meeting of the Fiscal Network, which featured a dialogue with Kevyn Orr, the former Emergency Caretaker of Detroit. Comments from OECD colleagues Sean Dougherty, Peter Hoeller, Muge Adalet McGowan, Teresa Ter-minassian, and Camila Vammalle were valuable in revising the paper. Technical assistance from Celia Rutkoski was most appreciated. The views expressed in this paper are those of the author and do not necessarily represent the views of the German Ministry of Finance.

JEL Codes: H70, K30

Keywords: Subnational insolvency, municipal bankruptcy, debt resolution frameworks

1. Introduction and main findings

High indebtedness of subnational governments (SNGs) can lead to serious peril, undermine their proper functioning and impair the provision of essential public services. By depriving governments of needed fiscal capacity, it may hinder their ability to cope with acute crises, such as the COVID-19 pandemic. Such indebtedness may also deter infrastructure financing and public investment and thus limit long-term growth. Most notably, increasing debt of a single subnational government can generate negative externalities for other SNGs and the central government by diminishing their creditworthiness and increasing overall borrowing costs. Excessive SNG debt levels raise the likelihood that a debt default leads to contagion, thus impeding all government levels from access to borrowing, and even threatening overall financial stability – as experienced by Argentina. The central government may be forced to bail out SNGs, which can risk triggering unsustainable fiscal policy by SNGs, if the possibility of bail-out encourages moral hazard behaviour. Notably, unforeseen "Black Swan" events, such as a pandemic, should not normally encourage such moral hazard, and may appropriately be dealt with by central governments.

Insolvency frameworks provide rules to resolve unsustainable borrowing in an orderly and prompt way, in an effort to deter bankruptcy and preserve crucial fiscal capacity (OECD, 2016). They define how to proceed when a subnational entity has gone bankrupt. They clarify how debt will be restructured, which public services will be maintained and what steps need to be undertaken to restore the financial health of the insolvent SNG. They stipulate the debtors' and creditors' rights and regulate third-party intervention. Insolvency frameworks serve to enable a fresh start and to promote a fiscal recovery of highly indebted governments. They may also underpin the commitment of upper-level governments to a no-bailout policy and thus may prevent subnational governments from piling up debt to unsustainable levels. However, only a few countries have established insolvency frameworks, but even these commonly apply only to the local or municipal levels, and only rarely to the provincial or state levels.[1]

This paper stresses the benefits of introducing insolvency frameworks for subnational governments and analyses existing frameworks in Colombia, Hungary, South Africa, Switzerland and the United States, and other frameworks discussed in the literature. It also provides options for designing and implementing a subnational insolvency framework intended to prevent subnational insolvency and facilitate a recovery from a budgetary crisis.

The main findings are:

- Budget discipline can be achieved by implementing budgetary rules and institutions, by balancing tax, spending and borrowing autonomy and by establishing a credible no-bailout system. In this regard, a well-designed subnational insolvency framework may have substantial merits. An insolvency framework may enforce existing measures to safeguard fiscal discipline. With a formal debt-restructuring mechanism in place, higher level governments can *ex ante* commit to a no-bailout policy inducing SNGs and creditors to take reasonable borrowing and financing decisions (the preventive function).
- Ultimately if a SNG is in severe budget crisis, the framework contributes to find *ex post* a timely solution to a subnational debt problem (the corrective function). It ensures clarity and minimises discretion from the outset. As a comprehensive statutory approach it is superior to *ad hoc* debt negotiations and contractual approaches, as it solves collective-action problems like hold-outs, which arise in debt negotiations.
- Based on an analysis of existing insolvency frameworks and approaches in the literature, several design options for subnational insolvency regimes can be extracted. How specific features are chosen, depends on which objectives are to be met: providing essential public services and enforcing fiscal adjustment and consolidation, deterring strategic default of an SNG, facilitating debt restructuring, protecting the contractual rights of the creditors and limiting interference with subnational sovereignty and constitutional rights. These objectives, particularly the provision of

essential services and enforcement of fiscal adjustment, assume a particular importance in the presence of exogenous crises, such as COVID-19, which may place particular strain on the fiscal capacity of SNGs.

- From existing insolvency regimes some lessons can be drawn. There is no one-size-fits-all solution. An insolvency framework has to take into account country-specificities (e.g. institutional and legal setting, social preferences) and to balance the different objectives. However, an effective and "balanced" framework that addresses the objectives mentioned above may include the following elements:
  - *Filing for insolvency*: The framework allows the debtor to file, which is approved by the court (regarding the sovereignty/constitutional rights), allows only a narrow set of eligibility criteria by applying the ultima-ratio-principle (deterring moral hazard) and grants an automatic stay on assets (facilitating debt restructuring).
  - *Debt restructuring*: It assigns the proposal right to the debtor and the veto right to the court (regarding sovereignty and creditors' rights), stipulates a simple majority rule in terms of number of creditors and a qualified majority rule in terms of claims (facilitating debt restructuring), gives priority to new interim financing (maintaining credit financing) and senior claims towards junior claims (preserving creditors' rights).
  - *Fiscal adjustment*: It foresees monitoring of subnational fiscal adjustments e.g. in spending and taxation as well as further necessary reforms by upper-level government (accelerating fiscal adjustment, deterring moral hazard) and stipulates sanctions in the case of non-adherence to the rules. This may also help to ensure adequate fiscal capacity in the face of future, unforeseeable shocks.
- Although the experience with existing insolvency procedures is quite positive, such insolvency frameworks may be difficult to implement in other countries. They may not be compatible with constitutional or sovereignty rights or require major structural and institutional reforms to be effective. Their introduction may lead to contagion effects to other government levels or even financial markets. They may also be opposed by lower-level governments and face strong lobbying by creditors, as political decision makers and creditors will be made responsible for the budgetary and financing decisions.
- Approaches such as opt-out/opt-in options, a minimalist framework for subnational amendments or gradual evolution, transition paths, central-government guarantees, conditional transfers or a debt-redemption fund may help to solve these implementation problems. However, these solutions may generate new trade-offs and disincentives, which may imply a departure from an effective subnational insolvency framework.

This paper proceeds as follows. Section 2 elaborates the motivation for implementing insolvency regimes for subnational governments – addressing subnational public finances and the measures and their limitations to prevent and cope with the indebtedness of subnational governments. Section 3 describes the design options for insolvency regimes and elaborates a general framework. Section 4 deals with the implementation of insolvency regimes – hereby addressing possible drawbacks and implementation problems, suggesting solutions and analysing trade-offs.

2. The case for subnational insolvency frameworks

2.1. Subnational finances

Subnational governments (SNGs) including state and local governments play a large role in public finances in many countries. In most, SNGs are responsible for the provision of essential public services (e.g. education, infrastructure maintenance, garbage collection, water supply). OECD-wide in 2014, SNGs

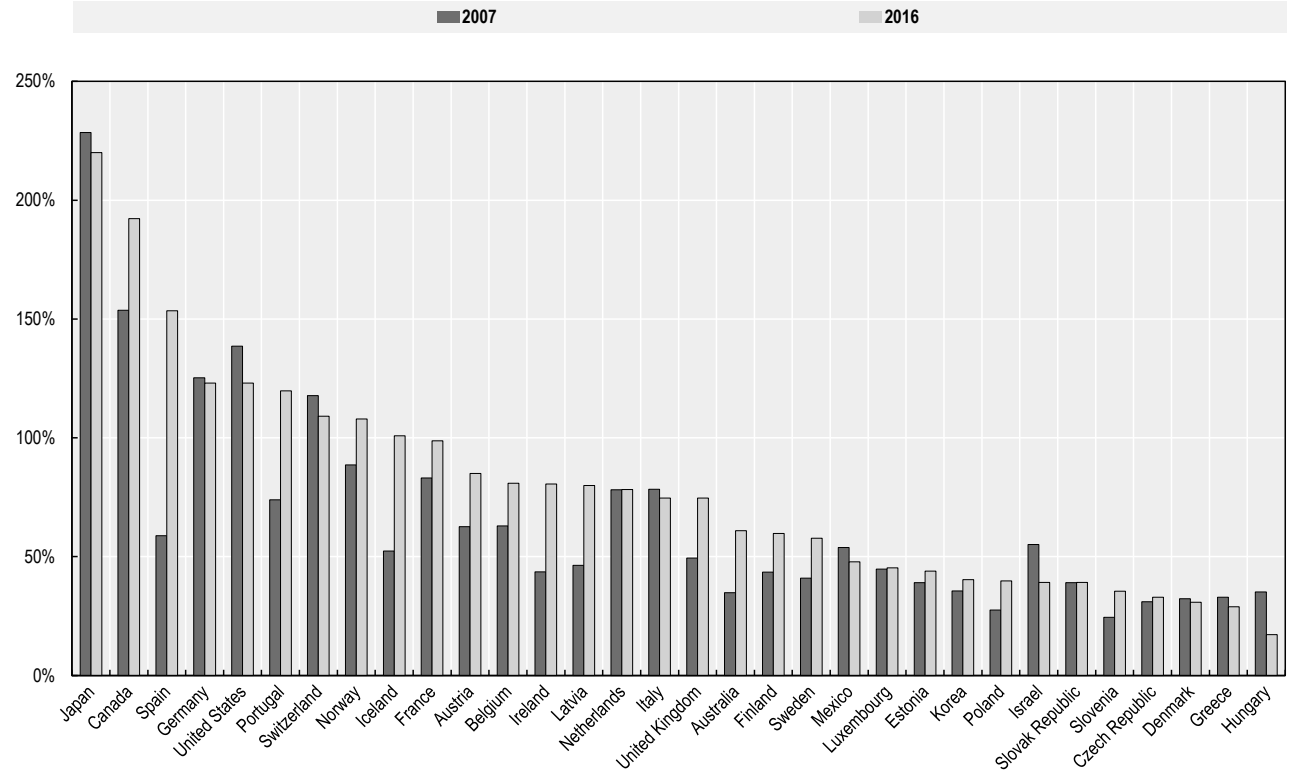
accounted for 33% of total government spending and 19% of own revenue (from own and shared taxes and user fees) (OECD, 2016).[2] The gap between subnational spending and subnational own revenue – the vertical fiscal imbalance – is bridged by intergovernmental transfers or subnational borrowing.

SNGs incur low levels of public debt compared with the central government. In 2013, SNG outstanding debt represented on average only 13% of the GDP and 17% of total public debt in the OECD (OECD, 2016). Although the global financial crisis led to a sharp decline in local revenues and increases in demands for social and welfare programmes (scissors effect) in many countries, the deterioration in overall subnational balances was relatively small, due to federal stimulus packages and additional federal grants (Blöchliger et al., 2010).

However, as SNGs have less taxing power and draw on a much smaller revenue base than central governments, a better indication of their capacity to repay debt is given by debt relative to revenues rather than GDP. SNG debt is high as a share of SNG revenues and has increased in the majority of OECD countries, amounting to 80% on average in the OECD in 2013. In Canada and Japan, they even reached over 200% of subnational revenue. In addition, there is strong heterogeneity in subnational debt-to-revenue ratios within some countries. For example, in Germany subnational debt levels ranged from less than 30% of subnational revenue in Saxony to more than 450% in Bremen in 2012 (Vammalle and Hulbert, 2013; OECD, 2016).

Apart from the relatively stable fiscal position of many SNGs, some were hit hard by the global financial crisis. Subnational debt-to-revenue ratios increased dramatically in Spain and Portugal (Figure 14).

Figure 14. Ratio of subnational debt to own revenue



Note: Data for 2015 are used for Japan, Israel and Mexico; 2014 for Switzerland; revenue data are on an unconsolidated basis to ensure broadest country coverage.
Source: OECD (2020) and National Accounts database.

2.2. Drivers of subnational debt – the problem of soft budget constraints

High SNG indebtedness may be driven by institutional deficiencies (e.g. limited taxing capacity) or persistent structural problems where revenues from own sources and intergovernmental transfers are insufficient to meet the spending obligations. It may also be attributed to the existence of a soft budget constraint (Kornai, 1979 and 1986): if the central government is unable to credibly commit to a no-bailout policy in case of a subnational financial crisis, SNGs are likely to engage in moral hazard. Budget discipline may become lax, leading to excessive deficits, which in turn elicit transfers from central government.

A number of factors influence the likelihood of bailouts and the occurrence of soft-budget constraints. For example, regions might be "too big to fail" (Wildasin, 1997; Büttner and Wildasin, 2006), "too small to fail" (Goodspeed, 2002; Crivelli and Staal, 2013) or "too sensitive to fail" (Bordignon and Turati, 2009; von Hagen et al., 2000). Bailout expectations might be driven by political-economy factors such as the same party affiliation of higher and lower-level governments (Hernandez-Trillo and Smith-Ramirez, 2009). They may be affected by imbalances in the assignment of spending, revenue and borrowing autonomy. They are shaped by explicit or implicit bailout guarantees such as constitutional rules prohibiting debt enforcement against subnational assets or demanding solidarity in case of subnational financial distress (Rodden, 2003). Bailouts in the past may serve as precedents for future bailouts.

2.3. Options for preventing excessive subnational debt

The negative implications of excessive subnational debt call for various measures that safeguard and restore subnational financial discipline and address the problem of soft budget constraints.

Strengthening budgetary institutions

During the last decade, many countries have strengthened their budgetary institutions to restrict excessive subnational borrowing (OECD, 2016). Budgetary institutions are rules and regulations according to which budgets are drafted, approved and implemented. They include fiscal rules, procedural rules and rules regarding the transparency of the budget (Alesina and Perotti, 1996) and may be complemented by fiscal or intergovernmental councils and other arms-length agencies.

Strengthening budgetary institutions may contribute to subnational fiscal discipline – as empirically shown for the US states by Hagen (1991), Poterba (1994), Alesina und Bayoumi (1996) and Fatás and Mihov (2006). However, cross-country evidence for the positive relationship between the strength of budgetary institutions and subnational fiscal discipline is ambiguous (Fornasari et al., 2000; Jin and Zou, 2002). For example, in many cases strict rule enforcement is not achieved. Borrowing restrictions can be evaded by using sale-and-lease-back operations (Jorgen and Pedersen, 2002; Letelier, 2011) or by accumulating off-budget debt (Ahmad et al., 2004).

Balancing borrowing, tax and spending autonomy and aligning autonomy with responsibility

Excessive debt is not only facilitated by weak budgetary institutions and a high degree of borrowing autonomy. It is also due to imbalances between subnational spending, tax and borrowing autonomy, leading to a low degree of fiscal autonomy. These imbalances of fiscal autonomy and misalignments with responsibilities are predominant in so-called mixed systems, where SNGs have large spending and borrowing powers, exhibit little tax autonomy, and thus depend heavily on federal transfers (e.g. fiscal equalisation schemes, tax sharing arrangements, and other intergovernmental transfers).

This may force local government to debt finance their assigned tasks when revenues from taxes and transfers are not sufficient. It may also set fiscal disincentives. Other than in federal countries like Switzerland, or unitary countries like the United Kingdom where budget decisions are internalised by each jurisdiction, mixed systems like that in Germany create fiscal externalities allowing debt to be shifted to

other jurisdictions (Blankart and Klaiber, 2006): SNGs draw on resources, which are not their own (the "common-pool problem") and expect to be bailed-out in case of an emergency. Then, they are likely to overspend, reduce tax-raising efforts and run large deficits.

Case studies from Italy (Bordignon, 2000), Argentina (Webb, 2003; Nicolini et al., 2002) or Germany (Seitz, 2000; Rodden, 2003 and 2005) as well as some cross-country empirical evidence (e.g. Rodden, 2002; Singh and Plekhanov, 2005) have shown that the existence of large vertical fiscal imbalances and a high degree of transfer dependency are related to less fiscal discipline. According to Bartolini et al. (2015), both subnational and central budget balances deteriorate with the declining degree of correspondence between subnational own revenues and spending. Blöchliger and Kantorowicz (2015) also show positive correlations between low fiscal coherence of constitutions, which includes imbalances in fiscal autonomy and a low degree of responsibilities, and negative fiscal outcomes.

Market discipline

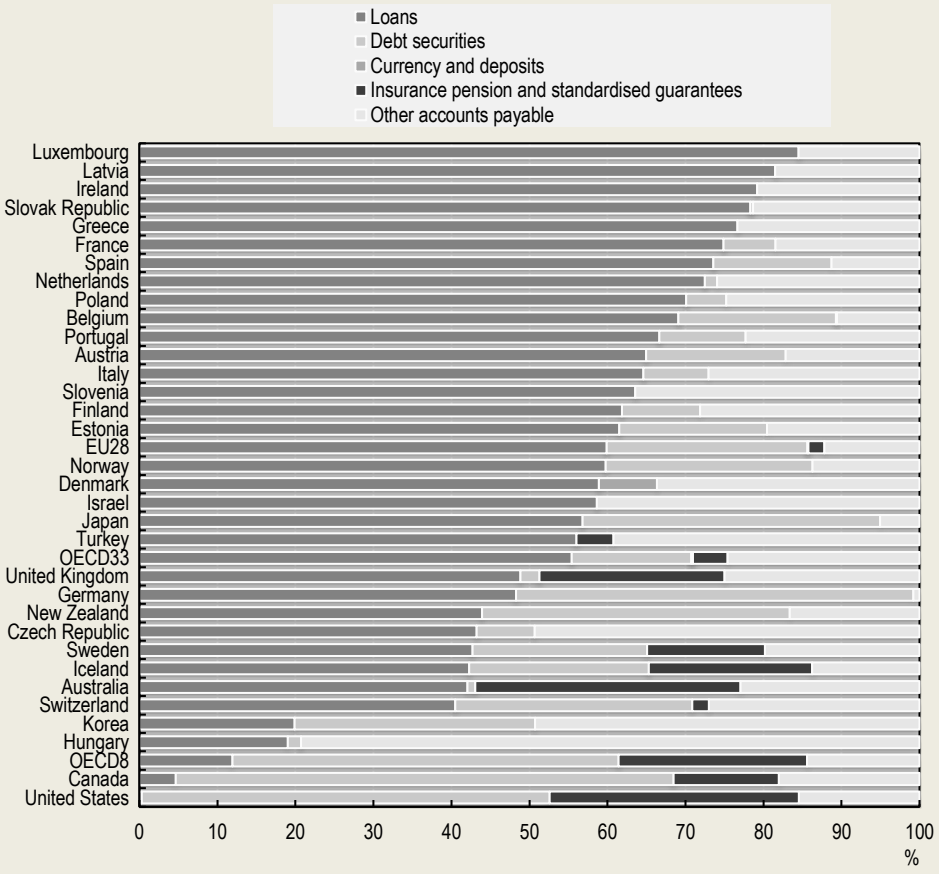
SNGs draw on different liabilities, including loans, government bonds, arrears to suppliers and pension liabilities (Box 21). Creditors like lenders and bondholders reward budget discipline with low borrowing costs and punish the deterioration of fiscal fundamentals. The higher creditors assess the risks of future defaults, the higher is the interest rate a subnational entity has to pay. Capeci (1994) and Bayoumi et al. (1995) confirm the disciplinary function of market institutions. They show for US municipalities that, when debt levels rise, bond yields increase first gradually at low and then rapidly at high debt levels. Above a certain debt level, credit becomes rationed.

Box 21. Types of subnational debt

The major part of subnational debt (75% of total debt on average in the OECD at the end of 2016) is financial debt, comprising loans and debt securities (e.g. government bonds). Debt securities are the predominant source of debt financing in federal countries such as the United States, Canada and Germany (over 50% in these countries, in the figure below). They are also widespread in some unitary countries such as Japan (38%), Korea (31%) and Norway (27%). However, unitary countries mainly use traditional loans from central government, public banks or commercial banks, which constitute a share of 60% (OECD33), compared with 24% on average in federal countries (OECD8).

A smaller part of SNG debt includes non-financial debt like the sum of other accounts payable (arrears, suppliers' debt, etc.) and pension liabilities (insurance pensions and standardised guarantees). Other accounts payable amount to 25% of the total debt and are important mainly in Hungary (79%), Korea (49%), the Czech Republic (49%) and Turkey (39%). Debt liabilities stemming from pension insurance or standardised guarantees also exist at the subnational level, especially in Australian and US states. In these countries, they account for 34% and 32% of subnational public debt, respectively.

Composition of subnational debt by liability type (2016)



Source: OECD (2018), OECD Subnational Government Structure and Finance database.

In many cases, the credit market does not function properly to limit excessive borrowing (OECD, 2016). Often adequate information about the borrower's outstanding debt and repayment capacity is not available. Moreover, in a number of countries, SNGs can draw on loans either from central government (Ireland, Slovak Republic) or from banks which are related to SNGs (Denmark, Finland, German municipalities). In this way, SNGs get privileged access to financing and do not compete with private borrowers. In case of positive bailout expectations, creditors may under-price subnational default risk. They grant highly indebted SNGs credit at preferential conditions, irrespective of their financial situation.

A number of empirical cross-country studies (Schuknecht et al., 2009; Sola and Palomba, 2015; Beck et al., 2016) show that the link between fiscal fundamentals and the cost of borrowing – indicated by the yield spread of SNG bonds – breaks down, if bailouts are explicitly provided or implicitly anticipated. While bailout expectations improve credit conditions for SNGs, they deteriorate the conditions of the central government. Jenkner and Lu (2014) provide evidence using Spanish data that – once a bailout is announced – default risk is transferred from the sub-sovereign level to the central government, simultaneously decreasing subnational risk premia and increasing sovereign ones.

2.4. The case for subnational insolvency frameworks

Commitment device for a no-bailout policy

The analysis has shown that strong and reliable budgetary institutions, balanced fiscal autonomy and its alignment with fiscal responsibilities, as well as market surveillance may prevent irresponsible budget policy. However, in many cases, policy measures have proved insufficient to constrain excessive public borrowing. Bailout prospects diminish the financial control by the credit market and the adherence of SNGs to fiscal rules. Instead of offering a bailout, one way to avoid a subnational budget crisis is to expose heavily indebted SNGs to bankruptcy, placing the debt burden on both the subnational government and its creditors – as long as it does not impose systemic risks on sovereigns or the financial market. In this regard, a subnational insolvency framework can be a commitment device that backs up a no-bailout policy.

The mere existence of an insolvency framework may signal that the upper-level government is likely to refrain from a bailout and reduces creditors' and debtors' moral hazard. Creditors might expect that its (subordinated) claims will lose value in case of a subnational insolvency. They are forced to scrutinise the creditworthiness of the SNG and price in the probability of subnational defaults and the possible debt discharge (e.g. through putting a higher premium on the borrowing rate). To avoid high borrowing costs, limited access to the capital market and/or the stigma of bankruptcy, the debtor may pursue a prudent fiscal policy. Hence, insolvency frameworks may serve to prevent SNGs from bankruptcy (the "preventive function**"**). They complement and enforce existing measures to safeguard financial discipline and to harden the budget constraint of SNGs.

Solving collective action problems

Moreover, in the case that a SNG cannot meet its obligations, insolvency regimes are a remedy of last resort to find a resolution to a subnational debt crisis (the "corrective function**"**) in an orderly and prompt way. An insolvency framework facilitates debt restructuring and enables a fresh start. As a comprehensive approach, it is superior to *ad hoc* and often chaotic negotiations and contractual approaches like collective action clauses (Box 22). An insolvency framework may include all creditors' claims ranging from those of government employees to bond holders. If designed predictably and transparently, it generates legal and procedural certainty for all parties involved in case of a subnational fiscal crisis.

Above all, it serves to solve collective-action problems like hold-outs arising in the debt-negotiation process. Debt restructuring may involve extending the maturity of debt and reducing the amount of interest and principal payments. In the case when a creditor minority is able to block a majority, the minority may strategically hold out from agreeing to a reasonable restructuring plan in the hope of recovering payment on the full contractual claim or obtaining more favourable terms. This might even induce willing creditors to vote against a restructuring (McConnell and Picker, 1993). Consequently, hold-outs reduce the value of the other creditors' claims. They create substantial delays in finding a solution to the debt problem and prevent a rapid recovery.

The hold-out problem may particularly be an issue for SNGs whose debt is held by a large number of bond investors rather than by single banks, as is the case in US states (Conti-Brown, 2012). The US subnational debt does not consist of loans, but mainly of debt-securities (e.g. government bonds) (Box 3). Changing payment terms of the bonds (e.g. maturity date, coupon, repayment of a bond) in general requires unanimous consent among bondholders. Due to the high number and the diverse and constantly changing identities of the bondholders, this can hardly be achieved (Schwarcz, 2011).

Box 22. Collective action clauses

Contractual approaches such as collective action clauses (CAC) can help to mitigate the collective-action problem. They permit modifications in payment terms with the consent of a qualified majority of bondholders, but they have some limitations (IMF, 2014). Firstly, CACs are not always included in bond indentures (Schwarcz, 2004). CACs are commonly used for sovereign bonds under English and New York law (Andritzky et al., 2016). They also have been mandated for all newly issued government bonds of euro area countries since 2013 according to Art. 12 of the ESM Treaty. However, relatively few state bonds have included CACs (Schwarcz 2011). States could insert these provisions ex post into bond identures – but an agreement with the creditors might be difficult or costly to reach. Exchanging existing bonds with bonds of supermajority voting might require changes in the payment terms (Schwarcz, 2004). Secondly, as CACs operate on a series-by-series or agreement-by-agreement basis, the majority principle may hold for a specific bond issuance, but not for the aggregate. Hence, a debt-restructuring agreement might still fail, if one group of creditors or bondholders cannot achieve the requisite majority. A possible remedy is a modification in the voting procedures of CACs (e.g. "single limb'' or "'two-limb" voting procedure)* (IMF, 2014). However, these changes might take time to become a significant part of public debt contracts (Fuest et al., 2016). Above all, CACs apply only to bonds. They do not solve equity concerns and collective-action problems arising among both bondholders and other creditors (Krueger, 2003).

Note: *A "single-limb" voting procedure requires only a single vote calculated on an aggregate basis across all affected bond series. A "two-limb" voting procedure additionally differentiates among different types of creditors.

Insuring against harmful effects and enhancing transparency

Apart from its corrective and preventive function, an insolvency regime also serves as insurance device against long-term negative effects of exogenous shocks such as sharp decreases in public-service levels (Adalet McGowan and Andrews, 2016; Liu and Waibel, 2008). A restructuring of debt, such as rescheduling or even a partial cancellation negotiated between debtors and creditors, allows the SNG to recuperate from this adverse event without being forced to make unreasonable decisions on spending cuts and tax increases. Debt repayment may be postponed until economic conditions improve.

Furthermore, insolvency regimes can enhance the transparency of the finances of subnational entities. Fiscal transparency is an integral part of many existing insolvency frameworks (Liu and Waibel, 2008), as filing for insolvency requires SNGs to disclose all fiscal and financial information, which is often scrutinised by independent third parties.

2.5. Existing insolvency frameworks and regulations on debt resolution

Measures for coping with subnational financial distress

For coping with subnational financial distress, countries rely primarily on budget rules and budget institutions to restore the financial health of subnational governments. Table 9 provides an overview of the measures of selected countries (for more detail see Herold, 2018: Table A.1.)[3]. In most countries, some form of consolidation plan has to be elaborated that defines expenditure cuts and tax increases. Measures also involve some intervention by higher-level governments, which, for example, monitor the implementation of consolidation plans and approve subnational borrowing decisions. In some countries, higher-level governments can put an SNG under forced administration – as found in some states in Germany. The state government can appoint an administrator to take over some or all tasks of a

municipality, as long as the measures mentioned above turned out to be insufficient. In Denmark, non-compliant local governments may in principle face sanctions (e.g. penalties), though they are rarely imposed in practise. SNGs may also be assisted by transfers. For example, in the Netherlands, financially troubled municipalities (so called Article 8 municipalities) may receive supplementary grants, if revenues are significantly and structurally insufficient to cover necessary outlays. The Spanish government may provide (liquidity) transfers to Autonomous Communities and Local Corporations.

