



OECD Journal on Budgeting

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

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

We regret we are unable to take unsolicited contributions to the Journal. We are, however, anxious to receive feedback from our readers. Your views on how to improve the Journal are welcome and can be sent to: The Editors, The OECD Journal on Budgeting, OECD, 2, rue André-Pascal, 75775 Paris Cedex 16, France. Fax (33 1) 45.24.17.06; email: pum.contact@oecd.org.

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Opportunity, Strategy and Tactics in Reforming Public Management

by
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Every successful public management reform is an amalgam of opportunity, strategy and tactics. Opportunities are country-specific conditions that facilitate some reforms and retard others; strategies are policies and actions that set goals for government and for the tasks to be undertaken in implementing wanted change; tactics are the methods used to mobilise support for and overcome obstacles to reform.

Although opportunity is rooted in local conditions, when similar reforms occur in many countries, it is likely that common change-generating conditions also spill over national boundaries. Management reform may become ripe because of elections and changes in government, shifts in public sentiment, a budget crisis or program failure, the drive of politicians or managers to be innovators and the seepage of new ideas into the conventional wisdom on how public organisations should be run. Reforms that appear in many countries may flow from a world-wide slowdown in economic growth or from broad, cross-national attrition in confidence in government. Opportunity both facilitates and constrains; it opens up some possibilities and shuts off others. But opportunity is not just there for the plucking; it must be detected and exploited. And constraints are not ironclad bars to innovation; they can be surmounted or evaded by wilful politicians and managers.

Strategy is the deliberate effort to create a future that is materially different from what would ensue if prevailing conditions were allowed to run their course. It requires verve and vision, the drive to set into motion change-driven processes, to establish objectives and priorities, to tear down old institutions and practices and to make way for new ones, to take the risks that accompany change, and to have confidence in what government should become and the steps required to achieve that vision. Strategy does not necessarily mean making big plans, for it also can entail embedding a culture of ongoing, incremental change in public institutions. In fact, strategy often involves choices between these two approaches or some variant of them. Strategy also entails implementing actions and the commitment to give the change process essential support and resources.

There sometimes is tension between opportunity and strategy, for the more one is beholden to the former, the less attention one might give to the latter. Often opportunistic reformers, by contrast, have a tendency to leap to the untried and risky. Despite the current affectation of labelling just about every government plan or reform as strategic, genuine strategic change is rare

because it is difficult to pull off. The temper of much contemporary management reform is reflected in Ireland's case. Referring to the government's strategic management initiative (SMI), Ireland observes that the focus "is essentially on management issues and challenges rather than on the role and function of government and whether these should be radically changed. As a result, the primary thrust ... remains on service delivery and better management of all aspects of administration; in short on delivering better government." But the paper also acknowledges that reform of the magnitude being pursued may be expected "to lead to a process of questioning the role and functions of government."

Does Ireland's SMI rise to the level of being regarded as truly strategic? Is its strategic management initiative an effort to transform public administration or to make spotty improvements? Is it animated by an overriding conviction that big changes are imperative, that even if the task is hard and must be pursued piecemeal rather than all-at-once, it should be undertaken? Similar questions can be asked of the German, Dutch and Norwegian reforms, and perhaps of initiatives in other countries as well. Does it matter whether reform is purposely strategic or merely opportunistic? Perhaps not, for some strategies fail and some opportunities blossom into much bolder innovations than were contemplated at the outset. Britain's management reform started modestly, with efficiency reviews and a financial management initiative, but they grew into a fundamental restructuring of public institutions and the opening up of public services to market competition and greater citizen/customer influence.

While it is likely that a well-developed strategy will produce different outcomes than would a reform born solely of opportunism, confining strategic thinking to the launch stage may condemn the enterprise to failure. It is a mistake to define goals and paths at the outset and to then follow the script regardless of what ensues. On the basis of almost 40 years observing government reforms in many venues, this writer would argue that the failure to systematically evaluate what has been accomplished is one of the greatest threats to durable innovation in public management. Over the years, in many countries management reforms have tended to live an examined life. They typically begin with much fanfare, but after a decent interval, most just fade away or are displaced by the next wave of reform. There are notable exceptions to this generalisation, however. In countries that have advanced the farthest in rebuilding public management, the early innovations have been rigorously assessed and recalibrated. New Zealand is a case in point. It is often said of that country's far-reaching reforms that they were propelled by a coherent, integrated set of principles. True enough, but a large number of the practices that now distinguish New Zealand's public management were not in the first tranche of state sector reforms. Purchase agreements came later, as

did strategic and key result areas, departmental forecast reports, strategic plans and efforts to assess the government's interest as owner of state entities. The constant in New Zealand's reform has been the purpose of change, not the toolkit of management practices. In New Zealand and elsewhere, the best strategy may be to set course at the start, forthrightly monitor progress, be honest about what has worked and what has not, and make numerous mid-course corrections.