Table 9. Overview of rules dealing with financially distressed municipalities and states in selected countries

	Insolvency frameworks		Debt-enforcement rules		Other rules dealing with SNGs in financial distress			
	Comprehensive insolvency framework	Private insolvency framework	Single debt enforcement rules	Prohibition of debt enforcement/ insolvency proceedings	Specific transfers	Implementation of consolidation plans	Intervention by higher level government	Sanctions
Belgium regions	○	○	○	○	○	●	●	●
Denmark	○	○	○	○	○	●	●	●
Germany local	○	○	○	(●)	●	●	●	●
Germany *Länder*	○	○	○	●	●	●	●	○
Korea	(●)	(●)	○	○	●	●	●	
Netherlands	○	○	○	○	●	●	●	
Norway	○	○	○	●	○	●	●	
Spain local	○	○	○	○	●	●	●	●
Spain states	○	○	○	○	●	●	●	●
Switzerland local	●	○	○	○	●	●	●	●
Switzerland cantons	○	●	○	○	○	●	●	○
Turkey	○	○	●	○	○			

Note: ○ not existent/ not applied, ● existent/ applied, (●) Korea: applicable for subnational public companies, Germany local governments: applicable only if specified by state law.
Source: OECD Fiscal Network – Survey on subnational debt resolution. See for more detail Annex A, Table A.1.

Only few countries provide regulations that deal with subnational insolvencies. Many countries, such as Denmark and Australia, have not developed any rules dealing with the resolution of debt in case of a subnational fiscal crisis. In Germany and Norway, insolvency proceedings against assets of the states (Germany), counties and municipalities (Norway) are even prohibited. In these countries, municipalities and states or counties cannot be declared insolvent.[4] Other countries, like Austria, explicitly allow debt enforcement against municipal assets, but do not have specific rules on how to proceed in case of an insolvency (Nunner-Krautgasser, 2013). In Turkey, municipalities may not become subject to bankruptcy proceedings but to debt enforcement according to the Code of Debt Enforcement and Bankruptcy (1932). In Switzerland, the personal and corporate insolvency law is applicable for the cantons and regions. Instead, Swiss municipalities in financial distress may become subject of an insolvency framework – as outlined below.

Box 23. Existing municipal insolvency frameworks

A prominent example is the Chapter 9 procedure in the United States deriving from the Bankruptcy Act 1938, which was adopted during the Great Depression, which led to multiple municipal defaults. At that time many municipalities had issued bonds for debt financing. Defaulting municipalities were faced with the hold-outs in debt negotiations. The primary aim of the Act was to deal with this collective-action problem arising in debt negotiations (McConnell and Picker, 1993; de Angelis and Tian, 2013).

The origin of the regulation in Switzerland dates back to the 19th century, when a few financially distressed municipalities had to be bailed out by upper-level governments. At that time, insolvency rules had been developed but not implemented. Further attempts of regulating insolvency were made during the economic crisis of the 1930s to prevent creditors from getting into trouble because of subnational defaults. But it was not until 1947 that the Federal Law on Debt Enforcement of Municipalities and other Corporations of Cantonal Public Law was adopted under the pressure of banking institutions and insurance companies (Schaltegger and Winistörfer, 2013).

The need for regulation of insolvencies in Hungary, Colombia and South Africa is attributed to systemic and institutional changes. The Hungarian Municipal Debt Adjustment Law was enacted in 1996, a few years after the disintegration of the former Soviet Union that led to the economic and political transformation of the country. In 1990, new regulations for local governments came into force that permitted unregulated subnational borrowing and resulted in sharp public-spending increases. With the macroeconomic downturn in the mid-1990s, many local governments were in severe financial difficulty and received central government grants to stay afloat. The aim of the insolvency regime was to limit moral hazard stemming from the bailout precedents and thus to restore local fiscal discipline and to allow the development of a credit-rating system (Jókay, 2013).

Colombia underwent a rapid decentralisation process, which started in the 1970s and accelerated in 1991. SNGs were granted more responsibilities for public-service provision and relied on increasing transfers by the central government. Hence, incentives to raise own resources and to safeguard fiscal discipline were weak. Rising debt and expenditure levels induced the Colombian government to pass several laws that aimed at overcoming institutional and regulatory shortcomings and to discourage excessive spending and borrowing. One of these measures is the provision of a debt-restructuring mechanism defined in the Law 550/1999 and complemented by Law 617/2000 (del Villar et al., 2013).

In South Africa, after the fall of apartheid, municipalities experienced key changes – the central-government guarantee of local debt was abolished, and municipal boundaries were redrawn (combining black and white, poor and wealthy urban communities). As finances of the amalgamated municipalities deteriorated, extensive inter-governmental grants were provided, limiting the need to borrow. South Africa's motivation behind the Municipal Financial Management Act 2003 was also to provide a comprehensive framework to its SNGs that regulate municipal finance and borrowing and thus to develop a capital market for municipal finance (Liu and Waibel, 2008; Brown et al., 2013).

Insolvency cases

Existence of subnational insolvency frameworks

The effectiveness of insolvency frameworks can be determined with regard to its corrective function by reviewing some cases. Fewer conclusions can be drawn for their preventive function (this is an area for further investigation).

The Hungary-Municipal Debt Adjustment Law was applied to 38 filings (1996-2010). About half of them were caused by projects related to overinvestment, imprudent borrowing and rosy projections of operating expenses and revenue. The law has established a clear no-bailout rule, minimising moral hazard. It is transparent and clear, so that no disputes concerning procedures arose in any of the cases. The local assemblies co-operated with the court and the trustee in each bankruptcy procedure. No assembly was threatened with dissolution or a new election. Vital public services were maintained in each case. However, insolvency rules may have turned out to be too strict for both the debtors and the creditors. Many municipalities that met filing criteria did not file for bankruptcy (although obligatory). The non-transparency of the accounting system (cash-based) makes it difficult to detect insolvency. Lenders and suppliers were also reluctant to initiate the insolvency procedure as they feared to lose their claims. In consequence, debt restructuring was often settled informally outside the insolvency procedure, possibly to the detriment of the other creditors (Jókay, 2013).

Switzerland experienced only one insolvency case. At the end of 1998, after having piled up debt amounting to CHF 346 million due to wrong investment decisions the Swiss municipality Leukerbad became insolvent (Uebersax, 2005). The municipality was placed under forced administration. The municipal government as well as certain creditors sued the Canton Valais (Wallis) for having failed its supervisory duties. They claimed that the Canton should, as a consequence, take over the debt. In 2003, the Federal Supreme Court dismissed the claims. It decided that the law does not stipulate the cantonal liability for the obligations of the municipality. In consequence, creditors accepted a debt relief of 78% of their claims. The Canton Valais provided a guarantee of CHF 30 million (Jochimsen, 2007; Feld et al., 2013). Every year, Leukerbad has to repay CHF 1.3 million (Teevs, 2013). Within a decade outstanding debt was reduced significantly (to CHF 13 million at the end of 2013) which corresponded to the municipal average in the Canton Wallis (Tagesanzeiger, 2014).

Besides the rehabilitation of Leukerbad, the application of the insolvency procedure generated further positive effects. It triggered the development of a differentiated rating system for the cantons and some municipalities as well as reforms in accounting standards at the municipal and cantonal level (Blankart and Fasten, 2009). Most importantly, the verdict in 2003 established a credible no-bailout policy and restored the functioning of the capital market: With the court's decision, the cantons were relieved from backing their municipalities facing serious financial problems. As a result, cantonal yield spreads decreased significantly and the link between cantonal risk premia and the budgetary position of the municipalities in the canton was cut (Feld et al., 2013).

From 1980 to 2016, 305 petitions under US Chapter 9 were filed. General purpose municipalities constitute only a small part (17.5% of those from 1980-2007). Most filings involved municipal utilities, special purpose districts or other public agencies of a state. Chapter 9 turned out to be effective to restore financial viability when unsustainable debt positions were due to a one-time event, mostly by wrong investment decisions, for example by Orange County, California and Westfall, Pennsylvania. It was ineffective when the financial problems were the result of structural problems and systemic budget problems involving the erosion of the tax base, loss of manufacturing jobs and a decaying infrastructure (e.g. Prichard, Alabama and Vallejo, California). One reason is that Chapter 9 has little impact on the fiscal adjustment process and does not launch deeper administrative reforms (McConnell and Picker, 1993). It might even aggravate the financial situation, for example by increasing administrative costs, for instance, by retaining legal and financial professionals, complying with court requirements or negotiating with creditors (De Angelis and Tein, 2013).

The largest municipal bankruptcy filing in US history is that of Detroit, Michigan. Having accumulated debt amounting to over USD 18 billion (USD 26 000 per inhabitant), Detroit filed for insolvency under Chapter 9 in July 2013. By the end of 2014, after 16 months, Detroit emerged from it. In November 2014, the court approved the debt restructuring plan that had been negotiated with bondholders and pensioners. According to the plan, liabilities will be reduced by USD 7 billion. Creditors experienced a substantial haircut of 80% on their claims, while pensions were cut only slightly. Fees to lawyers, consultants and financial advisors related to bankruptcy resulted in total to more than USD 150 million. In conclusion, the insolvency

proceeding of Detroit enabled a fresh start. It launched an administrative restructuring process and attracted new industries and capital (Geissler, 2015).

In May 2017, the US territory of Puerto Rico declared insolvency. Its liabilities amounted to USD 122 billion in total (USD 35 000 per inhabitant and 124% of GDP[5]) – consisting of USD 74 billion in bond debt and USD 49 billion in unfunded pension obligations (Williams Walsh, 2017). As a result of failed debt negotiations Puerto Rico was submitted to the bankruptcy like procedure as set out in the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA). The law has received much criticism (Box 4) which raises the question about the optimal design of insolvency regimes.

Box 24. A current case of subnational bankruptcy: Puerto Rico

In May 2017, Puerto Rico became subject of a bankruptcy-like restructuring process stipulated in Title III of PROMESA – the Puerto Rico Oversight, Management and Economic Stability Act. It is the first time that an American state or territory has filed for bankruptcy proceedings. As Chapter 9 is not applicable to a US territory like Puerto Rico, the US Congress enacted PROMESA in June 2016. It established an oversight board of external experts with wide-reaching powers and a process for restructuring debt and other measures in order to overcome the Puerto Rican debt crisis. The new law has attracted much criticism (Dayen, 2017; Stiglitz and Guzman, 2017). One concern is that Title IIII of PROMESA is substantially different from Chapter 9 rules – especially in assigning powers to the parties involved in the debt-restructuring process. Under PROMESA, the Puerto Rican government will have fewer rights than a municipal government under the Chapter 9 bankruptcy procedure (e.g. concerning the right of filing, negotiating with the creditors, making a restructuring proposal).

Proposals of subnational or sovereign insolvency frameworks

In the literature, some proposals for subnational insolvency frameworks can be found which specifically address the level of state governments. Schwarcz (2002) proposes a general model law of a subnational debt restructuring mechanism based on US corporate and personal bankruptcy law that could be enacted in other countries. Explicit approaches for the US states are provided by Schwarcz (2011), Skeel (2012) and Feibelmann (2012), applying the US bankruptcy law to the state level. An insolvency framework for the Swiss cantons is elaborated by Waldmeier (2016).

Moreover, an extensive literature exists which deals with bankruptcy procedures and debt restructuring for sovereign states. The literature may also be applicable to the states and provinces in federal countries which exhibit a high degree of sovereignty and, like national governments, rely predominantly on debt financing through government bonds. The most prominent model is the Sovereign Debt Restructuring Mechanism (SDRM) developed by Anne Krueger in 2001 – a formal IMF controlled mechanism for an orderly restructuring of unsustainable sovereign debt. It was extensively debated, refined (Krueger, 2003; IMF, 2002; 2003), but finally failed to be implemented. Related work was done by Raffer (1990) and Schwarcz (2000; 2004), Bolton and Skeel (2004), and Paulus (2002; 2009).[6] The fiscal crisis in Greece and the establishment of European Stability Mechanism led to a resurgence of discussions of sovereign debt restructuring mechanisms. An application of the SDRM to the euro area is proposed by Gianviti et al. (2011). Other approaches envisaging an orderly debt restructuring mechanism for the euro area are provided, for example by Fuest et al. (2015) and Andritzky et al. (2016).

In the following section, the existing insolvency regimes in Colombia, Hungary, South Africa, Switzerland and the United States as well as the approaches suggested in the literature are analysed to provide options for designing and implementing a subnational insolvency framework

3. Designing insolvency frameworks

3.1. Differences between public and corporate insolvency

Insolvency frameworks for SNGs follow the same rationale as personal and corporate insolvency regimes. They stipulate rules and procedures to deal in an orderly fashion with an entity in financial distress. Subnational insolvency frameworks show some similarities with private ones, but differ from corporate ones in some aspects:

- The aims of corporate insolvency frameworks are to recover money owed to creditors (e.g. by repossessing collateral assets of debtors), to rescue the business and to restore its viability through restructuring the liabilities of viable firms. They may also serve to permanently wind-up a failing firm through liquidating the assets and facilitating an orderly exit (Adalet McGowan and Andrews, 2016). In contrast, subnational insolvency regimes, like personal bankruptcy regimes, focus solely on restoring the viability of the subnational entity and enabling a fresh start. A subnational entity cannot be dissolved like a company and continues to exist.
- While the main objective of corporate insolvency regimes is to differentiate between viable and non-viable firms and to balance the rights of debtors and creditors, subnational insolvency frameworks primarily focus on protecting the core functions of the subnational entity. Many public services need to be provided publicly so that a certain service level can be guaranteed. In particular, in case of the provision of local public goods (e.g. security, fire services) markets tend to fail because of the free-riding problem. Hence, in the restructuring process claims by government and employees (including pensioners) are often given priority over other claims (e.g. from creditors, suppliers). Only a limited number of assets can be seized in order to maintain elementary public services, while a wide range of assets can be sold in a private sector insolvency.
- SNGs face the difficulty to accurately value their assets and to identify the triggering status of insolvency. In contrast to private and corporate insolvencies, subnational insolvencies often cannot be determined by simply comparing assets and liabilities. Some SNGs use cash rather than accrual accounting (see Irwin and Moretti, 2020, in this volume). Others are protected against the seizure and sale of assets. In many cases, the assessment of insolvency has to involve a complex analysis of present and future cash flows based on a number of assumptions.
- Subnational frameworks must have regard to the sovereign powers of SNGs and the democratic rights of the citizens. This constrains for example the creditors' right to initiate the insolvency procedure and reduces the possibility of third party intervention into the debt restructuring and the adjustment process. While in many countries (e.g. Germany, France, United States) creditors may file for corporate restructuring and liquidation procedures (Adalet McGowan and Andrews, 2016), most subnational insolvency proceedings can only be initiated by the debtor.

3.2. General design features

Procedures and objectives

Regarding the different features of insolvency frameworks, existing regimes differ substantially due to cross-country differences in social attitudes and preferences, legal traditions, institutional settings and historic developments. Though, all insolvency frameworks stipulate rules determining how to proceed in

the following steps: *i)* initiating the insolvency procedure, *ii)* carrying out the debt restructuring procedure, and *iii)* achieving fiscal adjustment.

In the first step, the framework determines the triggering criteria which need to be fulfilled to file for insolvency. It assigns the right of filing (to debtor, creditor, or higher level government). It determines which institution (e.g. court, higher level government) is involved in the assessment of filing and whether a stay on assets is granted to the subnational entity. Second, for carrying out the debt settlement process the procedures assign the right of proposal (e.g. debtor, creditor, trustee) and the right to veto the proposal (e.g. court), identify the order of claims, stipulate the creditors' voting rights according to which the proposal is accepted and define the seizable assets or the essential services to be maintained. Third, the debt restructuring procedure is often accompanied by a fiscal adjustment process, which might involve third party intervention to put in place reforms and restore viability.

Insolvency frameworks have to balance different and conflicting objectives. These objectives are (Liu and Waibel, 2008):

- Providing essential public services and setting in motion the adjustment of public finances (e.g. spending and taxation) and other fiscal or structural reforms;
- Deterring strategic default of the SNG;
- Facilitating debt restructuring (e.g. interest reduction, maturity extension, debt relief) and solving collective action problems;
- Protecting the contractual rights of the creditors and thus maintaining access of the SNG to the capital market;
- Limiting interference with the authority of democratically elected local officials and constitutional rights.

Subjects of the insolvency procedure

Subnational entities that can become subject of a subnational insolvency procedure may comprise subnational governments as well as subnational agencies such as public companies or public-private partnerships. In Hungary, South Africa and Switzerland, only local governments, municipalities or similar entities (e.g. parishes) are subject to these insolvency laws. In Colombia also parts of the decentralised service delivery sector that is not monitored by any sectoral superintendency (administrative authority)[7] are covered by the law. The US rules define a municipality to be "a political sub-division or public agency or instrumentality of a State". This broad definition includes state-sponsored or controlled entities that raise revenues through taxes or user fees to provide public services (e.g. school districts, hospitals, sanitary districts, public improvement districts, bridge authorities) (United States Courts, 2017; Jones Day, 2010).

Court and higher-level government involvement

Three different kinds of insolvency frameworks can be distinguished – depending on the role of the courts, higher level governments or other authorities in the procedure (Liu and Waibel, 2008; 2010):

- In pure judiciary frameworks the court has wide-ranging decision-making authority in the whole insolvency process. For example in Hungary, the court decides whether a municipality is eligible for filing for insolvency, gives consent to the crisis budget and appoints a trustee which leads and supervises the bankruptcy and reorganisation process.
- In administrative procedures, higher level governments determine the status of being bankrupt, carry out the debt restructuring procedure and take control of subnational finances. An administrative procedure is used in Colombia because the judicial system does not always function well. Bankruptcy procedures for SNGs are led by the Superintendency of Corporation (SOC) in co-operation with the Ministry of Finance and Public Debt. Switzerland also follows an administrative

procedure though the courts are also involved: the determination of insolvency, the management of the creditors' meeting and the setting up of a supervisory commission for fiscal intervention is done by the cantonal bankruptcy authority.

- In hybrid insolvency systems both the court and the administration are involved in the debt restructuring process. For example, in South Africa and the United States the bankruptcy court approves the petition to file for bankruptcy and the debt distribution scheme, which sets out how debt will be restructured. The elaboration of the restructuring plan as well as fiscal adjustment is either left to the municipality itself (United States) or to an administrative authority (South Africa).

Under an administrative procedure system, debt settlement and fiscal adjustment may be reached faster than under a judiciary procedure, especially in countries with an underdeveloped court system. The disadvantage of administrative systems compared with judiciary systems is that SNGs might expect the higher level government to provide additional public funds and thus increase the risk of moral hazard. Moreover, they may be less immune to political pressures and discretionary decision-making and tend to be more biased in favour of one or the other parties involved than judiciary procedures. Hybrid frameworks might be superior because they combine both systems. As the court has the final decision on the debt distribution scheme or debt adjustment plan, it can be assured that the outcome is fair and equitable for all parties, assuming an efficient legal system.

3.3. Initiating the insolvency procedure

Trigger and eligibility criteria

Various criteria can be applied, when deciding, whether debt restructuring proceedings should go ahead. The trigger which is used by any existing insolvency framework is the necessity of the municipal entity to be insolvent. But different definitions of insolvency exist. In the United States, municipal entities are insolvent when they are unable to pay their debt now and in the future. In Switzerland and South-Africa municipalities have to show that they are unable to fulfil their bond obligations. In general, these relatively open definitions of the insolvency status require a careful examination of the financial situation of the local entity. This may involve a multi-year analysis of available reserves, ability to reduce spending and raise taxes, and legal opportunities to postpone debt payments (McConnell and Picker, 1993). For this purpose, Swiss municipalities have to hand in a detailed explanation of the financial situation when filing with the administrative authority. South Africa regards additional indicators that might reveal serious financial problems and persistent material breach of financial commitments. In contrast to these countries, Colombia and Hungary apply more specific indicators of insolvency. For example, Hungarian municipalities may file for insolvency when an invoice is not disputed or paid within 60 days of the due day.

Furthermore, the South-African, Swiss and US frameworks follow the ultima ratio principle. In Switzerland, a municipality can only apply for bankruptcy, if all reasonable measures have been exploited and have failed to avoid bankruptcy. In South Africa, debt restructuring is the last option of a multi-step procedure of an early warning system and a mandatory fiscal intervention by the provincial authority. It requires that in accordance to the financial recovery plan set up during provincial intervention, all assets not necessary for effective administration or basic service provision have been liquidated and all employees have been laid off, except those affordable in terms of projected revenues. According to the Chapter 9 rules, the municipality must have shown pre-filing efforts to work out financial difficulties and come up with good faith solutions with the creditors.

In the United States, to apply for Chapter 9, a further requirement that accounts for state sovereignty has to be fulfilled: the municipality must be explicitly authorised to be a debtor by state law. In 2012, only 12 states give full authorisation, 12 conditional authorization (attaching further preconditions), 3 limited authorisation (applying only to a subset of municipalities) and 23 give no authorization to file under Chapter 9 (Spiotto, 2013).

The definition of the eligible criteria may be crucial for meeting creditors' claims, providing public services and preventing debtors' moral hazard. They should give a clear notion of the incidence of insolvency and eligibility for an insolvency procedure, so that creditors and local government can take appropriate actions sufficiently early to cope with their financial difficulties. Applying a simple indicator – as used in Hungary – may have the benefit to be transparent, but it may have the disadvantage to be an imperfect proxy for the actual debt servicing capacity of the subnational government, which is influenced by financial, institutional, economic and political constraints (Weder di Mauro and Zettelmeyer, 2010). It also can be easily misused for strategic default.

Eligibility criteria which involve a thorough assessment of the financial situation seem better for indicating the real need of an insolvency procedure. They also should signal to the SNG and the capital market that insolvencies are the remedy of last resort, and thus should demand efforts by the local government to solve the debt crisis – as stipulated in the South-African, Swiss and US law. This reduces the risk that a municipality files for premature insolvency (Type one error). However, triggering criteria must also assure that the insolvency procedure is not initiated too late, e.g. when policymakers gamble for a resurrection (Type two error) (Andritzky et al., 2016). A delay might harm service delivery to the citizens, undermine a fair settlement of creditors' claims and unnecessarily delay subnational fiscal recovery.

Right to initiate the insolvency procedure

Insolvency frameworks can be initiated by the debtor, the creditors, higher level government or other authorities. Filing can be voluntarily or compulsory. In most countries the debtor files voluntarily with the bankruptcy court (United States, South Africa) or the relevant authority (Switzerland). In Hungary, the municipality is obliged to apply for insolvency with the county court, when it fails to meet its obligations. The Hungarian framework also allows the creditor to petition the court. In the case of Puerto Rico, unlike Chapter 9, Title III of PROMESA designates the oversight board to file on behalf of the territory with the district court.

The argument for debtor's filing is that the debtor knows best the true financial situation and the severity of indebtedness. A voluntary rule would not intervene with sovereignty rights, but a mandatory rule or a creditors' right as regulated in Hungary would do. Hence, many proposals for sovereign bankruptcy regimes permit the debtor to initiate the insolvency procedure (Berensman and Herzberg, 2009).

However, a mandatory filing – advocated by Bolton and Skeel (2004) – can be justified by the argument that subnational decision makers which fear to lose their reputation might be inclined to delay the procedure, as in sovereign debt restructuring. Applying an involuntary trigger may increase the chances of a more timely bankruptcy proceeding. It may motivate SNGs to avoid financial difficulties and renegotiate creditors' claims ex post. For these reasons, Feibelmann (2012) proposes an involuntary bankruptcy procedure for the US states which is initiated by the federal government: The federal government should force a state into bankruptcy, if it is likely to need substantial support or threatens the national financial and economic stability.

Granting creditors the right to initiate the insolvency procedures gives creditors more power in the insolvency procedure possibly reducing the costs of subnational borrowing, but also bears the risk of failed timing of the procedure of conflicting interests among creditors. Bolton and Skeel (2004) suggest for sovereign proceedings to be initiated by the creditors that the filing decision requires some minimum percentage of creditors to prevent that a minority overrules a majority.

Assessment of insolvency and conducting the debt restructuring process

The assessment of the SNG's eligibility as well as the management and supervision of the debt restructuring process are important parts of the insolvency procedure as they have far-reaching implications on the progress and the outcome of the procedure. Whatever institution (court, trustee,

administrative authority) is involved in the process, it should have the necessary prerequisites of independence, impartiality and competence (IMF, 2003a; Berensmann and Herzberg, 2009).

In all existing frameworks, assessment of insolvency is left to a third party such as the (bankruptcy) court (United States, Hungary, South Africa), the cantonal bankruptcy authority (Switzerland) or the Fiscal Affairs Department (Colombia). In Switzerland, a commission of experts may assist in assessing the financial situation of the municipality.

In Hungary, South Africa, Colombia and the United States, once the petition is accepted, the court or administrative authority appoints a trustee to lead and supervise the debt restructuring process. The bankruptcy court in the United States or the SOC in Colombia serves to enforce the insolvency rules and adjudicates disputes between the debtor and creditors. Apart from existing institutions, creditors and debtors may also set up an *ad hoc* arbitration commission that conducts the debt restructuring process and to settles disputes. This may be particularly relevant in sovereign bankruptcy proceedings (Raffer, 2000; Paulus, 2002) where suitable independent supra-national institutions are missing.

Stay on enforcement and cessation of payment

Filing for insolvency may trigger a stay on enforcement for the period of debt restructuring. A stay implies that all legal proceedings by creditors are suspended and that the debtor's assets cannot be attached. In this way, the parties involved in debt restructuring get some breathing space to reorganise debt and to negotiate in good faith, while not being distracted by law suits. The suspension of obligations prevents creditors from undertaking enforcement measures (rush to the court house or grab race) (Sturzenegger and Zettelmeyer, 2006; Thomas, 2004), especially when asset attachment is not restricted (Schwarcz, 2002). As it ensures that no creditor would receive payments from the debtor or would be allowed to seize assets at the expense of the other creditors, it also contributes to an equitable treatment of the creditors and preserves the final value available to all creditors (Berensmann, 2003b).

Most existing insolvency frameworks as well as many proposals foresee a stay on enforcement. In the United States and Hungary the stay is triggered automatically. In South Africa, the municipalities can apply for a stay of all legal proceedings for a period of a maximum of 90 days. In Switzerland, the authority can temporarily cease debt enforcement, if it does not deteriorate the financial position of the creditors. However, creditors may claim for continuation. Apart from that, the activation of a stay may also be subject of an affirmative vote of a (qualified) majority of creditors (IMF, 2002).

The main advantages of the stay are that it facilitates debt restructuring and prevents opportunistic behaviour by single creditors. However, protecting the debtor from creditors' legal actions may encourage moral hazard. It may also interfere with creditors' rights. Thus, limiting the duration of the stay (like in South-Africa) and giving the creditors a veto right (Switzerland) appear reasonable. This may accelerate the restructuring procedure and balance the rights of the debtor and the creditors. Limiting the stay on enforcement to certain types of claim (e.g. non secured claims) may also be less intrusive into contractual rights than a standstill. Payment to public employees (e.g. teachers, firemen, police), suppliers and services could be continued so that public service provision is not impaired (Schwarcz, 2002). In this regard, Bolton and Skeel (2004) advocate a targeted stay applicable solely to asset seizures, so that ordinary litigations (which do not interfere with the restructuring process) can be continued.

3.4. Debt restructuring features

Proposal right and veto right

The assignment of both the proposal right and the veto right is decisive for the outcome of the debt negotiation. According to Tsebelis (2002), the outcome is likely to be biased to the party that has the power to present a proposal. Assigning the debtor the proposal right may give priority to maintain public services.

Granting proposal power to the creditors respects creditors' property rights but might induce collective action problems. Under Chapter 9 the debtor has the right to propose the debt adjustment plan, while under PROMESA the oversight board has this right. In Hungary it is the task of the committee appointed by the debtor (and led by the trustee). The South African framework even grants the trustee the right to draft the debt settlement proposal.