Doing all this requires effective leadership. Successful reform does not just happen by itself; it depends on leaders who exploit openings and give impetus and direction to change. Strong leaders do not just "read" opportunities; they make them – by moulding public opinion, bringing new blood with new ideas and initiative into government, reaching beyond safe and traditional constituencies to build coalitions in support of change and by taking political and managerial risks that broaden the possibility of change. Strategic reform requires this and more: leaders who venture beyond today's opportunities and constraints and boldly envision a different future, who then mobilise the political and institutional resources of government to produce transformative improvement in the structure and performance of public organisations and who bolster support for their strategy by elevating public expectations concerning the results that government delivers.

Strategy without opportunity cannot advance the cause of reform very far. Without favourable conditions, strategy becomes visionary, lofty ideas that have little prospect of being implemented. Indeed, without the right opportunity, strategy can end up as a substitute for action, fostering the impression that big changes are underway even though no implementing steps have been taken. On the other hand, opportunity without strategy is likely to exhaust itself in faddism, drifting from one fashionable innovation to the next, without leaving a lasting imprint.

Tactics blend together opportunity and strategy to enhance the odds that intended changes will be successfully implemented. It entails judgements on the pace and sequence of innovation, the organs that should be entrusted with the task, the sectors on which reform is to be concentrated, the political cast given the reforms, the extent to which the government associates or distances itself from the changes, decisions on whether to proceed by administrative fiat or through legislative authorisation, and many other implementation decisions. A good tactician considers how strategy can best be executed in the light of available opportunities. Tactical skill requires institutional memory, a keen sense of timing and hard-nosed decisions on the approach to be taken.

Although management reform must be a blend of opportunity and strategy, the proportions matter. During the post-war period, management

reform was predominantly opportunistic; during the past two decades it has become increasingly strategic. There is a synoptic ambition in contemporary reform that was absent in earlier waves of innovation. Today's reforms are bolder, more uprooting, more goal-driven and more animated by the conviction that management has to be transformed and improved in order to strengthen democratic governance. The shift in orientation has been due to many factors, the most prominent include declining confidence in government, upheavals in management theory and business practices, revolutionary developments in information technology, pressure to devolve resources and responsibility from central organs to local governments and field units, efforts to slow or reverse the enlargement of government, and most important of all, in an age in which citizens expect more from government but think less of it, business-as-usual management is not good enough.

1. The roads not taken

Whether opportunistic or strategic, there are significant differences between today's reforms and those tried in earlier times. The generalisations set forth in this and other sections do not fit all countries. Some countries have been more opportunistic, others more strategic. Nevertheless, the paths they have taken are different from the ones favoured in previous reforms.

1.1. Contemporary reform is more likely to be comprehensive than piecemeal

It is not confined to a few institutions or a single process. The aim is to uproot entrenched management practices and behaviour, not just to upgrade the civil service system or budget procedures. Even when implementation is spread over an extended period, as has been the case with the United Kingdom's Next Steps Initiative, the comprehensive reach of the reform agenda is manifest at the outset.

In striving to restructure public management, some governments have resolved to reform all major sectors and administrative units. Others, however, have opted to pilot test their reforms before deciding on full implementation. Germany, for example, tested flexible budgetary management arrangements before it enacted legislation that authorised the new practices. Similarly, Sweden conducted a closely monitored test of three-year budgetary procedures before launching comprehensive management reform.

Often, however, pilot testing slams the door on further innovation, for it conveys the message that the government is not really committed to reform or is uncertain about the direction it should take. The key to successful pilot tests

that promote innovation is for the government to establish a strong commitment to reform in advance by specifying the steps it will take when the tests have been completed to revamp management systems and practices.

1.2. Contemporary reform is not confined to particular administrative processes

For generations, management reform has been compartmentalised along the main lines of public administration. One set of reforms has sought to rationalise budget decision-making, another has targeted civil service practices, still others have sought to improve public procurement, cash management, accounting systems or other parts of the machinery of government. In this way, activities that should have been linked were cordoned off into separate specialisations. Accounting reform proceeded on one track, budget innovation on a second, advances in auditing on a third. One group of reforms aimed at raising productivity, a second experimented with performance budgeting, a third introduced performance audits. The obvious interdependence of these isolated reforms were neglected because the principal aim was to improve a particular process, not to lift managerial capacity.