To restore balance between the different interests of the debtor and the creditors, it seems reasonable to assign a neutral third party the veto power. Most frameworks (United States, Hungary, South Africa) require the confirmation of the debt restructuring plan by the court. In Switzerland, the voting decision of creditors (proposal right is not defined by the law) has to be approved by the bankruptcy authority. Alternatively, an ad hoc arbitration commission could also perform this task. In some proposals of sovereign debt restructuring a (neutral) ad hoc arbitration body or committee elected by the debtor and creditors shall finally rule on a debt restructuring solution (Raffer, 1990; Paulus, 2002). Anyhow, if an efficient judiciary exists, the restructuring proposal should be confirmed by the court rather than by an administrative body or an ad hoc arbitration committee. A confirmation by the court would increase the binding effect of the proposal for all parties involved. It would also legitimise intervention into property rights especially when debt discharge is agreed and ensure that this is fair and equitable (Waldmeier, 2014; Liu and Waibel, 2008).

Voting rule

Frameworks may define the voting process and the voting rules to get the creditors' consent to the debt restructuring proposal. They may state an unanimity rule, a simple majority rule or a qualified majority rule. They may refer to all existing claims or differentiate between certain classes of claims.

In all countries, except South-Africa, creditors vote on the debt restructuring proposal. In the United States, the adjustment plan needs to be accepted by half in number and two-thirds in amount of each class of claims that is impaired. Similar voting rules can be found in the Hungarian and Swiss frameworks or are favoured in the proposals for subnational and sovereign debt restructuring (e.g. Schwarcz, 2000 and 2011). In Colombia, voting on the proposal is less transparent and clear. Different voting rights are assigned to the different classes of creditors e.g. pension fund claimants get an extra 25% voting weight added to the principal of their recognised claim (del Villar et al., 2013). An agreement becomes binding when it is accepted by an absolute majority of the votes.

It is indispensable to define a clear, transparent and equitable voting process, as it speeds up the completion of the restructuring process, reduces the uncertainty of the outcome of insolvency procedures, and respects the creditors' property rights. Using a simple majority rule in terms of the number of creditors accelerates finding a restructuring solution compared with a qualified majority or unanimity rule. However, it seems reasonable to complement the simple majority rule in terms of numbers of claims by a qualified majority rule in terms of volume. In this way, creditors holding the majority of claims cannot be overruled. Applying a majority rule to each class of voters may also serve to safeguard creditors' rights.

A majority rule may reduce the risk of the hold-out problem compared to an unanimity rule, but it does not eliminate it – especially when a veto right to each class of creditors is provided. Chapter 9 includes a mechanism to tackle the hold-out problem which is also favoured by Paulus (2002) and Bolton and Skeel (2004). It provides the court with the so called "cram-down" power: The court can confirm the plan under certain circumstances (e.g. if it contributes to a fair and equitable outcome), even when it is rejected by one class. Then the adjustment plan becomes binding on a dissenting minority.

Priority of claims

Frameworks may differentiate between different types of claims and may define which type of claim may receive preferential treatment. Priority rules may reflect country-specific equity preferences such as

protecting the labour force or outcomes of labour bargaining, granting social security benefits and maintaining public service levels. These objectives have to be traded-off against preserving access to new borrowing and maintaining liquidity as well as protecting contractual rights. Furthermore, frameworks could either lay down a detailed or a vague definition of priority of claims. A clear priority order may increase legal certainty for settling competing claims. It may reduce settlement disputes and accelerate the restructuring process, but it may also reduce the incentive to come ex ante to a debt solution with the creditors.

Irrespective of the priority order, frameworks should guarantee that creditors holding the same class of claims are treated equally. This rule is explicitly stipulated in the frameworks of Switzerland, Hungary and the United States. Yet, in the existing frameworks different priority rules can be found. Wages and pension contributions, tax and other government claims get preferential treatment in Hungary and Columbia and are even exempted from debt restructuring in Switzerland. In South Africa, priority is given to secured claims. In Colombia, secured creditors have the option to take the collateral or to include the claim in the restructuring process. Unsecured claims are mostly paid last.

Contrary to the Hungarian and Columbian law, the US Chapter 9 does not define a concrete payment order which provides some degree of flexibility to determine a priority structure. The treatment of secured and unsecured claims is given by the requirement of a cram down that a plan is fair and equitable. Accordingly, holders of secured claims receive at least the value of the securitised property. Those with unsecured claims often lose out (McConnell and Picker, 1993). They only receive “what they reasonably can expect under the circumstances” (Jones Day, 2010).

Different approaches exist how to classify new and senior debt. Under the US Chapter 9, priority can be given to debtor-in-possession-financing, i.e. new financing obtained for the debtor’s restructuring from the credit and capital market. Without this priority, due to the lacking creditworthiness of the debtor, creditors may not grant fresh capital, which is necessary for maintaining critical government functions (Schwarcz, 2000; 2002). Then higher level governments may be forced to step in as a lender of last resort. Furthermore, the debtor might be induced to play a Ponzi-type game substituting old liabilities with new ones. However, interim financing which is exempted from debt restructuring or receives preferential treatment should be limited to the amount necessary for fulfilling basic government tasks (Berensmann and Herzberg, 2009) and to reasonable trade debt needs (Bolton and Skeel, 2004).

There are several arguments for preferring senior debt to junior debt. This is for example granted by so called absolute priority principle in private US bankruptcy proceedings which may also be applied to US municipalities. Bolton and Skeel (2004) propose a first-in-time-rule according to which unsecured claims should be classified in terms of their emission dates. The older the claim, the higher is the priority. Giving priority to senior debt promotes budget discipline. It accounts for the fact that later creditors were better informed about the fiscal situation of the SNG and were better able to price in the probability of default by demanding higher risk premia than earlier creditors (Blankart and Fasten, 2009). Finally, it reduces the risk of debt illusion, i.e. new debt reduces the asset value of former creditors (Fama and Miller, 1972).

Seizable assets and essential services

Insolvency frameworks may stipulate *ex ante*, which kind of assets can be sold and which service level needs to be maintained. Defining the seizable assets or essential services may affect municipal services, raise sovereignty concerns and influence financing which implies a trade-off. On the one hand, a municipality has to be left with as many assets as are necessary to fulfil its constitutional tasks. On the other hand, the more “insolvency mass” is available for the creditors, the lower are ex ante the costs of credit financing.

The seizable assets or essential services can be defined either in detail or more vaguely. With a clear-cut definition or a catalogue of seizable assets and essential services the outcome is more predictable. A clear definition leaves less room for manipulation than a fuzzy definition where assets may be shifted between

different accounts or non-essential assets may be declared essential. However, it may not be practical, as it reduces the possibilities to adjust to a changing environment.

Definitions of non-seizable and seizable assets can be found in the Swiss, South African and Hungarian regulations. In these rules, neither assets that are essential for public service provision nor tax revenue can be seized. A clear definition of essential services is only provided by the Hungarian framework, which lists 27 items.

Dismissal and sanctions

It might be useful to stipulate an early termination of the insolvency procedure or other sanctions in case the SNG or the creditors deter debt restructuring or do not comply with the framework's rules. Sanctions enforce insolvency rulings and make the agreement binding for the parties involved.

All regulations except the Swiss law foresee an early dismissal of the insolvency procedure or other sanctions when a municipality does not adhere to the rules or breach contract. In Hungary, sanctions may comprise fining the mayor for delaying the initiation of the debt adjustment process or dissolving the city council for not finding an agreement within a certain time frame. Even criminal and civil prosecutions can take place (Jókay, 2013). The South African framework provides sanctions (e.g. dissolution of the city council), when the municipality does not adhere to a fiscal recovery plan elaborated during state intervention. In the other frameworks, the debt restructuring plan is declared null and void, if the debtor fails to comply with it. Then the debtor is burdened with his original debt.

The threat of an early dismissal may contribute to facilitate the debt restructuring process. Specifying time frames as in Hungary may push the SNG to find a timely debt solution. Sanctions on missing fiscal adjustments like in South-Africa accelerate the process of budgetary and fiscal reforms and deter strategic default. However, the sanctions or a dismissal may conflict with sovereignty or raise constitutional issues and make it more difficult to maintain public service levels.

3.5. Fiscal adjustment and consolidation features

Fiscal adjustment

Debt restructuring should be accompanied by fiscal adjustment. It may involve expenditure cuts, tax increases and the raising of new income sources, but also include structural reforms (e.g. enhancing the efficiency of public service provision). Hence, fiscal adjustment may serve to rectify fiscal mismanagement and overcome structural problems, mitigate the negative effects stemming from an adverse exogenous shock, and thus hasten the fiscal recovery of a municipality. It also serves to deter debtors from running into insolvency. Furthermore, fiscal adjustment allows a better distribution of the burden of a debt crisis. It assures that both the creditors and the taxpayers share the burden of the debt restructuring. Nevertheless, the scope of fiscal adjustment is limited. Preserving basic municipal functions precludes deep expenditure cuts. An increase in taxes rates may also erode the tax base as citizens and businesses could leave the subnational entity (voting with their feet) (Blankart and Klaiber, 2006).

The existing insolvency regimes require some form of fiscal adjustment. Switzerland has included specific fiscal adjustment rules in the insolvency law. In South Africa and Colombia, debt restructuring rules are part of or are complemented by a fiscal adjustment framework. In most frameworks, the approval of insolvency depends on pre-filing efforts of the municipality to adjust the budget and to restore financial health (South Africa, Switzerland and the United States).

The US Chapter 9 framework gives the municipality in bankruptcy the power to assume and reject executory contracts (contracts that are yet to be performed) and unexpired leases. The municipality can suspend burdensome non-debt contractual obligations including collective bargaining agreements, and thus remove substantial budgetary costs stemming from employee payroll compensation and other

employee benefits (United States Courts, 2017; de Angelis and Tian, 2013). The rejection of non-feasible contracts may help to facilitate financial recovery, but it may undermine necessary reforms and encourage strategic filing.

Fiscal intervention

Fiscal intervention may contribute to enforce fiscal adjustment. It can be exerted by the court and/or an administrative authority. Fiscal intervention by a (competent and independent) third party may accelerate the fiscal adjustment process and fiscal recovery of the subnational entity. As it deprives political decision makers from financial autonomy, it sanctions the political failure, which led to the subnational bankruptcy. Fiscal intervention is even useful from a political economy perspective: third parties can take unpopular decisions more easily without fearing the consequences by the electorate.

Some frameworks give the higher governmental authority extensive rights to supervise fiscal adjustments and to intervene in subnational policy making (South Africa and Switzerland). According to the Swiss law, in case the municipality is in severe fiscal distress, the bankruptcy authority can mandate a supervisory commission to decide on behalf of the municipality on budget restructuring, spending cuts, tax increases, the selling of assets or on raising new income sources. In South Africa, a municipal government has to be subject to mandatory fiscal intervention before it can apply for debt restructuring. Then, an administrative authority elaborates a recovery plan to be implemented by the municipality, recommending changes to the budget and revenue raising measures of the municipality.

However, fiscal intervention by a third party may interfere with sovereignty. Hence, the US Chapter 9 guarantees that state sovereignty is recognised by the courts: day to day activities of the municipality are not subject to court approval. The control of the municipality is explicitly reserved to the states (Liu and Waibel, 2008).

3.6. Conclusions for an effective design of insolvency frameworks

Objectives and corresponding elements

Given country-specificities and trade-offs, no one-size-fits-all optimal framework exists. The design of the subnational insolvency framework and choice of the different features should be consistent with the broader cultural, economic, legal, constitutional and social context of the country (Canuto and Liu, 2013). It should also take into account a country's priorities for achieving different objectives.

Table 10 provides a detailed overview about how the different features of insolvency regimes need to be designed to meet the different objectives. In order to maintain essential services and facilitate fiscal adjustment, the framework should provide for a wide definition of non-seizable assets, sanctions in case of missing adjustments and fiscal intervention by the upper-level government. The two latter features may also serve to deter moral hazard – as well as triggering criteria which apply the "ultima ratio principle". Beneficial to facilitating debt adjustment are features which grant a temporary stay on enforcement, stipulate a cram-down rule and define a clear and detailed payment order. Creditors' rights are best protected when triggering criteria are defined restrictively, the veto right is assigned to a neutral third party and a wide range of assets can be seized. Ensuring that constitutional and sovereignty rights are respected, calls for strict eligibility criteria as well as a limitation on asset attachment and policy intervention.

Drawing on these features, existing frameworks set different priorities. Chapter 9 gives more emphasis to facilitating debt adjustment, in particular deterring the collective action problem, and safeguarding constitutional rights than the other countries, but puts less emphasis than other frameworks (Hungary, South Africa and Switzerland) on safeguarding public services and promoting fiscal adjustment.

Table 10. Overview of objectives and corresponding features of insolvency frameworks

	Essential public services and allowing fiscal adjustment	Deterring strategic default	Facilitating debt adjustment and deterring collective action problem	Protecting creditors' rights and maintain credit financing	Respecting constitutional rights
Type	**Administrative or hybrid framework**	**Judicial or hybrid framework**	**Administrative or hybrid framework**	**Judicial or hybrid framework**	**Hybrid framework**
Filing	Mandatory filing of debtor		Mandatory filing of debtor	Allowing creditors to file for municipal insolvency	Voluntary filing of debtor
Eligibility criteria	Less restrictive triggering criteria	**Restrictive triggering criteria applying the ultima ratio principle**		**Restrictive triggering criteria applying the ultima ratio principle**	**Restrictive triggering criteria applying the ultima ratio principle**
Stay	Granting a temporary stay and temporary cessation of payments		**Granting a temporary stay and temporary cessation of payments**	Limiting stay on enforcement to certain classes of claims	
Proposal right		Assigning proposal right to the creditors/ third party or assigning veto right to a neutral third party	Assigning veto right to a neutral third party	**Assigning proposal right to the creditors or assigning veto right to a neutral third party**	Assigning proposal right to the debtor
Voting rule			**Applying a simple majority rule or stipulating a cram-down-rule**	Applying at least a majority rule in each class	
Priority of claims	Priority to labour claims and government claims	Priority to creditors' claims	**Defining a clear and detailed order**	Priority to creditors' claims, priority to claims from interim financing	Priority to labour claims and governmental claims
Seizable assets	**Restrictive range of seizable assets**	**Wide range of seizable assets**		**Wide range of seizable assets**	**Restrictive range of seizable assets**
Dismissal/ Sanctions	**Sanctions for missing fiscal adjustments**	Sanctions for missing fiscal adjustments	**Dismissal or sanction for deterring debt restructuring**	Dismissal or sanction for deterring debt restructuring and fiscal adjustment	
Fiscal intervention	**Wide-reaching governmental intervention**	**Wide-reaching governmental intervention**			**Limited governmental intervention**

Note: Cells in bold = most relevant for meeting the objective.

A subnational model framework

Though there is no-one-size-fits-all solution, some general conclusions can be drawn from the existing insolvency regimes to develop a rudimentary model framework. Unlike the country-specific proposals of Waldmaier (2014), Schwarcz (2011) and Skeel (2012), the model proposed here abstracts from compatibility with specific constitutional law.

The basic approach is:

- *Filing:* SNGs may commence voluntarily the debt restructuring proceeding by filing with the court (administrative, bankruptcy or constitutional court) or an administrative authority. The court or administrative authority approves the petition after having scrutinised the eligibility criteria.
- *Triggering:* Triggering criteria are applied that define the status of insolvency and implement the ultima-ratio-principle: First, the SNG must be insolvent i.e. not able to meet its financial obligations now and in the future. Second, it must have taken all possible measures to prevent insolvency (e.g. fiscal adjustment efforts, fiscal reforms, submission under upper-level control, negotiations with creditors). The SNG is required to disclose all information about its fiscal and financial situation and pre-filing reform efforts.
- *Automatic stay:* A stay on assets is granted automatically. It does not impair the SNG's ability to to pay its employees and to pay for services that are essential.
- *Proposal and veto right:* The SNG proposes a debt restructuring plan to the creditors to be further elaborated and negotiated in an iterative process, until consent is reached. With the court's final approval the plan becomes binding on all creditors (if applicable).
- *Voting rule:* The debt restructuring plan is approved by a simple majority of votes in terms of number of creditors and by a qualified majority in terms of claims in each class.
- *Seizable assets:* Seizable assets are defined according to the country's specific preferences.
- *Priority of claims:* The priority of claims is defined according to the country's specific preferences. Nevertheless, non-secured claims should be prioritized according to seniority. New financing should be exempted from debt restructuring and fully serviced.
- *Fiscal intervention:* The incumbent government stays in office. The administrative authority controls subnational fiscal adjustment policy.
- *Sanctions:* In case the SNG delays deliberately the progress of debt restructuring and fiscal adjustment, the SNG is sanctioned (e.g. by early termination of the procedure, intervention by higher level government, dismissal or new elections)

These general features can be amended and adapted to fit country-specificities. For example, unitary countries could give more emphasis to the role of administrative authorities (e.g. higher level governments). Federal countries might follow a more judicial procedure by strengthening the role of the courts. For reasons of constitutionality and sovereignty it might be necessary to omit or weaken some features that may undercut substantially subnational autonomy or other constitutional rights (e.g. interference by higher level governments). Abstracting from these modifications, the model outlined above balances the different objectives. Table 11 applies the results from Table 10 to the model framework. It suggests that all objectives are met.

Table 11. Objectives and corresponding features of the subnational insolvency model framework

	Public services, fiscal adjustment	Deterring strategic default	Facilitating debt adjustment	Protecting creditors rights	Respecting constitutional rights
Filing	•				•
Eligibility criteria		•		•	•
Stay	•		•	•	
Proposal right			•	(•)	•
Voting rule			•		
Priority of claims	depends on country-specific choices				
Seizable assets	depends on country-specific choices				
Dismissal/Sanctions	•	•	•		
Fiscal intervention	•	•			

Note: • fully applied, (•) partly applied – depends on the assignment of veto right to the court.

4. Implementing insolvency frameworks

4.1. Limitations and drawbacks

Incompatibility with constitutional and sovereignty rights

Insolvency frameworks have several limitations. One argument is that subnational insolvency frameworks might be incompatible with constitutional or sovereignty rights – especially when dealing with insolvent states. In federal countries such as Switzerland, the United States and Germany, each state is a sovereign authority, with their own legislative, executive and judicial powers. Any interference of central government such as intervention of a higher level government into subnational fiscal policies or the imposition of sanctions on subnational decisions makers in case of non-compliance with the rules may conflict with their constitutional rights.

On the other hand, it can also be argued that an insolvency framework – as curative instrument – may even be necessary for enabling financially troubled SNGs to exercise their sovereignty rights. Insolvency regimes chosen voluntarily and allowing temporary intervention into sovereignty rights might be legitimate, if the principle of proportionality is taken into account and federal basic principles are not violated (Waldmeier, 2014). Nevertheless, implementing an insolvency framework may in many cases require substantial constitutional changes. If these change existing constitutional rights, consent by a qualified majority of the SNGs may be needed.

Lacking institutional prerequisites and structural reforms

Insolvency cases have shown that the implementation of insolvency regimes often needs to be preceded by major structural and institutional reforms in order to enhance the responsibility of SNGs for their fiscal policy and enable SNGs to adapt fiscal policy to changing environments. Hence, tax and spending powers have to be assigned in a way to achieve fiscal equivalence. Any explicit and implicit bailout guarantee has to be ruled out. Effective subnational control institutions as well as transparent budgeting and reporting systems have to be created. Without fixing fundamental institutional and structural deficiencies, insolvency frameworks would be of limited use for achieving long-term financial health. They would serve only to curb the symptoms of political and institutional failures in the short run – thereby imposing high costs on tax payers and creditors (Levitin, 2012).

Lack of a transitional regime change

Introducing an insolvency regime faces the difficulty that it implies an immediate regime change – shifting from a state in which the central government will back SNGs to a state in which insolvencies become more likely. Without having any further rules or arrangements of transition in place which allow the agents involved (e.g. creditors, investors, SNG, central government, voters, industry) to gradually adapt to the new circumstances, the introduction (or even its announcement) of an insolvency regime may lead to disruptive reactions by the agents. This may end up in a situation worse than before.

For example, in case of high subnational indebtedness, implementing an insolvency framework may bear the risk of contagion to other governments and the financial market. It reduces the creditworthiness of SNGs holding a large amount of debt, increases their refinancing costs and increases the likelihood of insolvency. A possible default in one SNG may undermine the creditors' confidence in all SNG debt, and thus worsen overall borrowing conditions for SNGs. Defaulting on loans and bonds may also pose systemic risks when they affect banks. These may be transmitted to other institutions and governments and may result in market turbulence or even the collapse of the credit market.

Halstead et al. (2004) have shown that the unprecedented announcement of bankruptcy of Orange County in December 1994 had wide-ranging spillover effects on municipal bonds, municipal bond funds and bank stocks. The announcement resulted in significantly negative abnormal returns for municipal bond funds without direct exposure to Orange County and for non-Orange County municipal bonds. Contagion also spilled over to the common stocks of investment and commercial banks that dealt in or used derivatives. Similar contagion effects even may arise with the introduction of insolvency regimes in a situation of high subnational indebtedness without providing for further transitional arrangements or rules.

Political economy issues

The implementation of insolvency regimes could fail for political economy reasons as well. Due to the uncertainty about the consequences of its implementation – especially the risk of contagion and profound structural and federal reforms–, SNGs may oppose the implementation of an insolvency framework. Apart from that, another main reason for their refusal is that it may impose a system change to a no-bailout-system – redistributing the debt burden from third parties back to the debtor (and creditors). SNGs can now be held liable more easily for their budgetary policy by the voters, reducing the leeway for opportunistic behaviour.

In addition, political decision making may be negatively affected by the creditors lobbying strongly for maintaining the status quo (Schwarzc, 2004). In the past, they have been profiting from good financing condition of the SNGs which were guaranteed by the solvency of the upper-level governments. Under an insolvency system, they have to renounce on the simple investment option with secure returns and instead face the risk that assets might become devalued or written-off.

4.2. Possible solutions and their trade-offs

Voluntary or flexible implementation

A simple remedy to the problem of constitutionality and the unwillingness of SNGs to implement a subnational insolvency law is to design a framework, which gives the SNG sufficient freedom of decision in determining the debt restructuring and fiscal adjustment process. A possible solution may be to let the subnational government decide *ex ante* whether the insolvency rules stipulated is applicable in case of a financial crisis or not – similar to the state's authorisation for filing for Chapter 9 ("opt-in" option). Another approach may be to integrate an "opt-out" option into the framework – as considered by Bolton and Skeel (2004) for sovereign states – that allows the state to exit from the framework. In both cases, those not covered by the insolvency framework might set up their own rules or, if not, might end up with an ad hoc

debt restructuring in case of insolvency. In order to grant legal certainty to creditors and to avoid disincentives of the SNG, the decision to implement insolvency rules need to be taken when introducing the insolvency law. Governments may opt-in or opt-out even at a later date, but only if they adhere to the budget rules.

The positive side of this proposal is that the SNG is free to decide on the application of an insolvency regime – trading-off the negative effects of the potential loss of sovereignty with the advantages of being part of the uniform insolvency framework. The negative side is that this voluntary framework may not eradicate negative incentives. Those not submitted may still speculate on being bailed out by the central government or other third parties.

Hence, an alternative is a flexible approach, which makes the implementation of some insolvency rules mandatory for SNGs based on common standards and regulations. For example, a common minimalist framework could be defined, laying down the general rules and principles of the insolvency procedure, similar to the approaches of Schwarcz (2004 and 2011). The minimalist framework is then completed by subnational law defining the specific features of the debt restructuring process.

The flexible approach may also respect sovereignty rights and reduce the reluctance of SNGs to implement detailed rules on debt restructuring. In addition, it would guarantee some minimum requirements to effectively address the moral hazard and the hold-out problem. At the same time, it can be tailored to the special needs of the SNG. However, the existence of diverse subnational insolvency regimes may reduce transparency and make it more difficult for creditors to evaluate the outcome of possible insolvency proceedings and thus to price subnational debt. In addition, an insolvency regime may be created that induces lenient decision-making in favour of the debtor.

Gradual or lagged implementation

A solution to avoid disruptive effects and also to overcome the reluctance of political decision makers is to gradually implement a bankruptcy law and to embed it into existing rules and institutions – similar to the suggestions by Nunner-Krautgasser (2013) and Schwarcz (2004). A starting point may be to first stipulate rules that allow debt enforcement against some assets of a SNG. At a later stage, general procedural rules and principles are developed in a minimalist framework. Complex material questions (e.g. priority of claims, essential services, seizure of assets, sanctions, fiscal intervention) are gradually implemented later.

A lagged implementation of an insolvency regime as proposed by Fuest et al. (2016) for the euro area may be another solution. The authors suggest to define today (taking advantage of the reform window) an insolvency procedure, which becomes effective at a certain date in the future. In addition to that an explicit transition path is stipulated, including further measures to allow for phasing-in of the new rules.

The merit of these two approaches is that the diverse agents (SNG, investors, creditors) are not faced with a *fait accompli*. They have time to adapt to the new rules. The benefit of a gradual implementation is that the framework is left deliberately vague, when it is introduced. This allows the various actors involved to act under the “veil of ignorance”. In particular, it leaves scope for further adjustment according to the changing environment and upcoming needs. Instead, a lagged implementation provides predictability. The agents know already what the framework will look like. Then, the transitory phase enables them to make policy adjustments before the insolvency framework enters into force. The drawback of both approaches is that they bear the risk of getting stuck or not being finalised which may generate legal uncertainty.

Central government guarantees or conditional transfers

Another option for dealing with weak subnational finances and fragile financial markets is to foresee the provision of guarantees or conditional transfers by the central government during a transitory period. This approach was followed by Colombia. In the first six months after the implementation of Law 550, the central government guaranteed 40% of the restructured debt, if the SNG met certain conditions (e.g. approval of

fiscal programmeme, agreement on restructuring plan). A 40% guarantee was also offered to entities for their adjustment lending from commercial banks or international development banks. An SNG may even receive a 100% guarantee of new loans to finance adjustments for achieving the spending limits set out in the law (del Villar et al., 2013).

The provision of conditional transfers or federal guarantees may not only provide necessary liquidity to insolvent SNGs. It might generate political consent and reduce the risk of contagion, when introducing an insolvency regime. Through conditionality, it may help the implementation and adherence to fiscal rules. Nevertheless, it may still increase the risk of moral hazard, if the time period is set too long. Pressure by politicians, society and investors may force decision makers to prolong the bailout guarantee or turn it into a permanent mechanism which would undermine subnational reform efforts.

Establishing a debt redemption fund

In case of severe subnational indebtedness, it might be necessary to hive off existing liabilities in order to avoid adverse market reactions. Konrad (2008) suggested establishing a common debt redemption fund which takes over and pools existing subnational debt. The central government provides an explicit guarantee for the debt accumulated in the fund – also including liabilities from common bonds that are issued for refinancing. SNGs are obliged to redeem their share of transferred debt (including interest payments) over a certain period of time. They are only liable for creditors' claims arising from new borrowing. Only these claims may become subject of the insolvency procedure in case of bankruptcy. A historic example is the so-called *Erblastentilgungsfonds* established in 1995 in Germany for incorporating the debt of the former GDR (Wissenschaftliche Dienste des Deutschen Bundestags, 2013).

The creation of a debt redemption fund may have several merits. It reduces the debt burden of highly indebted SNGs and facilitates their financial recovery, as maturities are extended and interest payments are reduced. It safeguards property rights of creditors' claims and avoids possible market disturbances, resulting from the introduction of an insolvency regime. Linked with the insolvency regime, it diminishes speculation on a future bailout. The establishment of a debt redemption fund may have several drawbacks. While highly indebted governments may profit from lower interest rates for the refinancing of outstanding debt, fiscally responsible SNGs may face worse financing conditions. Their interest rates may increase. Furthermore, centralisation of processes and tasks to the federal level are often difficult to reverse (The German Council of Economic Experts, 2011). Hence, there is also the political risk that the redemption fund meant to be temporary may be turned into a permanent institution which would undermine the functioning of an insolvency regime. Finally, the establishment of a debt redemption fund even poses new questions such as how to prioritise senior and new claims.

An alternative to a common (mandatory) debt redemption fund is to establish voluntary liability agreements between SNGs (with or without the involvement of the central government), which may be similar to the deposit protection fund established in the banking system (Konrad, 2003). The notion is that a SNG may voluntarily transfer debt in a commonly agreed fund under the joint liability of the participants. The SNG may be committed to fulfil certain regulatory requirements (e.g. meeting financial key figures, following consolidation paths). In case of non-compliance with these rules, the SNG would be excluded. The approach would increase budget discipline of the subnational governments and control by the creditors, but bears also the risk of separation between high and low-debt SNGs. SNGs with low debt levels and a high creditworthiness may have a low incentive to participate – leaving only highly indebted SNGs to pool their debt.

Conclusion on approaches solving the implementation problem

The approaches mentioned above may contribute to overcome the limitations of establishing an insolvency regime. All may help to reduce the opposition of subnational decision makers, creditors, and other agents concerned to introduce such a system. Integrating an opt-in or opt-out option or defining a minimalist

framework to be further specified by subnational law may respect the sovereignty principle. A gradual development of insolvency frameworks, the definition of transition paths, the provision of central government guarantees, or the establishment of a debt redemption fund may limit the risk of disruption arising with the "regime change". However, these solutions implicate a departure from the "balanced" insolvency regime. Most approaches may induce moral hazard (especially central government guarantees) or limit transparency and legal certainty (especially flexible solutions). Thus they diminish the effectiveness of insolvency frameworks in preventing bankruptcies and achieving a fast fiscal recovery.

In this regard, a delayed implementation could be a good option. It is associated with low disincentive effects and a high degree of clarity, provided that the timetable is credibly firm. In terms of practicability, solutions that include a minimalist framework may be preferable to the other solutions as they are easier to implement. In addition, they permit adjustments according to changing environments or specific subnational needs. However, delaying the implementation of a defined framework or implementing a minimalist model that is gradually developed to a comprehensive framework may have short-term adverse repercussions on subnational borrowing availability and costs. In case of a severe budgetary crisis these approaches may not be sufficient to avoid contagion. Then, the temporary provision of guarantees by the central government may be needed to calm markets. Conversely, the establishment of a debt redemption fund seems less feasible than the other approaches, as it adds further complexity to the difficult task of designing an effective insolvency regime.

Importantly, the negative effects of the adoption of a subnational insolvency framework are most likely to be minimised, if it is accompanied by any needed reform of subnational borrowing controls, and structural weaknesses of the intergovernmental fiscal relations system.

Note

1. One recent exception being Brazil's 2017 Fiscal Recovery Regime (Regime de Recuperação Fiscal), which provides breathing room for heavily indebted states with liquidity problems through a grace period on the debt administered by the central government, and demands fiscal adjustment measures to bring them back to a fiscal sustainable path (Fernandes and Santana, 2018; IMF, 2019).

2. OECD-averages are unweighted averages.

3. Selected countries include Belgium, Denmark, Germany, Korea, Netherlands, Norway, Spain, Switzerland, and Turkey. They responded to a survey on subnational debt resolution of the OECD Fiscal Network.

4. In Germany, state laws prohibit insolvency proceedings against municipalities but allow limited debt enforcement against some municipal assets.

5. IMF's World Economic Outlook database: USD 99 468 billion for GDP and 3 470 million for population.

6. A comparison of these sovereign insolvency approaches is provided by Berensmann and Herzberg (2013).

7. The institutions that are covered by laws and decrees other than Law 550 are private and public health providers, organisations that manage funds from the General System of Social Security for Health, and providers of public services in water, sewerage, electricity, fuel gas, basic public telephone distribution and mobile in rural areas. In insolvency cases of such entities, the concerned (sectoral) superintendency takes possession of the entity to ensure that the services continue to be provided.

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Managing and Prioritising Public Finances and Budget in Support of Strategic Development in the Slovak Republic: A Targeted Budget Review

This review looks at how the budgeting and public financial management system, as managed and co-ordinated by the Ministry of Finance, effectively supports Principles 2 and 3 of the OECD Recommendation on Budgetary Governance (2015). This report is divided into four sections providing recommendations at the end of each based on the OECD Principles of Budgetary Governance.

This targeted budget review was written by Juliane Jansen and Ana Maria Ruiz Rivadeneira, former Policy Analysts at the Budgeting and Public Expenditures Division of the OECD during the preparation of this report; and Peter Mandzak, Analyst at the Value for Money Division at the Slovak Ministry of Finance and former external consultant for the Budgeting and Public Expenditures Division at the OECD during the preparation of this report. The report benefited from contributions from Jón Blöndal (Head of Division), Andrew Blazey (Deputy Head of Division) and Delphine Moretti (Senior Policy Analyst).

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Foreword

In 2018, the Slovak Republic requested the OECD to undertake a targeted budget review focusing on the managing and prioritising processes of the budget in support of achieving strategic development objectives in the Slovak Republic. The targeted request resulted from a comprehensive Slovak-OECD project "Developing the Intervention Logic of Strategic Planning by Central Government Authorities" that supports the Slovak Republic to improve the governance tools and frameworks in place for the efficient implementation of its national strategy, and in particular the Sustainable Development Goals. An outcome of the project was the recognition of the fundamental role of public financial management and, in particular, the role of the budget to implement and finance national plans and infrastructure investment.

Conducted through the OECD Network of Senior Budget Officials, the targeted budget review follows a similar process to a full budget review but focuses on a subset of budget principles that are particularly relevant to the country at a specific point in time. This targeted budget review focuses on Principles 2 and 3 of the OECD Recommendation on Budgetary Governance (2015), specifically to, "closely align budgets with the medium-term strategic priorities of government", and to "design the capital budgeting framework in order to meet national development needs in a cost-effective and coherent manner".

This review looks at how the budgeting and public financial management system, as managed and co-ordinated by the Ministry of Finance, effectively supports the two Principles. It considers the extent to which medium-term expenditure aligns to Slovakia's[1] national goals, the planning and prioritisation process of capital investment, and the adequacy of the programme budgeting system for this purpose.

The review concludes that Slovakia has made significant progress towards aligning its budget to the government's medium-term strategic priorities, most notably the establishment of the Value for Money (VfM) initiative and the formulation of a national investment plan with a long-term planning horizon. The review identifies concerns about the effectiveness of the system for longer-term strategic development and suggests a set of adjustments to the budget process. The adjustments refer to robust and reliable medium-term expenditure planning; collective fiscal responsibility and priority setting; high-quality performance information; a strong evaluation function; and enhancing co-operation across Ministries by sharing of expertise and identifying a system to implement the National Infrastructure Plan.

Abbreviations and acronyms

BIS	Budget Information System
CAP	cross-agency priority
CBA	Cost-Benefit Analysis
CBR	Council for Budget Responsibility
DPMO	Deputy Prime Minister's Office on Digitalisation and Informatisation
EU	European Union
FPI	Financial Policy Institute
GAO	US Government Accountability Office
GDP	Gross Domestic Product
GG	General Government
GGB	General Government Budgets
GPRA	Government Performance and Results Act
GPRAMA	Government Performance & Results Act (GPRA) Modernization Act of 2010
IU	Implementation Unit
LOLF	Loi organique relative aux lois de finances
MTEF	Medium Term Expenditure Framework
MOF	Ministry of Finance
MTO	Medium Term Objective
NIDP	National Infrastructure Delivery Plan
NIP	National Infrastructure Plan
NPC	no-policy change
NRP	National Reform Programme
OMB	Office of Management and Budget
PIC	Performance Improvement Council
PMO	Prime Minister´s Office
RIA	Regulatory impact assessments
SAO	Supreme Audit Office
SDGs	Sustainable Development Goals
SEA	Strategic Environmental Assessment
SGP	EU Stability and Growth Pact
SOE	State Owned Enterprise
SPU	Stability Programme Update
STDP	Strategic Transport Development Plan
UN	United Nations
VfM	Value for Money

Executive Summary

Since 2016, the Centre of Government of the Slovak Republic has worked to set a vision for national development priorities, with stable investment planning and resourcing for sustainable economic growth. To support the Slovak Republic deliver on these goals, this targeted review considers the Slovak budget framework, the application of that framework in a medium-term budget process, and the role of the performance and evaluation framework in relation to the budget process. The purpose of this focus is to consider the extent to which medium-term expenditure aligns to the country's national goals, the planning and prioritisation process of capital investment, and the adequacy of the programme budgeting system.

Budgeting framework

The foundational document of the medium-term budget in Slovakia is the EU Stability Programme and the National Reform Programme is the main reference document for the government's strategy. However, these programmes guide rather than align to budget decisions. Ways to strengthen the alignment in the context of the medium-term expenditure framework (MTEF) would be to establish a binding allocation or 'ceiling' on expenditure and at the same time support the ceiling with baseline estimates of expenditure across the same period. The purpose of these two recommendations is to establish greater certainty on the allocation of funding over the medium-term and to inform the allocation decisions with baseline information from ministries and agencies. As such, the recommendations in this report aim to strengthen the top-down and bottom-up provision of information within the MTEF.

The decision making process could be strengthened by introducing a pre-budget strategy debate before the Cabinet makes decisions on budget allocations. The purpose of a debate would be to inform the government's decision-making and to enhance the collective responsibility for the performance of the MTEF. In general, adopting a more participative approach within the government to setting (and evaluating) budget objectives should be considered as a standing feature of the budget process.

Planning and prioritisation process for capital investment

Slovakia's plan to reduce its dependency on EU funds may lead to challenges in terms of planning its capital investment. In general, capital expenditure in the Slovak Republic is well integrated into the General Government budget process, however, around 57% of capital expenditure by the Slovak Government is funded by EU funds and is subject to a separate system for planning, resource allocation, disbursement, monitoring and evaluation.

Building on recent improvements, the government should focus on its co-ordination of medium- and long-term planning for capital investments. The OECD understands the Deputy Prime Minister's Office for Investments and Information is developing a National Infrastructure Plan (NIP). Introducing tools to plan and prioritise infrastructure projects at a sector level will likely help improve co-ordination and the implementation of the NIP. Recent reforms have strengthened the project assessment and evaluation process. A next step will be to monitor and report on the implementation of the NIP and to ensure the systems are connected to the budget process.

Performance and Evaluation

In 2004, Slovakia introduced a programme budgeting framework. Similar to other OECD countries, programme budgeting in Slovakia follows a "presentational performance budgeting" approach, that is, it provides supplementary information to increase the transparency of the budget to help parliament and citizens understand the objectives of public spending and the results achieved. However, the framework makes a limited contribution to strengthening accountability and informing budget decisions. The government should consider how it could integrate the use of performance information into the budget

process, so it can inform the allocation and prioritisation of public resources within line ministries and across the government as a whole. An integrated approach that connects performance information to budget decisions would better support the alignment between the annual budget allocations, the medium-term expenditure framework and the national development priorities of the government.

In Slovakia, line ministries and agencies are encouraged to monitor and evaluate programmes on voluntary basis and there are few incentives to undertake evaluations. A systematic approach to evaluation and *ex-post* assessments could inform the importance of well-defined objectives and indicators; highlight which measures impact on a Sustainable Development Goal or national goal; and provide feedback for decision making. The government should consider ways to introduce focused assessments of the impact of its policies. Effective ways to achieve this include developing a more cross-cutting vision into the spending review process and strengthening the role of the Supreme Audit Office.

Box 25. Summary of key recommendations

Strengthen the Slovak budgeting framework for robust and strategic medium-term planning by:

- Introducing baseline estimates of expenditures over the three-year medium term to support the information available to set credible expenditure ceilings.
- Regularly updating baseline estimates within a single budget year.
- Including baselines in the automatised Budget Information System.
- Ensuring time, space and sequencing process for interdepartmental engagement to agree on the expenditure baselines.

Prepare for the transition from EU funding of capital investments by:

- Strengthening the governance framework for capital investment, including planning, allocating, monitoring and evaluating processes and capacities.

Reinforce the medium-term dimension for stable budget planning by:

- Introducing a strategy debate into the budget cycle to enhance collective fiscal responsibility and priority setting.
- Making expenditure ceilings for total expenditures and ministerial envelopes binding.

Link strategic infrastructure planning to the budget process by:

- Enhancing co-operation across ministries and sharing of expertise.
- Ensuring a top-down approach of the development of the NIP to ensure the strategic prioritisation of infrastructure projects.
- Identifying and managing major future risks and uncertainties in infrastructure planning.
- Implementing a system to monitor the implementation of the NIP.
- Linking strategic infrastructure planning with fiscal planning.

Improve the alignment of performance information to strategic goals by:

- Ensuring that performance information is collected and can be relevant and useful for budget formulation, parliamentary debates and oversight.
- Encouraging parliamentary engagement to build demand for performance information by ensuring sufficient time and dedicated capacity.

Strengthen the evaluation function of the government to demonstrate progress toward strategic objectives by:

- Standardising spending reviews as a tool for performance evaluation and eventually informing medium-term expenditure ceilings

Establishing a co-ordinated system and the necessary capacities for monitoring, evaluation and quality control.

1. Introduction

Since 2016, the Deputy Prime Minister's Office for Investments and Informatisation of the Slovak Republic has been working to set a vision for national development priorities, with stable investment planning and resourcing for sustainable economic growth. In July 2018, the Government presented its Voluntary National Review on the implementation of the 2030 Agenda for Sustainable Development Goals at the United Nations High Level Political Forum. The Review outlined six priorities for the implementation of the Sustainable Development Goals (SDGs) in Slovakia, including education, transformation towards an environmentally sustainable and knowledge-based economy in the context of demographic change, sustainability of settlements, regional development in the context of climate change, social inclusion and tackling health disparities.

To deliver on these priorities and to achieve national goals, a joined-up approach is required. The priorities are to be integrated into a long-term national development strategy and into sectoral policies and investment plans, in order to ensure a whole-of-government approach and adequate financing. This involves institutional leadership from the centre of government, a close working partnership with the Ministry of Finance, active engagement of line ministries and agencies, and accountability to parliament, audit institution and civil society.

Slovakia has developed tools to align its budget to the government's medium-term strategic priorities, most notably the establishment of the Value for Money (VfM) initiative and the formulation of a national investment plan with a long-term planning horizon. Despite these improvements, the government is concerned about the effectiveness of the system concerning longer-term strategic development. In particular, the programme budgeting system, the medium-term expenditure framework and the planning and prioritisation process for capital investment have been identified as key areas for improvement.

The OECD has provided assistance on strategic planning to the central government authorities of Slovakia. One of the deliverables included a report by the OECD on the 'legal and institutional framework at the central level for strategic planning', including in the context of a National Investment Plan and implementation of Agenda 2030.

This report is the result of an assessment of current framework and processes in place for setting national priorities, with a particular focus on investment planning. More specifically, it focuses on the OECD budgetary governance Principle no. 2, which calls on governments to "closely align budgets with the medium-term strategic priorities of government", and Principle no. 3, "design the capital budgeting framework in order to meet national development needs in a cost-effective and coherent manner".

Section two describes the budget framework in the Slovak Republic and compares features in the framework to other OECD countries. Section three explores the medium-term dimension of the budget process and how it supports government priorities. Section four explores current practices in performance budgeting, highlights progress under the value for money initiative, and identifies ways to strengthen the use of performance information in the budget process. This report provides recommendations at the end of each based on the OECD Principles of Budgetary Governance.

2. The Slovak budgeting framework

2.1. Summary

A well-defined budget framework is essential to ensure that the allocated resources contribute to the government's strategic priorities within the limits of fiscal targets. The Slovak budget system has a sound legal and constitutional grounding, which includes the roles and responsibilities of the executive and legislature for the formulation and execution stages of the budget. The introduction of the Constitutional Act on Budget Responsibility 493/2011 supported the long-term sustainability of public finances, transparency and efficiency of public spending. In particular, the establishment of the Council for Budget Responsibility (CBR) was a key advancement for monitoring and evaluating compliance with the fiscal rules and enhancing fiscal transparency.

The budget framework in the Slovak Republic is closely aligned to the requirements of the EU Stability and Growth Pact and the Two Pack. In general, the budget process follows OECD best practices, but the system could be further be strengthened by having a clear identification of expenditure ceilings and strategic budget functions based on baseline analysis over the course of the annual and multiannual budget cycle. Despite recent improvements, including the reformed preparation and evaluation process of large investment projects, the system for the medium and long-term planning for capital investments could also be strengthened.

This Chapter comments on the Slovak legal system; describes the country's annual and multi-annual budget processes; and discusses the role of capital expenditure in the budget process.

2.2. Slovak legal foundation for the budget process

The **Act on the General Government (GG) on the Budgetary Rules of Public Administration 523/2004** is the main document for budget formulation and execution. The Act regulates the budget process, budget management rules, and the roles and responsibilities of the Ministry of Finance and other legal entities involved in the budget process. In 2011, the Act was amended in line with the EU Stability and Growth Pact (SGP) and the Two Pack (Box 26). It created the statutory basis for a balanced budget, defined as a structural deficit equal or lower than 0.5% of GDP, set in accrual terms, which is the same as the Medium Term Objective (MTO) presented in the 2018 Slovak stability programme. The Act also contains a corrective mechanism in case of deviation from the medium-term objective or the trajectory, including expenditure limits for the time of correction. However, multi-annual expenditure and revenue indicators are not mandatory.

Box 26. Slovakia and the EU Fiscal Framework

As a member of the European Union (EU), Slovakia must comply with the 3% limit on the general government (GG) deficit and the 60% ceiling on GG debt. The Slovak Republic is also bound by the EU Stability and Growth Pact (SGP), which requires that public finances are managed "close to balance or in surplus" over the medium term. Slovakia is subject to the more recent strengthened EU economic governance framework (Six-pack and Two-pack) and is a signatory to the Fiscal Compact Treaty, which embodies and clarifies the various EU economic governance rules.

Slovakia's domestic national fiscal strategy is closely aligned to EU rules. According to the 2016 Government's manifesto, Slovakia's fiscal policy strategy aims to achieve a balanced budget by 2020.

As a member of the Euro-area, Slovakia submits a "Stability Programme Update" (SPU) to the EU in April, setting out the country's Medium Term Objective (MTO) and associated economic analyses,

which are updated every year. The stability programme, prepared by the Ministry of Finance, presents macro fiscal policy scenarios and identifies the financial priorities to be addressed in a given three-year period. At the same time, Slovakia submits a "National Reform Programme" (NRP). The NRP is one of the country's main strategy documents, mapping the country's stability programme and the manifesto of the government. The Deputy Prime Minister Office for Investments and Informatisation and the Ministry of Finance co-ordinate the NRP.

Source: Ministry of Finance; OECD (2018[23]), EC (2018[2])

The Constitutional Act on Budget Responsibility 493/2011 was introduced in 2011 in response to the financial crisis and the rapid increase of General Government gross debt, which jumped from 28.5 % of GDP in 2008 to 52.2 % of GDP in 2012. The Constitutional Act has the objectives of: a) achieving long-term sustainability of public finances; b) enhancing the transparency and efficiency of public spending; and c) supporting the long-term competitiveness of the Slovak Republic, while taking into account economic and social justice and solidarity between the current and future generations.

The Constitutional Act also introduced important innovations to the fiscal framework, including enhanced rules for fiscal responsibility and transparency. In particular, it establishes the Council for Budget Responsibility (CBR) (Box 27) as an independent fiscal institution of the Slovak Republic to monitor and evaluate compliance with the fiscal rules and enhance fiscal transparency.

The new fiscal responsibility rules introduced an upper limit for the General Government debt, the so-called "Debt brake" (Box 28). Together with the MTO of a balanced budget, the debt limit now constitutes the main fiscal target of the Slovak Republic. The Constitutional Act also included provisions for municipalities and established a long-term sustainability indicator, calculated by the CBR, which aims to inform public debate[2]. The debt limit, however, was not created as the operational target, as expenditure ceilings were expected to perform this role (OECD, 2016[3]). However, mandatory medium-term expenditure ceilings for spending ministries have not been introduced yet, contrasting the Ministry of Finance's remit to achieve the aggregate fiscal targets as defined in the Stability programme.

With regard to fiscal transparency, the Constitutional Act provides a statutory basis for two independent committees responsible for macroeconomic and tax forecasts for the budget (Box 29, next section). It also requires information on the consolidated budget, tax revenue, contingent liabilities, net worth, one-off effects, financial results of state companies, and a debt management strategy on the budget (OECD, 2016[3]).

Box 27. The Council for Budget Responsibility

The Council for Budget Responsibility (CBR) was formed in 2012 as an independent fiscal institution of the Slovak Republic. It´s main objective is to monitor and evaluate fiscal performance, increase transparency of public finances, raise public awareness, and facilitate better decision-making in the parliament. The main tasks of the CBR are defined in the Constitutional Act on Fiscal Responsibility.

The nature of the council's work is descriptive, rather than normative. It has no mandate to formulate policy recommendations. Its functions are both prospective, when analysing long-term fiscal sustainability or the draft budget, and retrospective, when assessing the government's compliance with fiscal and transparency rules. Additionally, the CBR can choose to cost individual pieces of legislation. However, the legal mandate of the council prioritises the analysis of long-term fiscal sustainability and assessment compliance with the fiscal and transparency rules, leaving the third function, costing of legislation, optional. Moreover, it has no mandate to cost the election platforms of political parties. The

council has no role in macroeconomic forecasting for the government, which is the task of a separate body (see Box 29).

Source: Von Trapp, L., I. Lienert and J. Wehner (2016), *Case Study of Slovakia* in "Principles for independent fiscal institutions and case studies", OECD Journal on Budgeting, vol. 15/2, https://doi.org/10.1787/budget-15-5jm2795tv625, Official website of the CBR, http://www.rozpoctovarada.sk/eng/rozpocet/125/what-do-we-do

Box 28. The Slovak fiscal pathway

The Constitutional Act introduced a debt brake aiming to stop the rapid increase in general government (GG) gross debt. The debt brake sets an upper limit of 60% of GDP, as well as debt-reducing procedures. Starting in the fiscal year of 2018 and until the end of the fiscal year of 2027, the upper limit of the GG debt is to be gradually decreased by one percentage point per year until it reaches 50% in 2027. Hence, from 2027 onwards a debt-reducing procedure will apply if debt reaches or exceeds 40% of GDP. To comply with these targets, there are different procedures for different levels of debt, for example:

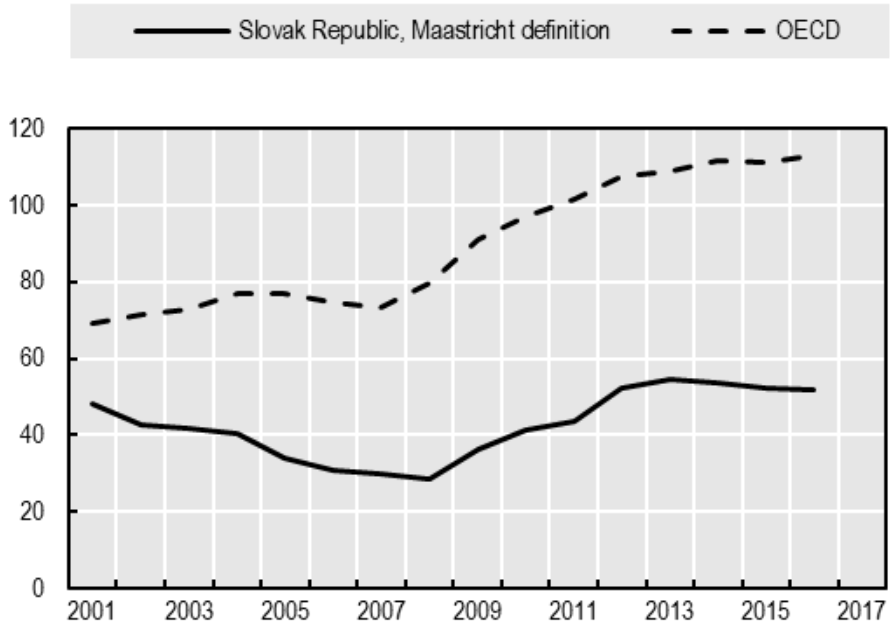
1. A written justification from Ministry of Finance to the National Council if debt levels reaches or exceeds 40% of GDP.
2. The Ministry of Finance can block the state-budget expenditures up to 3% of the total state-budget expenditures as approved in the state budget Act for the respective fiscal year, and block the Prime Minister's and Government reserves of and the reserve of the if debt levels reaches or exceeds 45% of GDP.
3. The Government may not submit to the National Council a general government budget proposal with budgeted deficit if debt levels reaches or exceeds 47% of GDP.
4. The Government needs a vote of confidence by the National Council, if debt reaches or exceeds 50 % of GDP.

The debt limits are subject to four numerically defined escape clauses relating to: 1) major recessions; 2) banking system bailouts; 3) natural disasters; 4) and international guarantee schemes. The debt ceiling is however not a sufficiently effective operational fiscal rule and entails the risk of pro-cyclical policy when debt approaches the ceiling (OECD, 2017[4]).

Source: Constitutional Act on Fiscal Responsibility, www.rozpoctovarada.sk/images//constitutional_act_493_2011.pdf; (OECD, 2016[3])

The reforms introduced in the last decade have placed fiscal discipline as the main objective in the budget framework, providing the government with guidelines and tools to strengthen its fiscal situation. Since the introduction of the Constitutional Act, debt levels have stabilised and started to decrease slowly. As highlighted by the latest OECD Economic Survey (OECD, 2019[5]), the fiscal situation is sound, with a deficit of below 2% of GDP in 2016 and a public debt around 52% of GDP, below the OECD average (Figure 15).

Figure 15. Gross Public Debt
% of GDP



Source: OECD (2019), OECD Economic Surveys: Slovak Republic 2019

2.3. Slovakia's annual and multi-annual budget processes

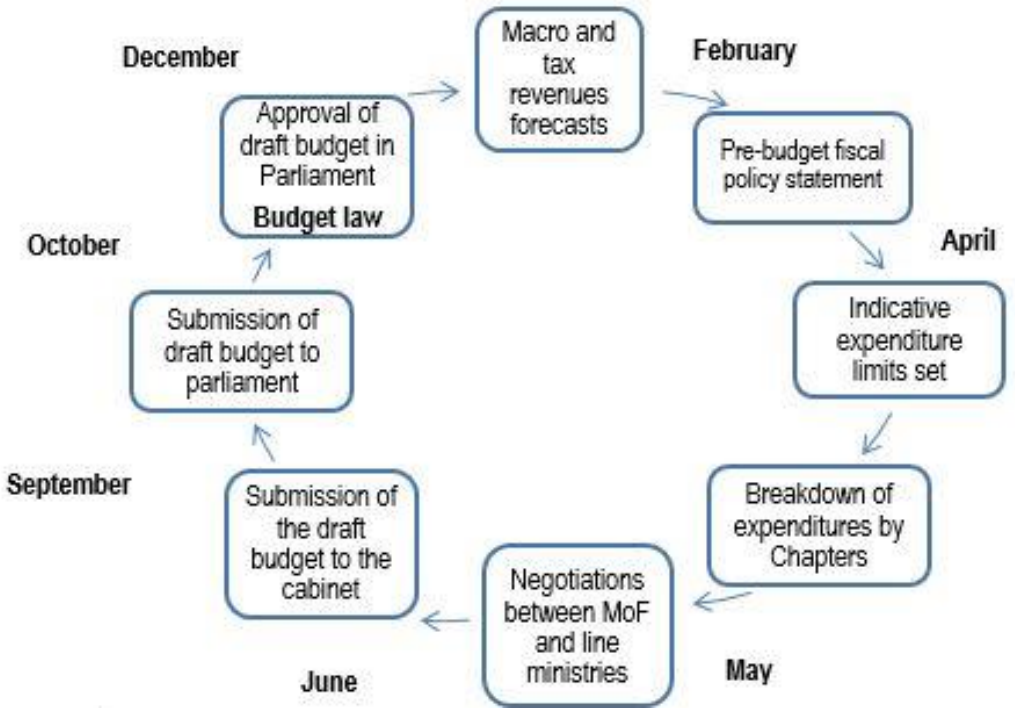
As discussed in the previous section, the budget process in Slovakia is derived from both domestic and European fiscal objectives. The 2004 budget reforms legislated a top-down approach to the Slovak budget process. Initially the top-down approach was first introduced in 2000 with a document called the *Starting Points for Budget Preparation*, which included macro-forecast, revenue forecast and main fiscal aggregates. This practice was legislated in 2004 and later on merged with Stability Programme[3].

Even though this approach follows the OECD best practices per se, in practice, the system could be further strengthened towards having a top-down delineation of expenditure ceilings and strategic budget functions, based on thorough baseline analysis over the course of the annual and multiannual cycle.

The budget cycle

The budget legislation in Slovakia frames the annual budget process through a non-binding multi-annual perspective. The GG budget is set in a multiannual framework that covers a three-year period. It refers to the state budget, which historically represents approximately 50% of the GG budget; and other entities of the general government, including social security, health insurance and municipalities. However, only the first year of the state budget is approved by parliament as binding budget law (Figure 16). The multi-annual GG budget remains indicative, approved by the executive of the Government (cabinet) only. Integrating other entities of the general government with state budget would support a more binding framework by strengthen Parliamentary oversight of all expenditure and revenues

Figure 16. Annual budget cycle in Slovakia



Source: Authors

Budget preparation

The budget year starts in January with an update of the Ministry of Finance's macroeconomic and tax revenue forecasts. The Ministry of Finance's macro-economic and fiscal forecast unit – the Financial Policy Institute (FPI) – forecasts medium-term tax revenues and social security contributions. Forecasts are updated three times a year and are approved by the Macroeconomic Forecast Committee and the Tax Revenue Forecast Committee established in 2004 and enshrined in 2011 under the Constitutional Act on Fiscal Responsibility to increase the transparency and objectivity of the forecasts and to help avoid over or underestimations by the agencies preparing the budgets (Box 29). However, social expenditure and non-tax revenues are currently not assessed which has contributed to over-estimations in the budget in the past. Based on these forecasts, the Ministry of Finance has until the end of April to formulate a stability programme, which serves as the medium-term fiscal framework from which the budget formulation process commences for the General Government (Section 3).

Box 29. Macroeconomic and tax forecasting committees

The Constitutional Act on Fiscal Responsibility established a **Macroeconomic Forecasting Committee** and a **Tax Revenue Forecasts Committee**, in order to increase transparency and objectivity of forecasts.

The Macroeconomic Forecasting Committee reviews the preliminary macroeconomic forecasts of the Ministry of Finance, which includes an overall evaluation of the character of the forecasts, i.e. conservative, realistic, or optimistic. If necessary, the Ministry of Finance adjusts the forecasts in the view of the evaluation.

The Tax Revenue Forecasts Committee builds its forecasts of tax revenues and social insurance contributions on the outcomes of the Macroeconomic Forecasting Committee. The Committee comprises several independent members (e.g. representatives of the central bank, academy, commercial banks and financial market), strengthens public control over the budget process and aims to increase transparency and objectivity.

Source: Ministry of Finance of the Slovak Republic

Budget formulation

Taking into account the fiscal framework, the previous year budget execution, and forecasted revenues, the Ministry of Finance defines the expenditure ceilings for budget chapters of the state budget for the first year and – on an indicative basis - the following two years. These numbers are further updated according to information from budget impact assessments (part of regulatory impact assessment), government resolutions and other relevant sources. The state budget consists of 35 budget chapters that correspond mainly to line ministries (13) and agencies, including the Office of the Government; the Office of the Supreme Court; the Supreme Audit Office; General Treasury Administration; and the Statistical Office. The indicative ceilings refer to the total expenditures and revenues in a chapter, including the EU funds, co-financing needs, capital investments and wages.

In contrast to some OECD countries, such as Sweden (Box 30), in Slovakia expenditure ceilings are not prepared based on baseline estimations. This means that line ministries and agencies are not requested to provide politically agreed baselines at line item level in the tri-annual budget. The role of these baselines would be to inform political decision making with respect to the medium-term framework and annual ceilings. In other words, baseline estimates could be the basis for the evaluation over the medium term of whether there exists room for new spending or a need for consolidation. Effective baseline estimates need to be updated to reflect changing external (price or demand changes) and internal circumstances, such as the introduction of new policies or laws.

Some ministries have introduced measures to improve the estimation of their expenditure. The recent introduction of a new budget structure (Box 41) in the Ministry of Health for example aims to help project more detailed baseline expenditures, responding to the need for objective determination of medical care as identified in the sector's spending review.

Box 30. The use of baselines in Sweden

Sweden's tradition of collective policy setting includes preparing and regularly updating the expenditure baseline, and the ongoing development of policy. It retains a strong co-ordination and directive function to ensure that the annual process runs smoothly and that fiscal discipline is upheld.

Early spring forecasts set the scene for the annual fiscal policy preparation process, using the latest data from the previous year. The economic projections in the first quarter of the year are based upon existing expenditure policies and rules. The forecast presented in the Spring Fiscal Policy Bill adds to the baseline of any new discretionary measures in the spring supplementary budget. These forecasts are used for the government's assessment of setting the indicative aggregate expenditure ceilings for the third (and the fourth) year that are presented in the Spring Fiscal Policy Bill.

The Ministry of Finance assesses whether the forecasts and baseline projections are compatible with and comply with the fiscal rules in each year. Taken together, both the top-down macroeconomic figures and the bottom-up baseline projections, along with the fiscal constraint of the Swedish 1% surplus rule, inform the considerations regarding the appropriate level of the expenditure ceiling for the new year 3 of the medium-term framework. Any remaining fiscal space is referred to as "room for reform". If no fiscal room is available, consolidation measures may be needed in the context of subsequent negotiations with line ministries (Section 3).

Source: OECD (2016) Budget Review of Sweden

Line ministries and agencies have a 3 – 4 week period to prepare detailed budget proposals within the expenditure ceilings. Despite the fact that it is not legally binding, the multiannual framework of the GG budget is considered as a starting point for the budget proposals for the following year. Line ministries and agencies allocate all expenditures within the given ceilings into programmes according to budget classifications in the budget information system (BIS). Restrictions in the BIS force the line ministries to prepare the information within the constraints set by the ceilings in each chapter.

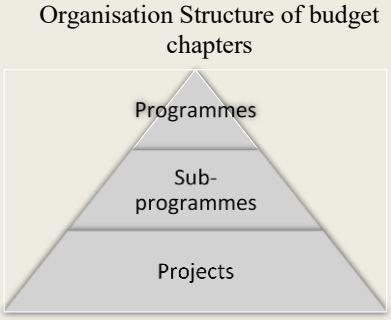
Within the chapters, line ministries are granted a high level of autonomy in formulating programme structure (Box 31). According to line ministries, this autonomy has contributed to a more effective organisation of the budget. Nevertheless, according to Ministry of Finance in recent years the programme structure has become more complex as line ministries add new programmes to the structure, rather than integrating new projects into existing programmes, thereby increasing the overall number of programmes and sub-programmes.

Box 31. . Budget Structure in the Slovak Republic

Programme budgeting was introduced in 2002[1] as a part of a public finance reform, when only a few chapters in the budget were structured by programmes. Since 2004, according to the Act on Budget Rules, all chapters of the state budget are required to be budgeted in programmes. In 2009, the programme structure was introduced to municipalities, however, since 2013 the programme structure for small municipalities (up to 2 000 inhabitants) has been voluntary.

Each budget chapter is divided into programmes, sub-programmes and individual projects or items (*Figure*). Line ministries are granted a high level of autonomy in formulating programme structure within the budget chapters. The budget section of a line ministry or agency co-ordinates the development of the programme structure in co-operation with the sections responsible for individual programmes.

The programme structure is provided as a separate annex to the budget law, containing the names of programmes and sub-programmes with allocated expenditures, but no information on goals and measurable indicators.



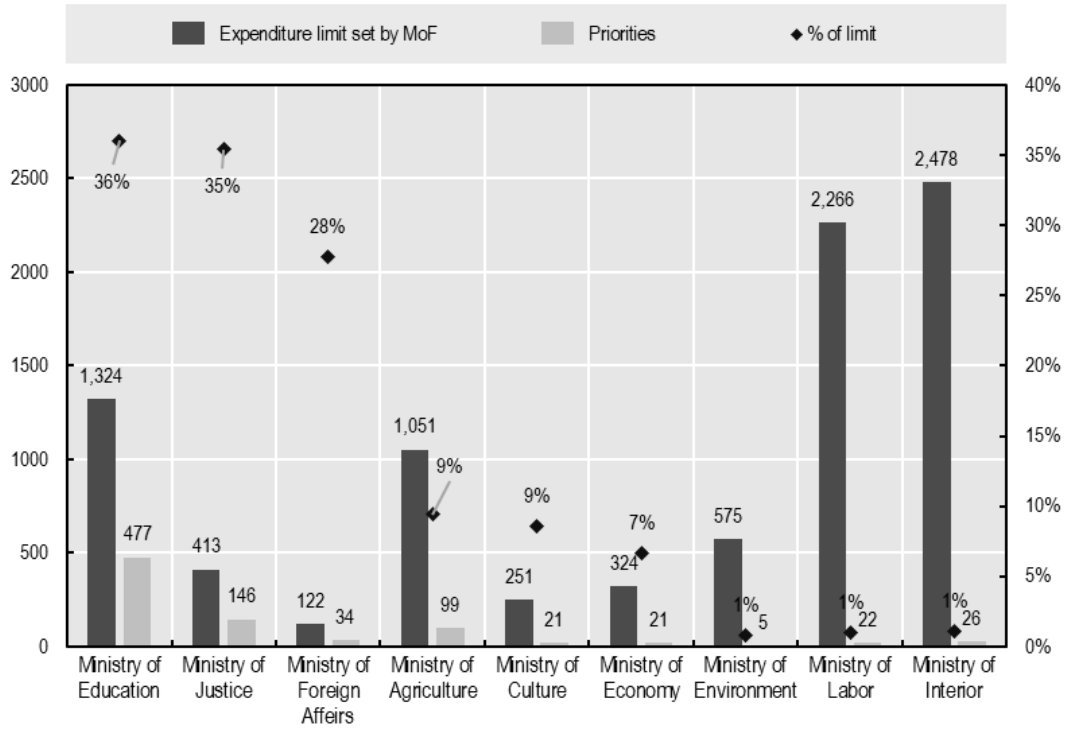
Source: Authors.

Note: [1] Pilots were running also on pre-accession EU programs since 2002
Source: Ministry of Finance of the Slovak Republic

While in theory, this appears to be a top-down approach, in practice, the process includes a negotiation stage for additional priorities. This entails that, additional to the budget proposals within the given ceilings, line ministries and agencies can request funds, sourced from a "reserved priorities envelope" which is subject to negotiations with the Ministry of Finance. The additional funds aim to accommodate claims for the continuation of measures that were approved in the period of the current budget and to focus the budget negotiations on priority projects.

The criteria to allocate these priority funds is not public, and there is limited information on the process to prioritise funding. As the total value of the "reserved priorities envelope" is not disclosed, there is the risk that many line ministries or agencies can overstate the need for additional funding. For example, line ministries may omit indispensable expenditure allocations in their draft budgets, to request them during negotiations, as they can count on their approval due to the essential nature of the measures. During the formulation of the budget for 2019-21, the Ministry of Education and the Ministry of Justice requested expenditure increases of around 35% (Figure 17). These significant changes decrease transparency, and reduce planning capacity for line ministries as well as the Ministry of Finance. In total, during budget formulation for 2017, the difference between first draft and approved state budget expenditures was over 5% (EUR 770 million increase).

Figure 17. Formulation of budget for 2019 for selected budget chapters, million Euro



Source: Ministry of Finance of the Slovak Republic

An effective top-down approach would require a clear top-down delineation of binding and realistic expenditure ceilings under which line ministries develop their budget proposals. To ensure that identified fiscal space can help improve fiscal responsibility and accommodate truly new priorities, Slovakia could consider introducing a more collective and transparent approach. Regularly updated baselines will already help to accommodate claims for the continuation of approved measures within binding Chapter ceilings. Additional identified fiscal space could therefore be linked to new priority projects. This could above all relate to cross-cutting priorities, such as the newly identified national priorities towards the implementation of the SDGs. As part of a decision rule, Slovakia could consider using any fiscal space to accommodate innovative cross-ministry proposals in specific areas of national development priorities. New Zealand's experience of social investment is outlined in Box 32.

Box 32. Social investment and budgeting in New Zealand

In recent years, New Zealand has pioneered a "social investment" approach, as a way of improving the lives of New Zealanders by applying rigorous and evidence-based investment practices to social services. The "returns" from such investment are better social outcomes, many of which are mutually reinforcing over time. For example, investing in the education of vulnerable groups is assessed by reference to impacts on time spent in prison and reduced re-offending; which would lead to better quality of employment; which in turn would facilitate children spending more time in school; and better access to family supports. In principle, this approach should also generate longer-term savings for the national treasury and promote fiscal resilience: "what is good for the well-being of communities and families is also good for the country's books".

To accommodate this approach, New Zealand's traditional budget process has been supplemented with a "social investment" track. The Treasury is open to receiving resource-allocation proposals under this track, provided that the proposals are put forward collectively by more than one ministry. This joined-up approach forces ministers and officials to work together, and to open up to unfamiliar perspectives. For example, a multi-agency proposal regarding mental health combined inputs regarding employment, justice issues as well as clinical perspectives, and allowed for a proposal to be developed that could not have come from one ministry acting alone.

Source: Presentation of Mr Brendan Boyle, Chief Executive of the New Zealand Ministry of Social Development at the OECD's "New Approaches to Economic Challenges", Monday, 4 September, 2017, www.oecd.org/naec/naec-seminars-2017.htm

Budget approval

Based on the budget negotiations, the Ministry of Finance drafts the GG budget, including the state budget, which is submitted to the government (cabinet) usually in late September or early October. The government is obliged to submit the approved GG budget to parliament before 15 October. Any proposal of changes leading to a higher deficit compared to Stability programme target cannot be approved.

In parliament, the Finance and Budget Committee publishes a report on the draft budget with recommendations, which are perceived as rather formal. The individual thematic chapters are discussed by the relevant committees. However, they do not provide systematic inputs or recommendations to the draft budget. Parliament approves the annual budget law by the end of December.

The Supreme Audit Office (SAO) and the Council for Budget Responsibility (CBR) furthermore produce evaluations of the draft GG budget checking compliance with legislation, strategic goals of the government and fiscal rules. The reports are submitted to parliament for information, but not formally discussed. The SAO reports present an expert opinion (Box 33). None of the opinions on the draft budget needs to be formally addressed by government . Concrete measures to respond to the SAO or CBR report could improve the impact of the analysis.

Parliamentary oversight is mostly limited to the approval process of the current year. As in many OECD countries, parliament approves the state budget only for the first year, while the government approves the medium-term GG budget (Box 29. For the current State budget, there are seven binding indicators formulated on cash basis that are subject to legislative approval: 1) total revenue; 2) total expenditure; 3) co-financing with EU funds 4) revenue and expenditure of EU funds; 5) capital expenditure; 6) wages; and 7) programme structures[4]. However, with the MTO set in accrual terms, annual chapter ceilings and binding indicators based on cash limit provide limited accountability for the achievement of the medium-term fiscal target.

Box 33. The role of the Supreme Audit Office in the budget process

The Supreme Audit Office (SAO) of the Slovak Republic was established in 1993 as an independent body to audit the financial management of the government, central state administrative bodies, local administration units and European Union, including state special-purpose funds. Its independence, scope and responsibilities are based on Article 60-63 of the Constitution and the Act no.39/1993 on the Supreme Audit Office of the Slovak Republic. The SAO performs the following functions;

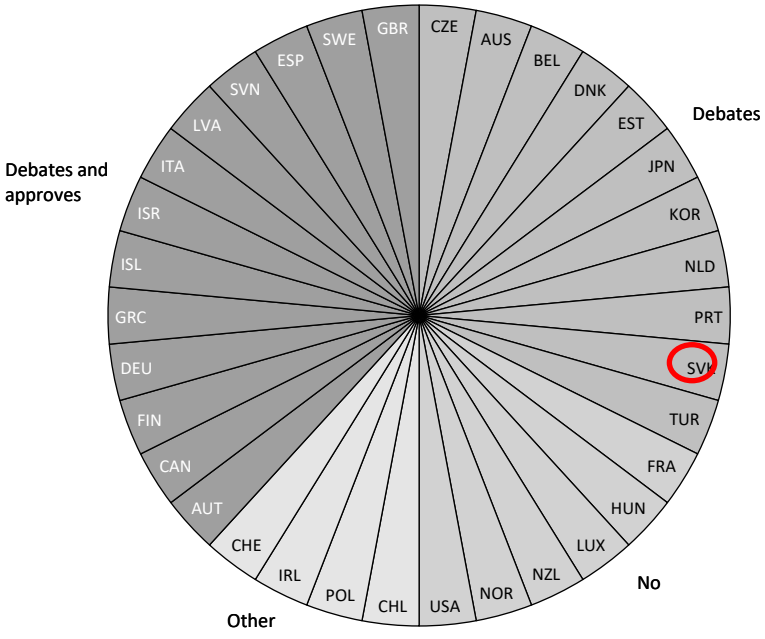
- Financial control: assessing the financial statements, budgeting and accounting of the audited entity in accordance with the accounting and financial reporting legislative framework.
- Compliance audit: aimed at the compliance with laws and regulations relating to public spending

- Performance audit: assessing whether the audited entity manages public funds economically, efficiently, and effectively (achieving goals and objectives).

Regarding the budget process, the SAO assesses the compliance of the draft GG budget with legislation and the strategic goals of the government. Its report (Opinion on General Government Budget) is presented to parliament for information. The SAO does not assess government policies, it can only highlight problematic areas and risks, based on recommendations from international organisations like the OECD or IMF, or based on conducted controls. For example, in its report on the GG budget 2018-2020 SAO highlighted risks in financial performance of public hospitals relative to private hospitals.

Source: Official website of SAO[5], Opinion on General government budget 2018-2020[6]

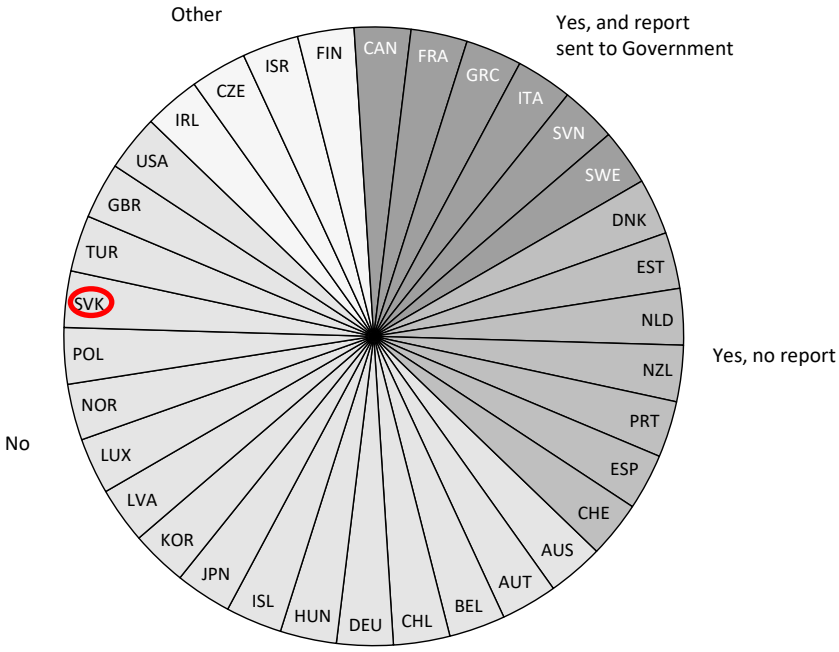
Figure 18. Does the legislature debate or approve the medium-term budget framework?



Source: Data drawn from question 3, 2018 OECD Survey on Parliamentary Budget Practices.

A budget process that informs and consults the legislature on fiscal policy and medium-term budget policy at an early stage, and that takes the views of the legislature into account during the budget formulation phase, promotes transparency and encourages fiscally responsible legislative decision-making (OECD, 2019[6]). The number of countries holding a pre-budget debate in parliament increased from three countries in 2012 to over a third of OECD legislatures in 2017-18 (OECD, 2019[6]). Of these, around half send the results of the pre-budget debate as a report to the government (Figure 19).

Figure 19. Does the legislature hold a pre-budget debate?



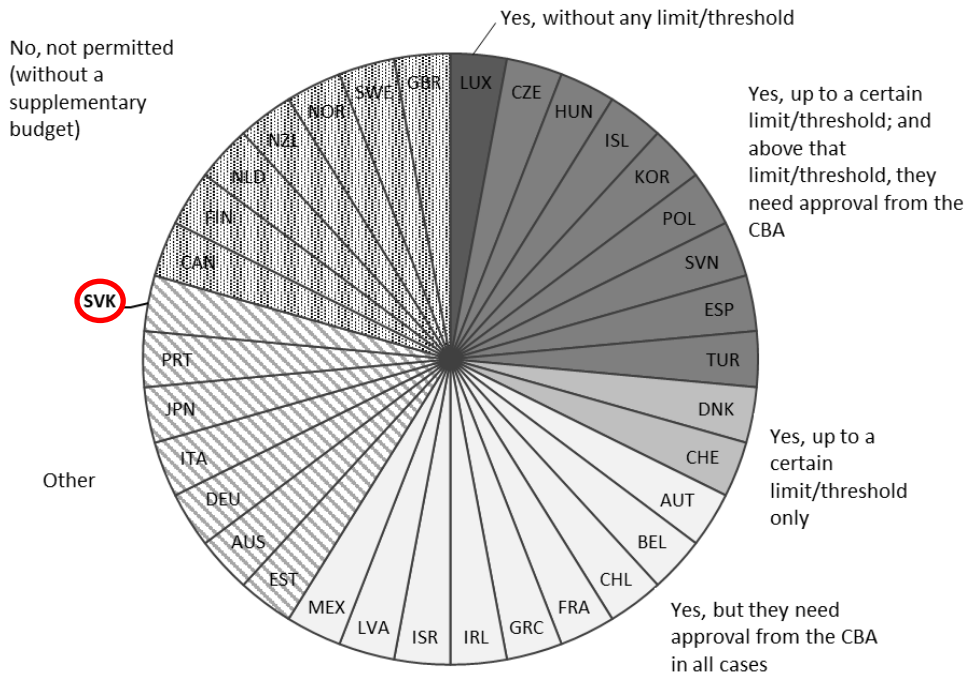
Source: 2018 OECD Survey on Parliamentary Budget Practices.

While the budget approval phase is where most legislatures come to the fore in the budget process, there is a trend away from treating the budget as a set-piece event. A more detailed analysis of Slovakia's parliamentary budget oversight, however, goes beyond the remit of this targeted assessment.

Budget execution

Line ministries have a rather high degree of budget flexibility during budget execution. Similar to most OECD countries, Slovakia allows budget adjustments without a supplementary budget (Figure 20). This means that, once the budget has been approved, budget adjustment impacting the binding indicators, require approval by the Ministry of Finance, but not parliament. In the last 5 years (2013-17), over 2 400 budget adjustments per year were made on average. According to the Ministry of Finance, more than 50 % of these were small changes. Within the set of binding indicators, including programmes, line ministries and agencies are free to re-allocate expenditures during the course of budget execution.

Figure 20. Re-allocation of funds during budget execution in OECD countries



Source: OECD 2018 Survey of Budget Practices and Procedures

Flexibility is granted to line ministries to carry-overs from one year to the next of capital expenditure, reserves, EU funds and military spending. In general, the Slovak state budget allows total expenditures to increase through budget adjustments by up to 1% if it does not impact the budget balance. Line ministries and agencies are able to overspend in chapters during budget execution by using carry-overs of unused funds or appropriations from one year to the next and the use of re-allocations from the budgeted reserve funds. This degree of financial flexibility to managers aims to encourage budget responsibility within chapters, but limits the Ministry of Finance's oversight to ensure compliance with fiscal targets.

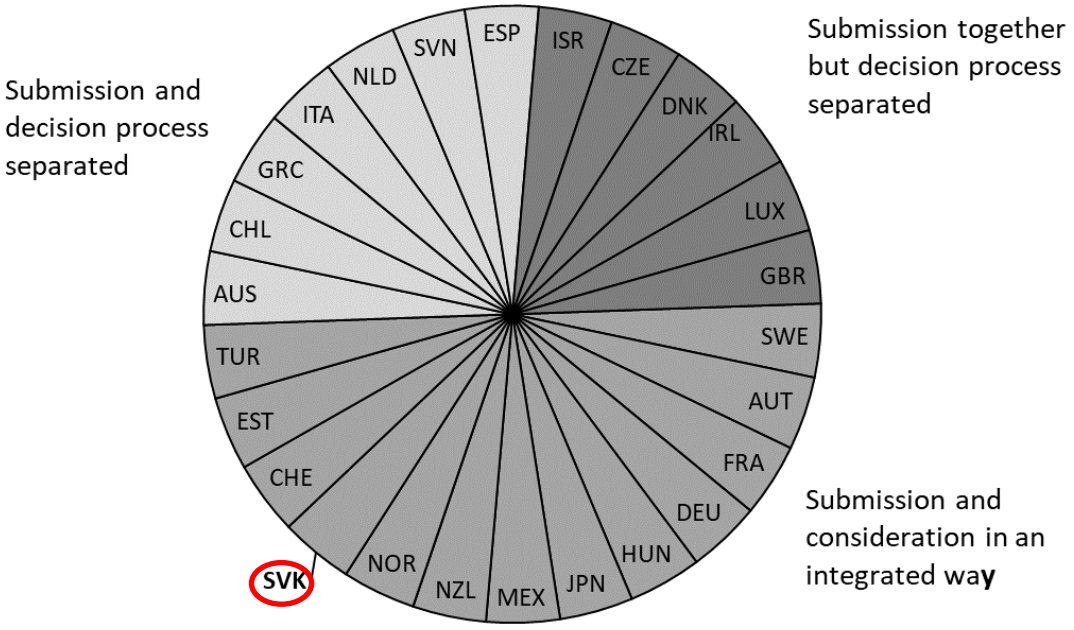
Capital expenditure is integrated in the budget process

This section considers the management of capital expenditure in the budget process and has specific regard for Slovakia's obligations for EU funding. Capital expenditure in the Slovak Republic is well integrated in the budget process. Line ministries submit proposals based on their individual priorities and they are negotiated with the Ministry of Finance together with current expenditure. As one of the binding indicators that determine legislative approval, limits on capital spending for every line ministry are decided within the budgeting process.

Integration between current and capital expenditure aims to improve budget planning, facilitate co-ordination and increase flexibility. Including Slovakia, around half of all OECD countries prefer an integrated system (Figure 21). The other 50% reported that they have separate processes to decide the capital expenditure budget (OECD, 2018[23]). Separated budgets are often used to ensure that mandatory items such as entitlements do not crowd out discretionary items such as capital investment (Posner, Ryu and Tkachenko, 2009[7]). Hence, countries using an integrated budget, should ensure that this practice is

also accompanied by guidelines or fiscal rules as well as the political will to limit government borrowing that finances current expenditure (Burger and Hawkesworth, 2013[8]).

Figure 21. Distinction between operational and capital expenditures requests



Source: OECD 2018 Capital Budgeting and Infrastructure Governance Survey

As many capital expenditures are multi-year projects, they require careful planning and monitoring. Under the Slovak budget process, requests from line ministries for capital funding include for the entire cost of a multi-year project. Carry-overs are allowed within the period of 2 years. As carry-overs are mostly allowed for capital expenditures, in some cases, line ministries reallocate operational expenditures to capital in order to carry-over these expenditures. The Slovak government has a register of every investment included in the state budget and separate modules, Register of Investments, for budgeting capital expenditures in the budget information system (BIS). This information system provides basic financial and non-financial information about the investment (name, current status, type, schedule, costs, budgeted expenditures etc.) for monitoring and evaluation purposes. However, in practice the reporting of this information is often outdated (information about current state are often not updated after completion), and investment types and parameters are not classified correctly. In many cases, diverse investments are aggregated within a Budget Chapter.

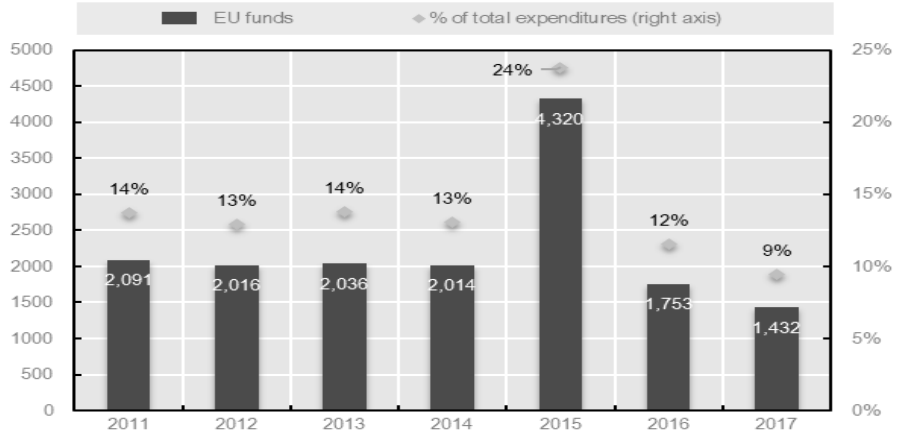
There are a number of infrastructure and network plans in the Slovak Republic, and there is room to improve the co-ordination across the plans. Currently, each line ministry prepares its own departmental strategy for capital investments and is responsible for the management of those investments. The Ministry of Transport has developed a comprehensive sectoral strategy. The prioritisation procedure within a ministry varies depending on the line ministry, but usually reflects political priorities, project preparedness and available funding. There is no formal framework that regulates infrastructure planning and prioritisation process across budget chapters. To address this shortcoming, the Deputy Prime Minister for Investments and Informatisation has launched a national infrastructure plan, which is to be implemented in the coming year (see Section 3).

In 2016, the government reformed the process of evaluating significant investments. As part of its value for money initiative, Slovakia has now defined a methodological framework for the process and preparation of large investment projects and their evaluation according to the principles of value for money. This implies that, for investment projects with a cost of more than EUR 40 million (and IT projects from EUR 10 million), following a feasibility study by the relevant Ministry, the Ministry of Finance is obliged to prepare and publish an evaluation. The evaluation provides recommendations of alternatives, cost-benefit-analysis and input values. Such systematic investment assessments are essential to help ensure that the projects are developed in a manner that is cost efficient, affordable, and trusted by users and citizens (OECD, 2017[9]).

A parallel system for EU funding

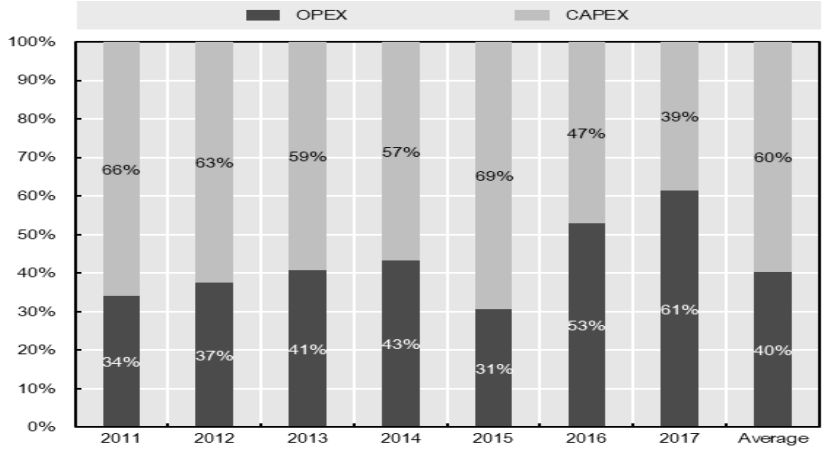
EU funds are an essential part of the Slovak budget. In the last 7 years (between 2011 and 2017), around 14% of total expenditures, and 57% of capital expenditure were from EU funds (Figure 22 and Figure 24).Yet, since 2016, operational expenditures have started to become more relevant (Figure 29).

Figure 22. Executed EU funds in Slovakia (in State budget), million EUR



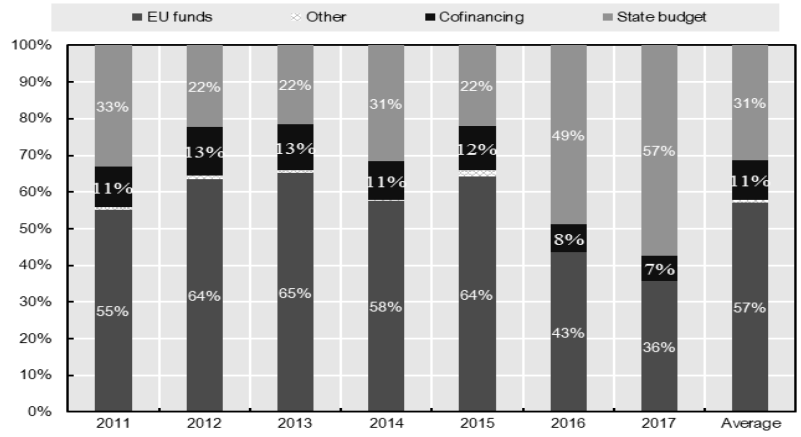
Source: Budget information system, Ministry of Finance SR

Figure 29. Structure of EU funds (in State budget)



Source: Budget information system, Ministry of Finance SR

Figure 24. Capital expenditures by source (in State budget)



Source: Budget information system, Ministry of Finance SR

However, the system of planning, allocating resource, disbursing and monitoring EU funds differs from and runs in parallel to the main budget process. The EU funds section at the Ministry of Finance is responsible for co-ordinating the preparation of the budget. It collects estimates from line ministries (executed resources, carry-overs, etc.) and proposes limits for the individual Chapters during budget formulation. During their operational programme period (which covers 7 years), EU funds can be carried over each year– both capital and operational, for up to two years after operational programme period.

A future transition towards reduced dependency on EU funds will need to take into account the gaps this transition will impose, not only in terms of financing, but also with regard to reporting and evaluation mechanisms.

2.4. Recommendations

Strengthen the Slovak budgeting framework for robust and strategic medium-term planning

5. **Introduce baseline estimates of expenditures over the three-year medium term to support the information available to set credible expenditure ceilings.** The role of baseline estimates is to describe the future budget consequences of current laws and policies at any given point in time. Such information provides rolling estimates of what is required to achieve programme objectives, and can include analysis of the factors that may cause allocations to vary from one year to the next. Estimates should be calculated based on the most recent macroeconomic outlook of the economy and other relevant information, such as the most recent measured expenditures.
6. **Regularly update baseline estimates within a single budget year.** Baseline estimates need to be regularly updated for the Government to be able to evaluate actual expenditures against its ceilings. Variations against budget may arise from changing external and internal circumstances. Updates about external circumstances should be done at the start of budget preparation and frequently during budget execution. Baseline estimates must also be amended when new policies or substantive laws are decided or enacted. The role of these updates is to inform political decision making with respect to the medium-term framework and the ceilings.
7. **Include baselines in the automatised Budget Information System.** To ensure agreement between line ministries and the Ministry of Finance, the regularly updated baselines need to be shared between the line ministries and the Ministry of Finance. The BIS seems to be a well-prepared system to do so. The line ministries should be responsible for inputting and updating

baselines in the system, while the expenditure divisions of the Budget Directorate should be responsible for the assurance and oversight of the updates.

8. **Ensure time, space and a process for interdepartmental engagement to agree on the expenditure baselines.** Baseline identification is not a purely technical affair. The Budget Directorate should establish the rules to administer the process and any differences of opinion about the baselines should ultimately be decided between the relevant ministers at cabinet. Baselines should inform, not undermine top-down priority setting. Once reliable baselines are identified, broad policy priorities can be managed by expenditure ceilings.

Prepare for the transition from EU funding of capital investments

9. **Strengthen the governance framework for capital investment.** Slovakia's transition to become less dependent on EU funds may lead to challenges for planning capital investment, as the country has traditionally relied on the EU system for planning, allocating, monitoring and evaluating capital investments. Reduced dependency in EU funds will require the government to improve its framework for capital investment, meaning in particular the strengthening of strategic planning of capital investment (see chapter 4). The OECD framework, Getting Infrastructure Right, highlights 10 successes factors of good infrastructure governance. A full assessment on the implementation of this framework in the Slovak Republic could provide a detailed insights and recommendations on how to move forward with the implementation of each one of the dimensions.

3. Strengthening the medium-term dimension in the budget process

3.1 Summary

Effective medium-term budgeting is a supportive measure between budgets, plans and policies and an integral part of providing predictability to policy making. For medium-term budgeting to operate effectively, it is necessary for the budgeting system to operate in a 'top down' manner. While there seems to be a clear vision of Slovakia's national and European fiscal objectives acting as top-down budget constraints, linkages to broader development objectives are less clear.

The Slovak medium-term expenditure framework (MTEF) with 3-year rolling ceiling lacks a binding character beyond the traditional annual cycle. The non-binding nature of the Slovak MTEF weakens its role as a tool to manage fiscal policy and improve fiscal planning and discipline. Moreover, limitations on the collective decision-making process undermines the extent to which the annual and medium-term budget reflects the government's priorities. Reinforcing the medium-term dimension in the budgeting process would support the basis for setting the annual budget as well as creating opportunities for strategic medium-term planning.

In order to ensure a whole-of-government approach, government priorities should be integrated into a long-term national development strategy and investment plans. Recent reforms have strengthened the project assessment and evaluation process in Slovakia. In particular, the government adopted a methodological framework for the preparation and evaluation of large investment projects according to the principles of value for money. Despite recent improvements, co-ordinated planning for capital investments would benefit from more attention.

Furthermore, there have been efforts to develop an integrated approach between the national long-term strategic planning and the SDGs. A strategic vision has been developed including a National Infrastructure Plan (NIP). Nevertheless, further steps could be taken to integrate the NIP into the fiscal management framework to improve the allocation of resources to achieve the vision for infrastructure development.

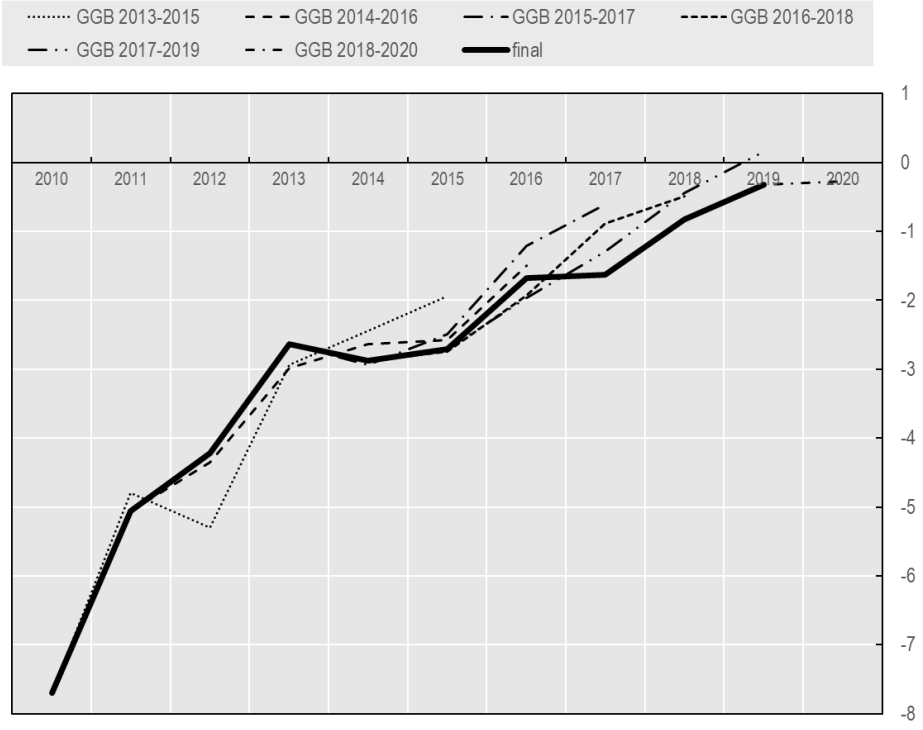
3.2. The stability programme as the basis of the multi-year perspective

The stability programme is the guiding document of the budget medium-term perspective in Slovakia. The Ministry of Finance has the lead role of preparing the budget for the Minister of Finance who then submits it to the cabinet for approval and to the European Commission for assessment. The document is then presented to parliament and serves as basis to prepare the budget bill.

The stability programme is an important instrument of the EU's surveillance of national budget policy. The programme presents the development path of the public finances for the previous year, the current year and the three following years, based on the most recent macro-economic forecasts. The stability programme must contain information on the medium-term fiscal objective for the general government structural balance. The stability programme presents indicative objectives for general government revenues, expenditures and balance expressed in nominal terms and as a percentage of GDP for the current year and the three subsequent years. It includes two fiscal scenarios: a "no-policy change" (NPC) scenario and a central scenario (also referred as the "fiscal framework of the public administration budget"). The NPC scenario is a projection of the end-year outcome of the previous year's budget at the aggregate level, without assuming any additional measures. In contrast, the central scenario is presented as the most likely outcome of fiscal policy.

As explained in the next section, expenditure targets for the three following years and their composition are indicative and can be and are modified when the draft budget is prepared in autumn (or in subsequent updates of the stability programme in the coming years) (Figure 31). There is no legal requirement to explain or justify changes to the target revisions, which underscores the low level of strictness of terms of respecting the plans set out in the medium-term planning documents (Sherwood, 2015[10]).

Figure 31. Government balance projections in successive General Government Budgets (GGB) in % GDP



Source: Ministry of Finance of the Slovak Republic, General Government Budgets

3.3. An indicative medium-term expenditure framework

Slovakia started to implement a medium-term expenditure framework (MTEF) relatively early compared to other countries in the region. Since the early 2000s, the government has prepared an overview of the macroeconomic and fiscal forecasts (revenues, expenditure, and balance) for a three-year period (Webber, 2009[11]). Since 2005, the MTEF has been an integral part of the budget. The budget IT system includes all the expenditures for three years. Furthermore, each new policy document or law proposal includes a budget assessment for three years.

Even though the three-year budget is presented to parliament with the same level of detail, only the annual budget for the first year is voted and enacted into law. The medium-term expenditure ceilings for the two subsequent years are indicative only. They are revised annually on a rolling basis. Adjustments are made according to changes in macroeconomic predictions and political decisions. There can be substantial changes between the ceilings initially projected and the ceilings set in the annual budget law (Table 12).

Table 12. Approved budget expenditures of general government

Euro, millions	2016	2017	2018	2019	2020	2021
GGB 2016-2018	32 235	32 735	33 957			
GGB 2017-2019	33 659*	34 534	35 638	36 336		
GGB 2018-2020	33 706**	34 686*	35 175	37 383	38 970	
GGB 2019-2021	33 669**	34 107**	36 646*	37 253	39 745	40 858

Notes: Approved budget in a given year; *updated numbers during execution, **final numbers
Source: General government budgets (GGB) of the Ministry of Finance of the Slovak Republic

Since its introduction, the Slovak MTEF has been used as a fiscal policy management tool, helping improve fiscal planning and fiscal discipline. However, the impact has been limited due to the non-binding character beyond the annual cycle. In particular, the MTEF could have a stronger role in supporting multi-year programme planning.

The purpose of the Slovak MTEF is to improve the quality and certainty of multi-annual fiscal planning by combining prescriptive yearly ceilings with descriptive forward estimates. However, it requires political commitment to ensure that fiscal targets are maintained and that discussions on policy priorities and trade-offs occur. Legally binding expenditure ceilings envelopes can support the political commitment. Across OECD countries there are examples of good practice, this report illustrates the case of Sweden (Box 34). As a result of cautious planning and the existence of a budget margin, the Swedish expenditure ceiling has never been breached since its introduction, even during the recent economic crisis.

Box 34. Main characteristics of Sweden's MTEF

Sweden's multi-year budget framework operates on three cascading levels. The first level constitutes the articulation of the government's fiscal policy objectives in macroeconomic terms, i.e. the level of surplus or deficit as a percentage of GDP. At the second level, these objectives are translated into a maximum level of total expenditure based on certain economic assumptions. At the third level, the limit for total expenditure is further operationalised by giving indicative funding levels for each of 27 expenditure areas.

The multi-year budget framework is legally binding. Parliament approves the maximum level of total expenditure for the government (Level 2) and the indicative level of funding for each of the 27 expenditure areas (Level 3). The amount of spending authorised in the annual budget is below the spending ceiling amount for that year, thus leaving a "budget margin" to deal with uncertainty. The

purpose of the budget margin is to provide a buffer against any forecasting errors so that the maximum level of total expenditure approved by parliament will not have to be amended. To achieve this, the government's guidelines specify that the margin should amount to at least 1.5% of ceiling-restricted expenditure for the budget year (year y), 2% for the following year (year y+1) and 3% for each of the following two years (year y+2 and y+3). In practical terms, the budget margin is left unaccounted for (and unbudgeted for) within the annual budget allocations and multi-annual expenditure ceilings. The fiscal margins are not regarded as "contingency reserves" but rather as operational stabilisation mechanisms.

The ceiling is not revised once set and an additional year is added to the ceiling each autumn alongside the budget. While there is nothing in the law preventing the Swedish national legislature (*Riksdag)* from re-opening the fixed expenditure ceiling each year, it requires that once an expenditure ceiling has been approved by the *Riksdag*, the government must take all necessary measures to avoid exceeding the ceiling, including proposing legislative measures to the *Riksdag* if necessary.

Sweden's fixed expenditure ceilings and indicative frames for expenditure areas provide a solid framework for realistic discussion about policy priorities and trade-offs. The top-down system requires that new spending priorities must usually be matched with offsetting savings elsewhere within that expenditure area, unless there is some scope for unfinanced reforms and the reform is of high political importance. The officials of the Ministry of Finance can exercise the prerogative to de-prioritise proposals that intrude upon the fiscal constraints or are considered inefficient, whereas significant proposed additions, with policy sensitivity, can be escalated for decision at political level.

In balance with this top-down character of budgeting, policy making in Sweden has a remarkably collaborative character. Unlike most other OECD countries, the process of specifying the detailed budget allocations is not primarily a bilateral process between a line ministry and the Ministry of Finance, but rather reflects a series of multi-lateral engagements and policy discussions, which culminate (as far as resource-allocation is concerned) in the specific "budget requests" submitted by the line ministries in May. Discussions on the budget proposals are carried forward at political and official levels through to August, when final determinations are made at a cabinet meeting in the latter part of that month.

Source: OECD (2016), Budgeting in Sweden, OECD Journal on Budgeting, Volume 2016, Issue 2

A possible drawback of setting fixed expenditure ceilings for outgoing years is the lack of flexibility to accommodate changes to the economic situation or new political priorities. In Slovakia, the state budget accommodates unexpected changes, including due co-financing needs of EU funds, debt service, and increasing social transfers under the General Treasury Administration budget chapter. In the past, the government budget included deliberately over-budgeted reserves or transfers during budget formulation to enable flexible reallocations at a later stage. Due to this practice, additionally executed expenditures in 2015 was 8 times higher than the 1% adjustment allowed (Ódor, 2016[12]) (see section 2.3.1). Nevertheless, the 1% expenditure rule was considered to be not broken, as the overspending by line ministries was enabled by in year re-allocations (*virement)* from the General Treasury Chapter managed by the Ministry of Finance.

A budget margin, as described in Box 34. can provide the needed flexibility mechanism to respond to emerging pressures from year to year without re-opening the overall expenditure ceiling, increasing their credibility. It is important not to integrate the budget margin within the budget ceiling, i.e. it should not be an appropriated amount. Furthermore, unexpected changes may be accommodated by flexible ceilings (Box 35). Nevertheless, while flexible ceilings act as stabilisers to some extent, they are limited in scope and cannot accommodate new pressures that may arise from new political priorities or demand-driven factors.

Box 35. Flexible Ceilings in the Austrian Medium-Term Expenditure Framework

The Austrian Medium-Term Expenditure Framework provides legally binding expenditure ceilings for the upcoming budget year plus the three subsequent fiscal years on a rolling basis. The binding expenditure ceilings specified in the MTEF apply to high-level groupings of budget chapters referred to as "rubrics" that correspond to the number of line ministries and agencies.

Within the MTEF, expenditure ceilings are also displayed at the level of budget chapters, but these ceilings have legal force only for the upcoming budget year. The BFRG ceilings are divided into fixed and variable ceilings depending on their linkage to the business cycle. The variable ceilings include a) social benefits; b) payments related to the European Regional Fund and the European Stability Mechanisms, c) other payments that cannot be sufficiently predicted.

Nevertheless, the OECD (2017) Budget Review of Austria highlighted that considerations should be given to amend current rules in order to introduce an explicit and realistic "fiscal margin" into the MTEF rubric ceilings that would accommodate pressures from new political priorities or demand-driven factors. An amended approach would involve a far more substantial and flexible "fiscal margin" which would (a) act as a buffer to absorb unexpected cost pressures, and (b) allow for new policy priorities to be accommodated, where necessary, while still respecting public finance objectives and fiscal rules.

Source: OECD (2017), Budgeting in Austria

In early 2018, the Minister of Finance announced an open discussion on introducing binding medium-term expenditure ceilings. The Institute of Financial Policy from the Ministry of Finance is leading an expert group that includes the Council for Budget Responsibility and other experts. The first proposal of the design of expenditure ceiling was published by the end of 2018 (Jakub et al., 2018[13]). The proposal highlighted benefits of dividing aggregate expenditure ceiling into individual ministries (clear responsibility of ministers, predictability of financial resources throughout electoral horizon). Hard limits on ministerial chapters could also strengthen incentives to identify savings, thereby reinforcing the implementation of the Value for Money project in the budget process. Recommendations on identified savings from spending reviews could furthermore be debated and incorporated during budget formulation phase.

3.4. Alignment between medium-term priorities and reSource allocation

While there is a clear vision of Slovakia's fiscal objectives acting as a top-down budget constraint, clear linkages to broader national or international objectives seem to be weak. In this way, stronger medium-term budgeting would serve as a vehicle to:

- provide assurance to policy planners about multi-year resource availability; and
- identify the appropriate medium-term goals against which resources could be allocated.

The above observation is based on the OECD Recommendation on Budgetary Governance (2015) which states that

> *"budgets should be closely aligned with the medium-term strategic priorities of government, through organising and structuring budget allocations in a way that corresponds readily with national objectives and developing a stronger medium-term dimension in the budgeting process, beyond the traditional annual cycle."*

The Slovak Ministry of Finance's main reference document for whole-of-government strategy is the National Reform Programme. The Ministry of Finance (Institute for Financial Policy and Value for Money unit) prepares this document and references the government manifesto (the coalition government's election platform identifying policy priorities and action plans to implement them over the course of the

government's mandate). From 2019 onwards, the SDG agenda is expected to be reflected in the National Reform Programme planning document as well as in a new national long-term vision for the Slovak Republic.

Following a top-down approach, the high-level objectives of the national long-term vision are envisaged to be derived from United Nations 2030 and the EU 2020 Agenda, followed by a national long-term vision and a strategy of society development. These objectives are further translated into inter-sectoral strategies such as the National Investment Plan (NIP) (Figure 32). However, neither the national long-term strategy nor its linkages to resource allocations are at in place at this time. To ensure that an improved budget planning process that is aligned to the national long-term vision does not only reflect the SDGs by definition, the government will have to ensure that these linkages are clear and verifiable.

Figure 32. Pyramid of strategic planning



Source: Road Map to National Infrastructure Plan of the Slovak Republic 2018-2030

A key element to identify the appropriate medium-term goals against which resources could be allocated is a collective decision-making approach. It should define the fiscal targets, medium-term priorities and corresponding expenditure ceilings necessary for the implementation of the national development vision. A key success factor of the previously discussed Swedish model is the practice of collective decision-making and policy-formulation (Box 34). In the context of the Slovak budget process, however, there remains room for improved collective priority setting.

A collective approach to priority setting may be supported by a pre-budget debate in parliament that informs and consults the legislature on fiscal policy and medium-term budget policy in this early stage. Such practice aims to promote transparency, encourage collective fiscally responsible legislative decision-making, and provide one opportunity to include a discussion on broader strategic national objectives into the budgeting cycle. An example is the Spring Fiscal Policy Bill in Sweden (Box 36.). Furthermore, strengthening the performance-based budgeting framework would also promote alignment between budget allocations and strategic plans of the government (as discussed in Section 4).

Box 36. Spring Fiscal Policy Bill in Sweden

To allow the government to frame the context for the annual budgetary process described in Box 35 in broad terms in the early part of the year, a "Spring Fiscal Policy Bill" is submitted to Parliament by 15 April each year. The Spring Bill includes comprehensive information on the fiscal policy outlook, perspectives on fiscal risks and long-term sustainability, a follow up of budgetary policy targets, and extensive baseline information on all areas of public spending. It focuses clearly upon medium-term fiscal plans and omitting details on expenditure, which is reserved for the Budget Bill.

The Spring Bill provides for parliamentary debate on fiscal policy, in general terms. As the Bill does not generally deal with detailed budgetary matters, in practice it serves to introduce greater transparency to the budget process to the benefit of the Swedish Parliament and the public in general. A functional benefit of the Spring Bill for parliament is providing a channel for parliamentary engagement in matters of fiscal policy prior to the drafting of the detailed budget.

During the preparation of the Spring Bill (February-April), high-level working groups involving the Ministry of Finance and the Prime Minister's Office meet regularly to help identify political and policy priorities which ought to be reflected in the budget planning. These discussions are informal and help to structure thinking and planning processes; they do not lead to definitive policy conclusions at this early stage. However, when line ministries present their "budget request" in May, it is expected that they will reflect the discussions and orientations from the spring meetings.

Source: OECD (2016), Budgeting in Sweden, OECD Journal on Budgeting, Volume 2016, Issue 2

3.5. A strategic approach to capital investment to achieve medium-term priorities

High quality infrastructure is one of the backbones of long-term inclusive development. As highlighted by the OECD Infrastructure Governance Framework (2017), a necessary condition for a successful infrastructure programme is appropriate strategic planning. This requires identifying which investments to undertake, determining the essential components and trade-offs, and identifying how to prioritise them. Conversely, weak or insufficient planning often impedes the successful implementation and operation of capital investment projects. The reason why designing a clear and coherent strategic vision is difficult stems essentially from the complex nature of infrastructure investment.

Most OECD countries have a long-term strategic infrastructure vision that cuts across all sectors. Some countries, like the United Kingdom have developed cross-sectoral strategies for infrastructure investment complemented with prioritisation tools (Box 37). More than a third of OECD countries have both an infrastructure plan and long-term plans at the sector level. Co-ordination between these instruments is essential to ensure a clear strategic vision for infrastructure. The same proportion of surveyed countries reported having only infrastructure plans at the sector level. Most of these countries only have long-term plans for certain sectors (e.g. roads, railways, energy, housing, health). In particular, Germany has a robust system to plan and prioritise infrastructure projects in the transport sector (Box 38).

Box 37. Strategic planning and prioritisation in the United Kingdom

The United Kingdom government has implemented a series of reforms to improve infrastructure planning, appraisal, prioritisation, and financing in the medium and long-term. The first cross-sectoral National Infrastructure Plan (NIP) was published in October 2010. The NIP provided the United Kingdom with an integrated strategy to prioritise, finance and deliver projects in key infrastructure sectors such as; transport, energy, communications, flood-control, defence, water, and waste.

The strategic planning system is complemented by a five Case Model to appraise and prioritise infrastructure projects. The model is an adaptable framework that guides the development of business cases and decision-making processes using five key themes. The more detailed issues of each theme vary depending point in the project cycle. The five key themes of enquiry are the:

1. **Strategic Case**: the rationale for why an investment is required, and a definition of the outcomes and the scope of what is to be achieved;
2. **Economic Case**: to demonstrate that the use of public funds optimises public value, usually involving an assessment of the costs and benefits of a range of options;
3. **Commercial Case**: to demonstrate the viability of the competitive procurement and contractual (including risk allocation) arrangements;
4. **Financial Case**: to demonstrate that the preferred option will result in a fundable and affordable investment; and
5. **Management Case**: to demonstrate that the preferred option is capable of being delivered successfully, in accordance with recognised best practice.

Source: National Infrastructure Delivery Plan (2010), EPEC (2015), VfM Assessment Review of Approaches and key concepts (March 2015), derived from Green Book Supplementary Guidance (2013 and 2018).

Box 38. Multiannual Planning Framework for Transport in Germany

The Federal Ministry of Transport and Digital Infrastructure uses a multiannual planning framework in the form of the federal transport infrastructure plan.

Methodology analysis framework

The transport plan covers a "long list" of projects that are evaluated according to Cost-Benefit Analysis (CBA). The list of projects is constructed based on the ministry's assessment of pressing economic infrastructure and regional development needs. For a particular project a more sophisticated methodology of analysis is applied, which includes key components such as, reduced transportation costs, travel time, safety benefits, security, regional economic/social impact, job creation and derived economic effects. The methodology is publicly available. If the result is positive (i.e. a benefit to cost ratio above, one) the project is included in the plan. Projects are ranked according to their score, the expected need for the project and the assessed urgency of the project.

Planning and Budgeting process framework

The federal transport plan is adopted by the federal government in its *Planning Act*. The next step are the requirement plans, which are also set in federal law (regarding federal roads and rail). When the

requirement plans are passed, they are operationalised into the five-year investment plans. This aligns with the medium-term financial planning framework for budgeting specific projects. However, the fact that an infrastructure project is accepted does not mean that its financing is assured. Financing for a project is then allocated in the budget process.

In a typical project cycle in Germany, the Federal Ministry of Finance is part of the steering committee of projects, ensuring that it is part of the project monitoring process. The Federal Ministry of Finance must give its approval for the project to move forward and notifies the parliament's budget committee. For instance, regarding transport infrastructure, the Federal Ministry of Finance negotiates the budget for the planned projects for a given year with the Federal Ministry of Transport.

Source: OECD (2015), "Budget Review: Germany", OECD Journal on Budgeting, vol. 14/2.

In Slovakia, line ministries assess and prioritise the capital investment needs. Currently, each ministry develops its own departmental strategy that generally includes a list of planned investment projects, based on political priorities, project preparedness and available funding. Projects across sectors are generally not compared against each other, and the capital-spending limit of each line ministry is decided within the budget process. Of note, the Ministry of Transport and Construction has developed a long-term strategic document, aiming to set a clear direction to develop the transport sector and specific implementation actions (Box 39).

Box 39. 2030 Strategic transport development plan of the Slovak Republic

In December 2016, the Slovak Ministry of Transport published its Strategic Transport Development Plan (STDP) to provide a comprehensive plan for transport infrastructure development. The document was created from both a bottom-up and a top-down approach. Five working groups for different types of transportation provided a bottom-up analysis for road transport, rail transport, public civil transport, water transport and civil aviation. To ensure co-ordination, the five sectoral analyses were integrated into a single strategy.

Since transport sector development is crucial for cross-cutting policy objectives, national and European strategic documents (including the Roadmap to a Single European Transport Area, Agenda 2030, European Strategy for low-emission mobility) were taken into account during its formulation. The document identifies key gaps in main transport sectors; identifies strategic goals; and defines organisational and operational measures to achieve them. Furthermore, the STDP is subject to a strategic environmental assessment (SEA), with the objective of securing high level of sustainable development.

Source: Strategic transport development plan of the Slovak Republic until 2030

Recently, an initiative has been launched to develop a more integrated approach, and to establish a national long-term strategic vision that addresses infrastructure service needs in Slovakia. The Deputy Prime Minister's Office for Investments and Informatisation is currently developing a National Investment Plan (NIP) that identifies investments required at the national level to implement its 2030 Agenda, a long-term vision for the future of the country, as well as its National SDG Agenda.

One of the key objectives of the NIP is to increase predictability and stability of public infrastructure investment, and to mobilise private sector financing. The NIP responds to an increased pressure to implement outcome-oriented spending, and to the challenge of potential reduction on EU funds availability after 2020. Therefore, active private sector participation and co-financing will be essential to implement

the plan. To be of use and attract potential investors, the Slovak Republic should ensure that the plan is underpinned by proposed financing strategies and delivery modalities. The NIP should cover sectors where responsibility for service delivery lies primarily with the central government, including transport (motorways, railways and airports), energy, ITC, research and innovation, healthcare, environment, agriculture and forestry, social inclusion and employment, and regional development. It is also aimed to include investment programmes and projects to support the development of a green economy.

As discussed under Section 3.4, the NIP was developed under a broader logic of strategic planning in Slovakia, following a top-down approach. Derived from United Nations 2030 and the EU 2020 Agenda, it translates the national long-term vision and a strategy of society development into concrete priorities of strategic infrastructure. The initial draft of the NIP prepared by the government is a step towards having a more integrated approach to infrastructure planning. Slovakia is currently preparing the Vision and Development Strategy 2030, which will integrate sectoral and regional priorities on the basis of the national Agenda 2030 priorities. Based on this document, the updated version of the NIP will be prepared, comprising of the strategic investment packages as recommended by the OECD (OECD seminar on Strategic Investment Packages, 15-16 March 2018, Bratislava).

However, there are still many areas for further improvement. A key barrier to the development of linkages between the NIP and the EU and UN strategic agenda is, however, that to date the strategic planning system has not yet been not fully implemented and the national long-term vision and strategy have not yet been developed.

The design of a long-term infrastructure vision requires a process that distils complex and multi-faceted infrastructure issues, cutting across a multiplicity of actors, sectors and interests, into a coherent set of decisions with long-term impact, including projects and processes. As highlighted by the OECD in the comments provided to the first draft of the NIP, there is scope to articulate synergies and trade-offs between sectors, as well as develop trans-sectoral investment prospects. Currently, the plan is a bottom-up list of projects covering a wide number of sectors. However, addressing transversal issues, complementarities and trade-offs between infrastructure projects should be integral to the overall plan.

Ideally, the strategy should provide guidance on how the needs should be met, although there has to be room for adjustment as more information is gathered. The current NIP is lacking tools to prioritise projects within and across sectors. There is a clear need to show how and according to what considerations projects are prioritised within the plan. In addition, there are no mechanisms in place to monitor, report and update the plan. Such mechanisms would require a systematic collection of data to ensure that the financial and non-financial information of investments are included in a register of investments within the BIS and reported on annually in the budget.

Finally, strategic planning need to be linked to fiscal planning. In the case of Slovakia, the NIP does not provide information on infrastructure financing and there is no link with the annual and multi-annual budget allocation process. While currently, NIP provides an overview of upcoming investments, it lacks additional analytical assessment and instruments to ensure comparability of investments from different areas. Moreover, returns from investments are not stated.

To date, the Ministry of Finance had limited participation in the discussion and preparation of the NIP. Hence, enhancing a well-defined active participation of the Ministry of Finance in the discussion and preparation of the NIP, as well as improved co-operations across ministries is essential. In particular, the Ministry of Finance's Value for Money Unit can provide expertise on feasibility, impact and prioritisation of relevant investment projects, and could support the DPMO to define criteria and considerations to prioritise projects within the plan and to address complementarities and trade-offs.

The Value for Money Project has strengthened project preparation and evaluation

In the Slovak Republic, contracting authorities make an initial assessment regarding the choice of delivery mode. Support for project preparation for PPPs from the Ministry of Finance is contingent on the project proposal satisfying a set of criteria. As part of the feasibility study, contracting authorities are required to perform a value for money analysis applying a public sector comparator. Recent reforms have strengthened the project evaluation process. In particular, the government adopted a methodological framework for the preparation and evaluation of large investment projects according to the principles of value for money (see Section 2). This has strengthened the project appraisal process for large projects. In the future, it is expected that every line ministry should use their individually adapted methodology based on an existing general framework. However, there is no concrete timeline for implementation.

Feasibility studies are prepared directly by spending units that submit them to the Value for Money Unit at the Ministry of Finance to start with the review process. Every study focuses on five main topics: i) objective of investment; ii) demand; iii) alternatives; and how iv) costs and v) benefits are calculated in the feasibility study. The Value for Money Framework gives non-binding recommendations based on cost benefit analysis and input values. There are, however, no specific tools or process to monitor the implementation of these recommendations.

3.6. Recommendations

Reinforce the medium-term dimension for stable budget planning

6. **Introduce a strategy debate of government into the budget cycle to enhance collective fiscal responsibility and priority setting.** A collective approach as discussed in Section 3.4 to the definition of fiscal targets, medium-term priorities and corresponding expenditure ceilings, and bottom-up baseline projections would strengthen the commitment to annual and multi-annual ceiling and enhance transparency and accountability. As part of this strategic debate, Slovakia should consider developing a designated stand-alone document to frame realistic medium-term expectations for the allocation of resource and which could serve as a strategy document to align broader strategic objectives. Such a document should align to the EU-related stability programme. An example of such fiscal statements is given in Box 37.
7. **The multi-annual expenditure ceilings for total expenditures and ministerial envelopes should be eventually binding.** By their very nature, high-level fiscal ceilings are set in a medium-term context. For the medium-term framework to work effectively, estimates and ceilings need to be reconciled within the context of a forward-looking approach to budgetary planning and policy formulation.
    - The MTEF may be specified at the level of ministries. Keeping expenditure ceilings at Chapter level allows reaping the benefits of controlling the expenditure growth path, providing and the spending units with predictability in their revenues resources to carry out their policies, while retaining sufficient flexibility.
    - Expenditure ceilings should include incentives and flexibility to ensure expenditure boundaries are respected, for example by building in a “budget margin” as a buffer amount, which is not allocated in the expenditure ceiling.

Link strategic infrastructure planning to the budget process

8. **Enhance co-operation across Ministries and sharing of expertise.** This would entail a well-defined active participation of the Ministry of Finance in the discussion and preparation of the NIP. In particular, the Value for Money Unit can provide expertise on feasibility, impact and prioritisation

of relevant investment projects. This will also support the DPMO to define criteria and considerations to prioritise projects within the plan.

9. **Ensure a top-down approach of the development of the NIP to ensure the strategic prioritisation of infrastructure projects** complementing the project by project assessment performed by line ministries. A top-down approach maintains the focus on policy objectives rather than projects, and helps form a strategic view on where investments are most needed. This implies a vision for the desired future state, which requires the government to set clear, high-level strategic objectives when determining the future infrastructure need. Inter-departmental or ministerial committees could support the design of infrastructure strategies. An effective top-down approach also requires an understanding of present conditions in the form of the current needs of the population and gaps in access to key services. Decisions on what infrastructure to build can be framed as part of a broader strategy for bridging the present and the future.
10. **Identify and manage major future risks and uncertainties in infrastructure planning.** A useful tool to future-proof infrastructure plans is to use analytical methods such as a scenario-based approach. This type of analysis can be used to test projects flexibility, identify the factors that are essential for the project to deliver its expected outcomes, and provide insight on alternatives to deal with future constraints to infrastructure investment. Scenarios can also help the policy maker develop a list of alternative options for investment depending on the future state of the economy (OECD, 2017).
11. **Implement a system to monitor the implementation of the NIP.** To provide the systematic collection of data, ensure that the financial and non-financial information of investments are included in a register of investments within the BIS and reported on annually.
12. **Clearly link strategic infrastructure planning with fiscal planning.** The NIP need to provide information on financing strategies and potential delivery modalities. Infrastructure projects under the NIP should be reflected in the annual and multi-annual budget allocation process. Furthermore, infrastructure plans should include an assessment of implementation costs and a projection on the potential sources of financing. In a fiscally constrained environment, the plan should balance assessed infrastructure needs with medium-term fiscal projections and other potential source of financing. Debt management needs to be assessed within the strategic investment plan. The strategic plan should inform investment decision in the medium and long term. However, it should retain some flexibility and it should be periodically updated in order to respond to emerging challenges and opportunities.

4. A performance and evaluation framework aligned to budget allocations

4.1. Summary

Performance budgeting is a key instrument to enable governments align budget allocations to important policy objectives. It supports governments to assess whether the policy objectives, for which spending was committed, are in fact being achieved. Although Slovakia has had a framework for programme and performance budgeting since 2004, the performance system has lost momentum and has become somewhat formalistic rather than contributing to accountability and informing the allocation of public resources. For example, while in 2004 there was an active working group on introduction of performance-based budgeting, headed by the Ministry of Finance and including all budget directors from line ministries, it was resolved later. Strengthening the performance aspects of the budgeting system would help decision-makers gain more value from the budget framework.

4.2. Budgeting for performance

A key aspect of performance budgeting is outcome orientation. According to the OECD, performance budgeting can be defined as "the use of performance information to inform budget decisions, whether as a direct input to budget allocation decisions or as contextual information and/or inputs to budget planning, as well as to instil greater transparency and accountability throughout the budget process, by providing information to the public on performance objectives and results" (OECD, 2019[6]).

Since 2004, the Slovak Republic has had a programme budgeting framework in place with one of the key objectives to enable line ministries to better align expenditures to the policy goals of the government. The Slovak programme budget follows a three-level approach, providing the structure to link budget allocations to information about performance, objectives and results. Each Budget Chapter is divided into programmes, sub-programmes and individual projects or items. While the overall objective of each programme does not necessarily correspond to the policy priorities defined in the government's manifesto, line ministries are advised to use the manifesto as guidance when doing so. At the lowest level of the programme structure, individual projects include a description of the outcomes to be achieved and contain indicators to monitor and evaluate the projects.

Similar to other OECD countries, programme budgeting in Slovakia follows a "presentational performance budgeting" approach (Box 40). This means that it is not designed for decisions on budget allocations, and is for supplementary information purposes only. A recent survey of OECD countries suggests that in most countries performance budgeting had most impact as a communication tool, increasing transparency around the budget, and enabling parliament and citizens to understand the objectives of public spending and the results achieved (OECD, 2019[6]).

Box 40. Performance budgeting approaches in OECD countries

The OECD identifies four models of performance budgeting. These models reflect the differing relationship between budgeting and performance data and the extent to which performance budgeting has a top-down or a bottom-up management perspective. Nevertheless, each national performance budgeting framework takes account of individual country circumstances, including administrative capacities, culture and priorities.

1. **Presentational performance budgeting**

   Performance information is presented with budgeting documents or other government documents but is included as background information for the purposes of accountability and dialogue with legislators and citizens on public policy issues and government direction. Performance information does not play a significant role in decision making on allocations nor is it intended to do so.

2. **Performance-informed budgeting**

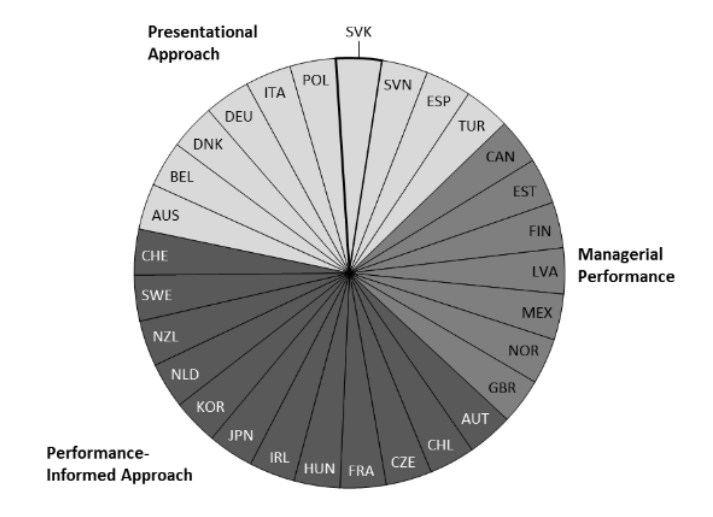
   Performance information is presented alongside the financial information and is expected to play a role in spending decisions; however, resources are related either to proposed future performance or to performance results in an indirect manner. There is no automatic linkage between performance and funding levels. The weight given to performance information depends on particular circumstances.

3. **Managerial performance budgeting**

   Using the system of performance information developed in the context of the budget process primarily as a tool of performance management and accountability at an organisational and management level, rather than primarily as a tool of resource allocation.

4. Direct performance budgeting

There are explicit links between budget allocations to units of performance (e.g. outputs). Funding is directly linked with results achieved. Appropriations can thus be based on a formula/contract with specific performance or activity indicators.



Source: *Source*: OECD Performance Budgeting Survey 2018; (OECD, 2019[6]) (OECD, 2008[14]); Policy Brief: Performance Budgeting: A User's Guide.

In theory, the Slovak system requires all line ministries to define programme objectives in line with the government's manifesto; as well as corresponding outcomes and measureable indicators on sub-programme and project level. In practice, however, this is not systematically implemented. Furthermore, while many line ministries submit goals, objectives, and indicators into the BIS, the quality of the information can vary. To address the issue the Ministry of Finance provides some guidance including:

- Methodology for programme budgeting which sets the general framework for programme structure formulation, the approval process and execution. It also provides instructions to monitoring and evaluation.
- Manual on programme budgeting which provides detailed information on how to formulate goals, objectives, goals and measurable indicators. The Ministry of Finance also produces illustrative examples of programmes.
- Manual for monitoring and evaluation was developed after introducing monitoring and evaluation into budget process in 2010.

However, these manuals are not always applied and there remains room for the improvement of the quality of the performance material for decision making or for information and transparency purposes. For example, the evaluation function is optional, and line ministries have produced few evaluation reports. Monitoring is performed on a more regular basis, but by the same people that are responsible for programme management, which could challenge objectivity. Although the Implementation Unit under the Prime Minister´s Office (PMO), offers assistance to ministries with the aim to improve their performance and evaluation system (Box 41), there is no central management of the monitoring and evaluation function and no follow-up on the monitoring reports.

Incentives to improve the quality of performance information remain low. To strengthen the performance budgeting system, the benefits of performance information need to be re-established communicated to line

ministries and parliament. Unless the budget system makes use of performance information there will be little incentive for line ministries to provide or use the information. By way of example, several line ministries reported that they have considered ceasing to voluntarily report performance information. This development reflects removing performance objectives in the 2015 budget information.

It will therefore be important to strengthen the discussion of performance information during the budget formulation and during the approval phase in parliament. This will require dedicated time to the discussion of performance objectives, indicators and their evaluation during the budget approval sessions in autumn. Plans by the DPMO to create a targeted parliamentary committee to report on the progress towards the National Development Plan can contribute to this outcome. In general, adopting a more participative, inclusive approach to the development and evaluation of outcome objectives may be considered more in depth when modernising the Slovak system.

However, high-quality performance information is needed to provide relevant information that can be used in the budget process and to increase the value of parliamentary budget debates. By providing meaningful performance information, performance budgeting can facilitate a more outcome-focused discussion in parliament and the public, and challenge the line ministries to provide meaningful qualitative information regarding their objectives.

Box 41. Performance budgeting in the Ministry of Health

Recently, the Slovak Ministry of Health started to develop a new approach to the performance budgeting of health insurance expenditures.

In contrast to other line ministries, the Ministry of Health operates with two separate budgets. The minor part financed by the state budget covers mostly administrative expenditures, and is, according to budget rules, budgeted in programmes. The second part, funded by the Health Insurance Company, is part of the Budget of Other Subjects of general government, accounting for over 5% GDP. It covers health expenditures and most of the capital investments.

To improve efficiency and performance monitoring for health insurance expenditures, the Ministry developed a new, programme-based structure organised by types of care. This new structure allows the Ministry to track spending in a more accurate and transparent way leading to more efficient allocation of expenditure and a more detailed and accurate baseline of expenditure. In a second step, the Ministry, in co-operation with the Implementation Unit of the PMO, is defining key performance indicators for every programme to improve monitoring and evaluation.

Despite positive experiences with the new system in terms of transparency, several problems remain, in particular regarding accountability. Although the Ministry of Health acts as a regulatory body, it has no power over decisions about budget allocation of the Health Insurance Companies. It can therefore not be held responsible for poor performance of activities that are conducted by Health Insurance Companies. This undermines the use of performance information to adjust and improve budget allocations.

Source: Based on information from Ministry of Health

The efficient use of performance information is a challenge for all OECD countries. Notable developments, however, have taken place in many countries with regard to the quality of indicators and a better balance between the need for sufficiently detailed information for transparency and decision making, brief and concise information for communication, and limited additional workload (OECD, 2019[6]). An example how to achieve this balance is the introduction of greater selectivity in the presentation of performance information (Box 42).

Clearly defined high-level objectives linked to government priorities would help to generate more policy discussion on the most efficient way to allocate funds to achieve government priorities and national targets. In Slovakia, objectives and targets are set at a much disaggregated level. In addition, these targets are process targets rather than output or outcome targets. High-level performance objectives should clearly reflect the policy priorities for which the government and public administration will be accountable. The government manifesto should in turn be designed with a view to its fundamental role as an "anchor" for outcome-orientation in policymaking and in budgeting. Furthermore, using a more selected set of internationally comparable indicators could help Slovakia to reinforce the relationship between performance information, budget allocations and the national objectives in correspondence with key Sustainable Development Goals (SDG). Clearly-linking performance information to the government's priority goals could furthermore promote debate on policy impacts.

Box 42. Greater selectivity for improved performance information

Performance indicators in France

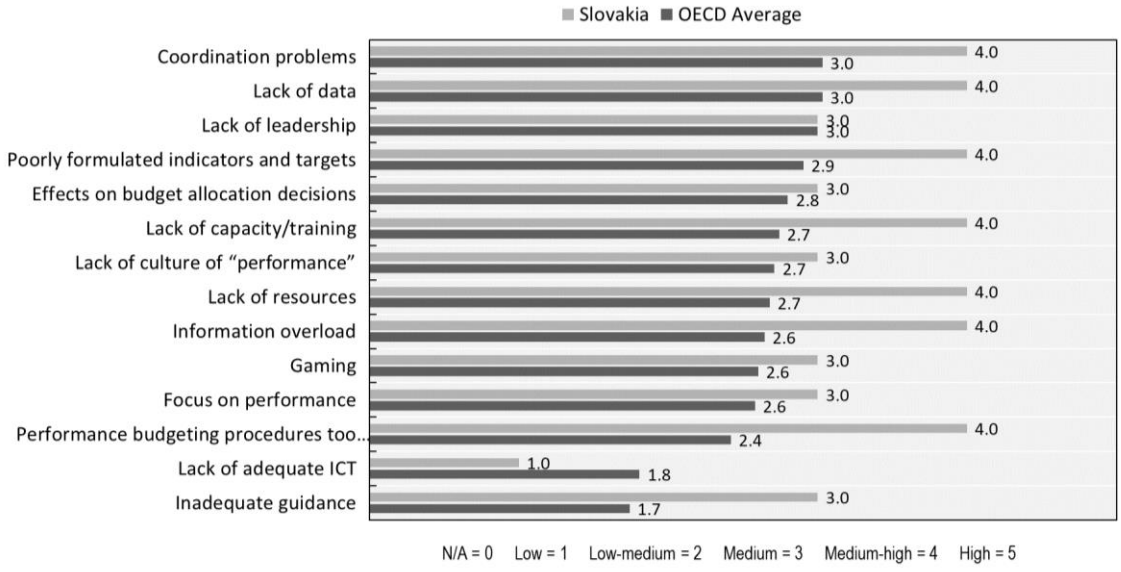
France offers an example of strong links between key performance indicators established at national level and budgets. France's organic budget law (*Loi organique relative aux lois de finances (LOLF)*) groups expenditures by "missions" that bring together related programmes that are associated with high level policy objectives and performance indicators. Recent reforms have additionally focused on streamlining the indicators to make them clearer to parliamentarians and the public; France enacted a law in 2015 requiring the Government to present wealth and well-being indicators other than GDP to promote debate on policy impacts. Based on the LOLF system the French government is developing a strategic dashboard using a limited set of internationally comparable indicators, including:

- Economic development indicators such as Foreign Direct Investment (OECD) and Doing Business (World Bank).
- Social progress indicators, such as healthy life expectancy at 65 by gender (OECD), percentage of 18-24 year olds with no qualification who are not in training (France Stratégie/Eurostat) and poverty gaps (World Bank).
- Sustainable development indicators such as greenhouse gas emissions per unit of GDP (European Energy Agency/Eurostat).

4.3. A greater role for co-ordination

According to OECD Performance Budgeting Survey 2018, challenges in most OECD countries when implementing performance budgeting include co-ordination and leadership – challenges that were also identified as major impediments of the Slovak System (Figure 33), together with poorly formulated indicators and targets, lack of data capacities, and information overload (see previous section).

Figure 33. Main challenges for the implementation of performance budgeting



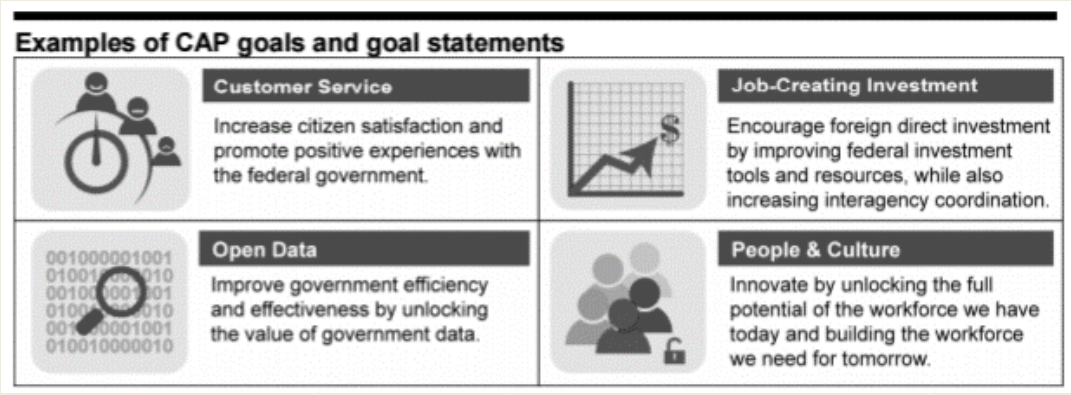
Source: OECD Performance Budgeting Survey 2018

Inter-agency co-ordination becomes particular important in the context of cross-cutting policy priorities. Achieving progress on the SDGs and Slovakia's national priorities will require evaluation, co-ordination, consultation and collaboration across numerous policy areas. For example, action against climate change and environmental degradation requires multiple coherent actions in areas ranging from infrastructure investments, environmental regulations and tax incentives to public education and awareness. The United States offers an example of institutionalised mechanisms to promote co-ordination around cross-agency performance goals (Box 43).

Box 43. United States – Co-ordination of cross–agency priority goals

The Government Performance and Results Act (GPRA) Modernization Act of 2010 (GPRAMA) requires the Office of Management and Budget (OMB) to coordinate with agencies to develop cross-agency priority (CAP) goals, which are four-year, outcome-oriented goals covering a number of complex or high-risk management and mission issues.

Examples of CAP goals and goal statements.



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Source: Performance.gov | GAO-16-509

The OMB and the Performance Improvement Council (PIC) have introduced a goal governance structure that includes agency leaders, and regular senior-level reviews on CAP goal progress. CAP goal teams reported to the US Government Accountability Office (GAO) that the CAP goal designation increased leadership attention and improved interagency collaboration on these issues.

Source: (OECD, 2019[6])

In order to integrate cross-cutting strategic development goals into the budget process, a sustained partnership between the DPMO and the Ministry of Finance is crucial. The OECD Recommendation on Budgetary Governance calls on governments to "*closely align budgets with the medium-term strategic priorities of government*," including through "*nurturing a close working relationship between the Central Budget Authority (CBA) and the other institutions at the centre of government (e.g. prime minister's office, cabinet office or planning ministry), given the inter-dependencies between the budget process and the achievement of government-wide policies*".

Nevertheless, communication and information sharing is ongoing. While the Slovak Ministry of Finance maintains a key role during budget formulation and execution, the Deputy Prime Minister's Office for Investments and Informatisation (DPMO) has been assigned the co-ordination of SDG implementation at national level, as well as strategic planning and the co-ordination of investment projects within the development of a national strategic investment framework. Despite existing co-ordination mechanisms, such as the *Council of the Government* and the *Inter-ministerial working group on the Agenda 2030 and the National Investment Plan*, designed to co-ordinate shared responsibilities, more work is required to operationalise the mechanisms. A centralised competence for co-ordinating cross-cutting objectives, including quality-control on performance information associated with broader policy priorities, and indicator development, could help to institutionalise co-operation across the key agencies and develop a functional system of programme budgeting. Such entity would furthermore be a key player with respect to performance evaluation.

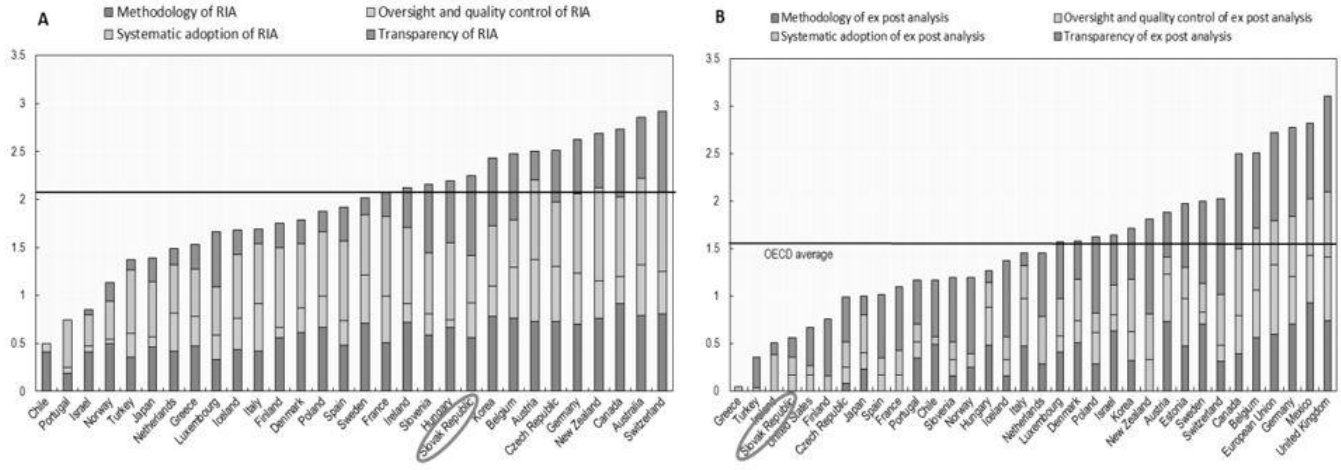
4.4. Programme evaluation is essential to ensure effective public spending

Evaluation should be undertaken to feed back into the strategic budget decision-making process and boost transparency and accountability for the management of stewardship of public funds (OECD, 2019[6]).

Monitoring and evaluation elements play a secondary role in Slovak's programme budgeting system. Since 2010, line ministries and agencies are encouraged to monitor and evaluate their programmes on a voluntary basis. This includes performance evaluation of programmes during programme formulation (*ex ante*) and after budget execution (*ex post*). Effective implementation however, is perceived rather low and not relevant for decision processes and increased transparency. In international comparisons, Slovakia scores around the OECD average in terms of overall quality of *ex ante* impact assessment of primary laws, but demonstrates low quality of *ex post* evaluation (Figure 34). In particular, systematic adoption, oversight and quality control achieve low results. *Ex post* evaluation, furthermore, shows a low degree of transparency and lacks a defined methodology.

Regulatory impact assessments (RIA) are conducted directly by line ministries and evaluated by a committee at the Ministry of Economy. The impact assessments analyse expected impacts in various policy dimensions (budget impact assessment, business environment assessment, social impact assessment, environmental impact assessment, IT impact assessment, impact on GG services for citizens' assessment). They however do not include an explicit performance-orientated part related to outcome objectives and corresponding indicators. Particular progress has been made by the recent introduction of mandatory *ex ante* evaluation for the appraising of large capital investment projects (see Section 3.5). In this context, notably the Ministry of Transport in co-operation with Ministry of Finance has made progress in evaluating investment projects and publishing data to the public.

Figure 34. Regulatory impact assessment (A) and *ex post* evaluation (B) for developing primary laws in OECD countries (composite indicator)



Note: Panel A: The results apply exclusively to processes for developing primary laws initiated by the executive. The vertical axis represents the total aggregate score across the four separate categories of the composite indicators. The maximum score for each category is one, and the maximum aggregate score for the composite indicator is four. This figure excludes the United States where all primary laws are initiated by Congress. In the majority of countries, most primary laws are initiated by the executive, except for Mexico and Korea, where a higher share of primary laws are initiated by parliament/congress (respectively 90.6% and 84%).
Source: OECD (2015), OECD Indicators of Regulatory Policy and Governance (iREG), http://www.oecd.org/gov/regulatory-policy/indicators-regulatory-policy-and-governance.htm, based on the 2014 OECD Regulatory Indicators Survey results. Data for Brazil, Colombia and Costa Rica are from OECD Indicators of Regulatory Policy and Governance (iREG) for Latin America 2016 http:// www.oecd.org/gov/regulatory-policy/ireg-lac.htm).

Although *ex post* evaluation is conducted by most line ministries, they are voluntary and the quality can vary. As reported by stakeholders, in some cases, *ex post* evaluation, which is recommended to include in the closing accounts of individual budget chapters[7], is limited to a few lines submitted into the BIS. The OECD was not aware of any quality assurance by the Ministry of Finance over evaluations. Slovakia needs to strengthen its capacities for *ex post* evaluations, in particular for co-ordinating cross-cutting objectives,

and quality-control on performance information associated with broader policy priorities, indicator development, and performance evaluation (Box 44).

Box 44. Programme evaluation in OECD countries

Korea

In Korea, the programme evaluation process seeks to measure the relevance, efficiency, and effectiveness of a programme. The *In-depth Evaluation of Budgetary Programme* institutionalised the in-depth evaluation process as part of the performance budgeting system. Every year, an evaluation panel is created for each of the group of cross-cutting programmes selected for evaluation. Panel members mostly come from public research institutes and universities and since many stakeholders are involved in any given programme, the evaluation panel holds frequent meetings to collect inputs and feedback. The completed evaluation reports are considered by the central budget office, which decides whether to reflect these results in resource allocation changes or programme consolidation. Line ministries are required to report with their follow-ups.

Austria

Austria's system of impact assessments is an advanced practice in international terms. It applies a mandatory basis across spending and regulatory policy areas, on both *ex ante* and *ex post* basis, with systematic links to the performance budgeting system, facilitated by an IT system and overseen in most cases by the Federal Chancellery. Since April 2015, the impact assessment system is applied in two tiers, with thresholds applying across various impact dimensions to determine the scale and scope of the assessment. If the threshold criteria are not surpassed, a "light" version of the impact assessment may be used, with fewer requirements for data as outcome indicators or *ex post* evaluations are not obligatory. In addition, impact assessments may be applied on a "bundled" basis to a series of initiatives that form part of a common policy initiative. This "bundling" also applies to spending programmes with similar aims.

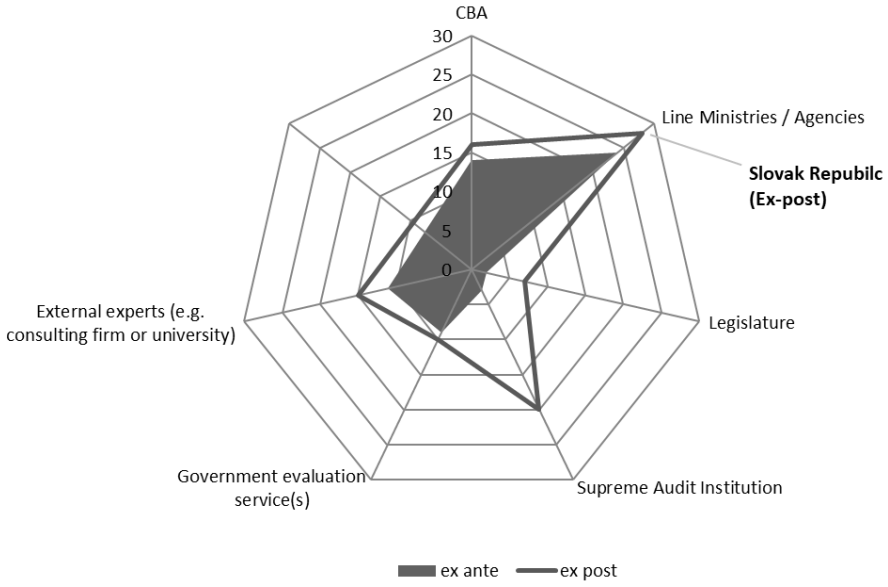
Source: (Downes, Von Trapp and Jansen, 2018[15]); (OECD, 2019[6])

The Supreme Audit Office of the Slovak Republic conducts periodic evaluation of performance information, including an assessment of the coherence of performance-objectives and outcomes with the national strategic plans, the Agenda 2030 and the stability programme, as well as the implementation of evaluation results. Recommendations by the Supreme Audit, however, are published as an opinion with no obligation of any actions being taken by the relevant line ministry.

As the use of self-evaluation without comprehensive external scrutiny can undermine the quality of evaluation, some OECD countries let external auditors conduct evaluations, such as academics, consultancies, and other organisations commissioned by government. In some cases, the government has set up arm's-length bodies, which commission or synthesise evaluations, with varying levels of autonomy and independence (Figure 35).

Figure 35. Governance of Evaluation in OECD countries

Number of OECD countries



Source: OECD, 2018 Performance Budgeting Survey

However, *ex post* evaluation of performance information, does not appear to feed into the decision-making process. According to OECD (forthcoming[5]), the single most important problem preventing evaluations from impacting on budget decisions in OECD countries is the absence of a mechanism to consider evaluation findings in the budget process, followed by insufficient bureaucratic and political interest in the evaluation findings.

A more systematic approach to *ex post* assessments, could a) reinforce the importance of well-defined objectives and indicators; b) highlight what and how measures had a substantial impact on any SDG or national goals; c) provide feedback that can be integrated into the policy making process. While Slovakia's performance system currently aims to improve transparency and accountability, ideally, the evaluation system should also be geared towards identifying ineffective or low priority government programmes that should be terminated or scaled back to assist either in reducing government expenditure or in creating additional budget space for high-priority new expenditures (OECD/Korea Development Institute, 2017[16]).

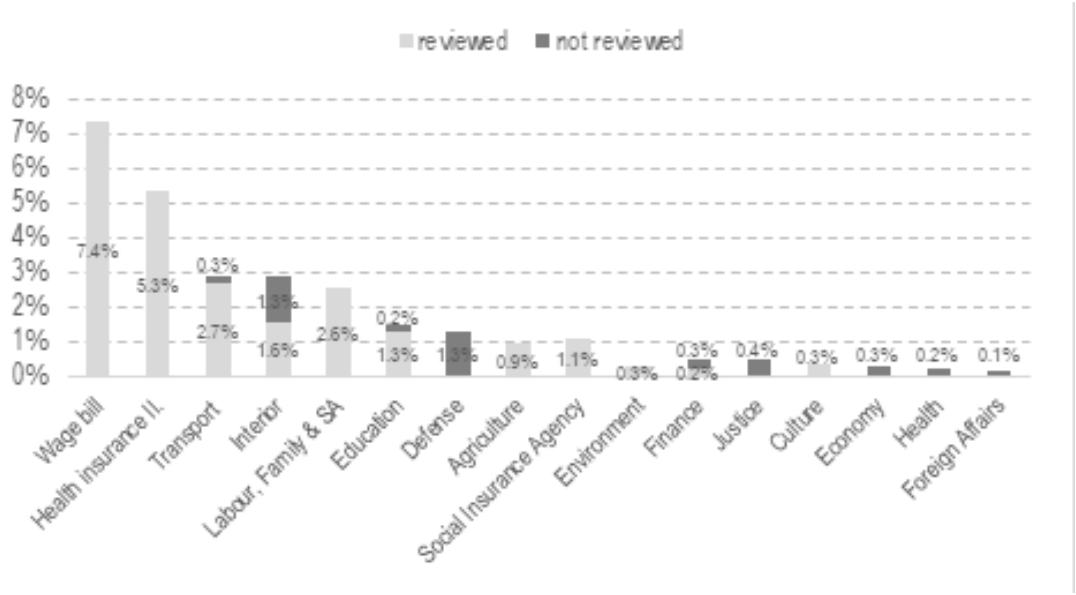
Spending Reviews improve the efficiency and effectiveness of public spending

Spending reviews are a distinctive tool to closely scrutinise the purposes and value of existing programmes and expenditures, and (in some countries) to expand fiscal space for policy initiatives. Since 2016, the Value for Money Unit of the Ministry of Finance started conducting spending reviews on a rolling basis, filling to some extent the gap to assess performance of the budget programmes. Spending reviews can be a relevant tool to review and evaluate existing policies and expenditures with regard to government-wide developments and objectives. In a number of OECD countries, the practice of spending reviews has proven effective for the re-prioritisation of spending or the identification of expenditure reductions.

Like in the most OECD countries, spending reviews in Slovakia are an annual exercise, which proceeds on a rolling basis (usually 3 reviews per year). The Slovak spending reviews are executed by joint teams of internal analytical units composed of staff from the Ministry of Finance and the relevant Line Ministry, co-ordinated by the Value for Money Unit at the Ministry of Finance. The individual topics for review are

proposed by the Ministry of Finance and approved by Government, in parallel with the preparation of the strategic documents (the stability program, the draft budget plan and the GG Budget.). Since 2016, spending reviews have focused on health, transport and informatisation (2016), and environment, education and labour market and social policies (2017).

Figure 36. Public spending, covered by a spending review, % GDP



Source: Ministry of Finance, Value for Money Unit

The Ministry of Finance envisages a fourth round of spending reviews for the coming year. In 2018, the Slovak Government enacted a law, which will introduce a series of rolling policy and thematic reviews with the aim of covering of government over a four-year parliamentary term, starting in 2020. Such cross-cutting assessments of the budget's impact can be used to promote horizontal government priorities and/or the SDGs. Applying such a perspective on evaluation would enable the government to track progress towards these priorities, and could enhance scrutiny by parliament and civil society. This next cycle of spending reviews would provide a chance to assess performance of cross-cutting expenditure programmes, and the programme budgeting system. Some OECD countries use cross-sectoral spending reviews that are focused on inter-agency collaboration to support government goals.

In order to monitor the effective implementation of the measures identified by the reviews, a special Implementation Unit (IU) has been created. The IU is located within the Prime Minister´s Office[8] to ensure a whole-of-government approach. The IU is responsible for the process of implementation of measures by defining target values for the given year (in case that the spending review did not specify volume of measures for specific years) and the means of reporting for responsible institutions (implementation plans). The IU is to produce an interim report (after 6 months) to evaluate measures, provide recommendations for the next 6 months and prepare quarterly dashboards. A comprehensive implementation report (final report) is a separate annex to the stability programme and is prepared once a year. The work by the IU is for guidance, as its findings are not binding. The first implementation report for 2017 reported 59% execution of measures on average. Total implemented savings amounted EUR 83 million (EUR 79.8 million in healthcare and EUR 3.2 million in transport).

As common for sectoral spending review processes, identified savings remain in the budget of the reviewed line ministry. While this may limit the control on the efficient use of the freed resources by the Ministry of Finance, it increases the incentives for the efficient implementation of identified measures and frees fiscal

space for line ministries to accommodate priorities that may have otherwise been requested to the Priority Reserve Fund.

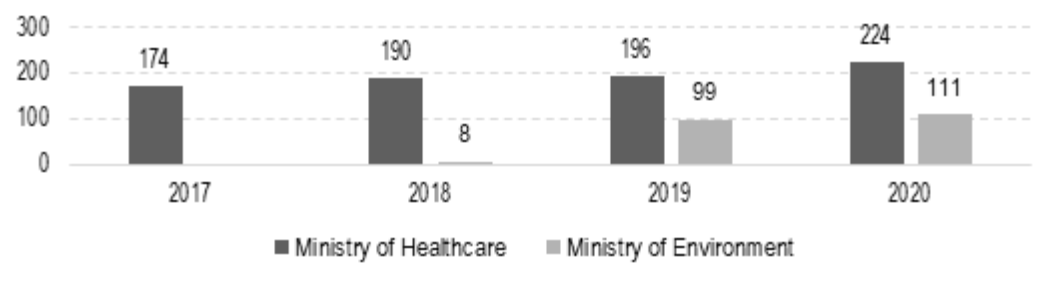
Since 2016, public expenditure amounting EUR 20.3 billion (24 % GDP, 59 % public expenditure) were reviewed. The realised savings resulting from the 2016 reviews undertaken in the health, transport and informatisation totalled EUR 83 million (0.09% of GDP). In 2017, expenditures amounting 7.3% of GDP were reviewed, identifying potential savings of EUR 277 million (4.7% of the envelope reviewed). Identified savings from spending reviews on healthcare and environment were implemented in GG budgets (Box 45). Findings from the 2016 evaluation on ICT spending, health care and transport were used in the 2017 budget preparations. However, almost a third of the measures identified were not implemented, or their implementation was postponed to 2018. Implementation was in particular a problem in state-owned enterprises (SOEs) and sectors, where the state is not the direct provider of services, such as healthcare, and education. In these cases, implementation could only be monitored at the end of the year in the closing accounts.

Box 45. Savings from the Healthcare spending review

Healthcare spending review has resulted most successful in term of realised savings. In 2017, the Ministry of Health achieved a fiscal saving of EUR 79.8 million, representing 45% of the set target (Figure below). The most significant saving was made in overconsumption of medicines (EUR 22.2 million), external referencing of the special medical supplies to EU average (EUR 13.2 million), and the procurement of hospital medical equipment (EUR 15.6 million). For upcoming years, key challenges include to continue to meet defined fiscal savings, ensure the full functionality of DRG, and the functioning of eHealth.

In contrast, the environmental spending review identified potential savings of EUR 111 million. (0.18% GDP) by 2020[1]. Identified measures included improving the efficiency of the Slovak Water Management Company operation, higher fees for waste disposal motivating a greater degree of waste recycling, implementation of nature protection funding, improved subsidy management, and revocation of optional exemptions in the area of excise taxes (coal, electricity, gas). The Office of the Deputy Prime Minister for Investments and Informatisation aimed to implement potential savings of between 5-7% of IT expenditures for 2017, of which 54% was fully or partially implemented.

Targeted implemented savings from spending reviews into budget



Note: [1] As included in the GG budget. The Spending Review identified full potential savings up to 149 million.
Source: General Government Budget 2018-2020, Ministry of Finance, Ministry of Health

The spending reviews programme has initiated a change of thinking about performance of public spending. Value for Money units have been developed in several of the reviewed line ministries and more priority is being given to develop a methodological toolbox and internal analytical capacity to do value for money analysis at the finance and line ministries (OECD, 2017[4]). In particular, because of the spending review

exercise, the Ministry of Transport has made significant progress in co-operating with the Ministry of Finance to move towards systematic evaluation of investment projects and publishing data to the public. Similarly, a key result of the spending review of the Office of the DPM highlighted the need for coherent rules for the assessment of investment projects irrespective of the source of financing (state and EU funds). To secure persistent focus on efficiency of public spending, the Ministry of Finance should insure that spending reviews' results continue to be regularly and systematically integrated into budgetary decision-making processes.

An option to consider would be to analyse results of spending reviews at the outset of the formulation of the fiscal strategy (discussed in Chapter 3) and to use them for setting the medium term resource and capital budgets for each chapter, as is done for example in the United Kingdom (Box 46). This would help developing the medium term planning and performance. It would involve however that spending reviews be comprehensive, rather than selective or rolling. A more detailed analysis of Slovakia's spending review process, however, goes beyond the remit of this targeted assessment. Slovakia may consider including these aspects in a full or targeted budget review.

Box 46. United Kingdom: Spending Reviews and Medium-Term Planning

Multi-year spending reviews were introduced in 1998. They usually set 3 to 4 year resource and capital discretionary budgets for each ministry, with the final year of each spending review period becoming the first year of the subsequent one – deliberately designed to deal with the rising uncertainty associated with medium-term targets.

Spending reviews are a principally top-down process designed to force allocative trade-offs between competing priorities. A fixed spending envelope (the so-called 'DEL envelope') is set prior to the conclusion of the exercise. It reflects a government's medium term fiscal policy because the DEL envelope is set by reference to the fiscal targets, tax receipts and non-discretionary spending (so-called AME spending), as forecast by the OBR. DEL spending is therefore sometimes described as 'the spending residual' – although reforms to taxation and to social security spending can be used to create more or less spending headroom given the amount of DEL is linked to tax and AME spending forecasts.

DEL spending is further divided into non-fungible capital (CDEL) and resource (RDEL) envelopes, thereby allowing a government to make a top-down strategic choice between levels of day to day and investment spending on all departmental spending, including healthcare.

Four to six months before the outcome is announced, individual spending ministries are required to submit capital and resource-spending proposals based on several scenarios set by the finance ministry (HM Treasury) – measured against a baseline agreed between each ministry and the Treasury, itself usually the subject of a negotiation. Each bid is scrutinised – sometimes by a ministerial committee led by the Budget Minister, the Chief Secretary to the Treasury – before final decisions are made by the finance minister (Chancellor of the Exchequer) in close collaboration with the head of the government (Prime Minister). Since 2010, infrastructure-spending bids have been considered from a zero base against each other as a means of seeking to identify those projects with the highest returns within a set CDEL envelope.

The policy analysis is often supplemented by parallel strategic reviews of major spending areas, or to try to identify areas of reform – such as the Strategic Defence & Security Reviews that often provide the policy context to spending on external security spending decisions.

Multi-year budgets are then presented to the UK Parliament, although the Parliament votes on each year's budgets through the Supply Estimate process.

Source: (OECD, 2019 (forthcoming)[39])

However, according to some line ministries, spending reviews may have contributed to the declining focus on monitoring and evaluation of performance information within the Slovak performance budgeting system. Spending reviews should be used in conjunction with performance budgeting to review the justification for spending and to identify budgetary savings that can be redirected to support priority goals. A possible way to support this would be the adoption of a strategy for evidence-based decision-making. For example, the so-called "ecology of instruments" approach (Box 47) is based on the mutually reinforcing effects that the implementation of regulatory tools and evaluative instruments, such as spending reviews can trigger.

Box 47. "Ecology of instruments": co-ordinated action in evidence-based policy-making

Empirical research and academic literature has tended to focus on individual administrative control instruments and regulatory tools, ranging from laws on administrative procedures, to issues of transparency and consultation, and to cost-benefit analysis and RIA. A theme of this research is that while today there is relatively well-defined knowledge of individual instruments, this has come at the expense of the 'bigger picture' of policy-making.

Research by Damonte, Dunlop and Radaelli (2014[18];(2014[19]; 2016[20]) opens an innovative avenue to design and manage regulatory reform. These scholars propose to consider "ecologies of instruments" instead of the political economy of introducing, mainstreaming and running individual regulatory tools. The general implication of the ecology theory is that, from the point of view of performance and effectiveness, the sophistication and effectiveness of individual instruments matter less than the overall mix of those instruments and their collective impact on interested parties (businesses, citizens, end-users). In other words, a single instrument must fit well within the broader "ecology" of other instruments.

Applying this concept to policy-making more generally, the "ecological landscape" is broader still, and needs to take account of the tools of budget-related policy-making: *ex ante* evaluation, resourcing, performance budgeting, *ex post* reporting and parliamentary accountability. The practical expression of this approach would be the development of a common, foundational methodology for evaluation and policy-making that can facilitate a full economic and social balance sheet for the use of policy makers and stakeholders.

Source: (OECD/Korea Development Institute, 2017[16])

Recommendations

Improve the alignment of performance information to strategic goals

13. **Ensure that performance information is collected and can be relevant and useful for the budget formulation, parliamentary debates and oversight.** Slovakia may facilitate oversight and accountability by (re-) introducing performance information in the budget documentation to inform and provide context for the financial allocations. Doing so, Slovakia should consider improving the quality of performance information by introducing selected, concise and internationally comparable objectives and indicators. A smaller number of high-level outcome targets that are clearly linked to government priorities can drive policy discussion within government and in parliament. Greater selectivity in presenting performance information can highlight the performance objectives to which the government is holding itself to account, for example through the development of dashboards to provide concise information on budget implementation, and based on internationally comparable benchmarks that align to the EU 2020 and/or the UN Sustainable Development Goals.

14. **Encourage parliamentary engagement to build demand for performance information.** This requires a participative approach already in the design phase of outcome objectives and indicators; and a strengthened discussion on performance information and evaluation during the budget formulation and approval phase, for example by a dedicated parliamentary committee to report on performance and/or dedicated time to the discussion of performance objectives, indicators and their evaluation during the budget approval sessions in autumn.

Strengthen the evaluation function of the government to demonstrate progress toward strategic objectives

15. **Standardise spending reviews as a tool for performance evaluation and eventually inform medium-term expenditure ceilings.** To maintain a consistent focus on efficiency of public spending, the Ministry of Finance should ensure to regularly and systematically integrate spending review results into budgetary decision-making processes. An option to explore in the future would be to analyse timely results of comprehensive spending reviews for setting the medium-term expenditure ceilings for each chapter, as is done for example in the United Kingdom (Box 46).
16. Establish a co-ordinated system and the necessary capacities for monitoring, evaluation and quality control by:
    - A centralised competence for co-ordinating cross-cutting objectives, including quality-control on performance information associated with broader policy priorities, indicator development. Such entity would furthermore be a key player with respect to performance monitoring and evaluation.
    - Considering focused assessments of the budget's impact on particular Government priorities such as gender equality or the environment.
    - Encouraging Supreme Audit Office (SAO) to conduct systematic evaluations of performance information, including an assessment of the coherence of performance-objectives and outcomes within the national strategic plans, the Agenda 2030 and the stability programme; and strengthening the role of the SAO and the CBR by requiring a formal discussion and response by government of the analysis results in parliament.

Notes

1. Slovakia and Slovak Republic are used interchangeably in this report.

2. The indicator does not directly impact fiscal policy or the formulation of fiscal targets.

3. The Starting Points for Budget Preparation included also breakdown of aggregate budget ceilings by Chapter, which however was discontinued when the document was merged with the Stability Programme.

4. All programmes, sub-programmes, projects/items and objectives are binding indicators

5. www.nku.gov.sk/web/sao/about-us

6. https://goo.gl/eHR45w

7. Guidance on performance evaluation www.finance.gov.sk/Components/CategoryDocuments/s_LoadDocument.aspx?categoryId=7282&documentId=3655

8. When created, the IU was based under the Deputy Prime Minister's Office for Investments and Informatisation.

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