Not surprisingly, reforms that concentrate on particular tasks rather than on managerial systems and behaviour rarely make much headway. Budget reform is a case in point, for it has been premised on the mistaken notion that the process by which funds are allocated can be revamped without taking account of the information generated by the accounting system, the demands made by auditors, the incentives provided by civil service rules and other administrative procedures, the embedded habits and norms or budget makers, the interface between managers and politicians and numerous other managerial considerations. In much contemporary reform, by contrast, budgeting is regarded as part of a grid of interconnected practices and processes. Budgeting cannot be reshaped without also restructuring the management framework within which financial resources are spent and activities carried out. The same can be said for reforming the civil service and other basic management systems.

1.3. Contemporary reform seeks to devolve rather than concentrate managerial authority

Reforming public management impels governments to assess and modify existing organisational structures. The assessment might lead to the establishment of new entities, a redefinition of organisational boundaries and responsibilities or the elimination of some units. But there is a marked difference between the restructuring favoured in the not-so-distant past and some contemporary realignments. Once, reformers sought functional

integration by consolidating related programs and activities in the same department. All educational activities were grouped in a Department of Education, transportation services in another department, the provision of health care in a third, and so on. This made for a small number of big departments, as well as for the concentration of managerial resources and authority at the centre of each department. Inasmuch as there is no perfect functional alignment, the quest for integration led to frequent reorganisation.

This type of reorganisation still occurs, as in Australia's consolidation of its departments into broad portfolios during the 1980s. But the main thrust these days is in the opposite direction – breaking up functionally integrated, multi-purpose departments into a number of service delivery entities, each with a clearly defined mission, operating independence and performance targets. There are two main reasons for decoupling services and operations. On the one hand, large departments that are structured as holding companies for loosely related activities tend to be top-heavy, slow-moving and inefficient entities that have high operating costs, quash innovation and give managers muddled messages as to the performance expected of them. On the other hand, in functionally integrated departments, service providers “capture” policy-makers, feeding them advice that blunts innovation and weakens accountability.

In the decoupled model, core departments retain important functions in policy-making and advice, setting standards and targets, and overseeing the performance of operating agencies. This form of organisation is still quite new and not enough experience has accumulated to assess its long-term effectiveness. Already, however, concern has been voiced that departments may have been weakened to the extent that they cannot carry out essential co-ordinating functions. It may be that in the enthusiasm to liberate operating managers, inadequate attention has been given to the resources and authority needed at the centre of government and in departmental headquarters to rationalise programs and policies that cut across agencies and to maintain strict accountability.

1.4. Contemporary reform relies on incentives, not just formal rules, to change behaviour

In traditional administrative reform, it is often assumed that changing formal rules suffices to alter the actions and performance of managers. This presumption is rooted in the command and control model of public administration, in which central authorities promulgate and enforce rules and subordinates comply. But a succession of failed reforms and new theories and evidence in business management, institutional economics, organisational theory and related fields have driven home the message that informal rules and managerial incentives must be changed in order for a high-performance

managerial ethic to take hold. Changing the formalities does not make much of a difference if the self-interested behaviour of managers sabotages organisational objectives.

Many governments have concluded that the best way to motivate managers to improve performance is to set clear and reachable performance targets, give managers sufficient flexibility so that they can improve operations and hold them personally and organisationally responsible. This orientation dominates the strategic reform agenda.

1.5. *Contemporary reform is concentrated on operations and service delivery*

In line with the emphasis on modifying incentives and behaviour, the focus has shifted in many countries from strengthening policy-making to upgrading line operations, the delivery of services, the productivity of the public service and the responsiveness of government to the interests of citizen/customers. Top-down reform inevitably leads to “one size fits all” rules which circumscribe operating discretion and deter field managers from tailoring their services to suit local conditions. In top-down reform, the relationship between the centre and operating units is hierarchical, the former make policy, set the rules, issue orders and demand compliance; the latter are supposed to carry into effect the policies handed down to them and produce the information demanded by superiors.

Top-down administrative structures have serious shortcomings: they demand compliance and uniformity when flexibility and diversity are called for; they stress inputs and neglect results; and they spur managers, who have a job to get done, to evade or subvert the rules. Beneath the veneer of rule-based public administration an informal managerial ethic flourishes, softening the rules and loosening the rigidities. Entrepreneurial managers devise means of outwitting the controls while paying lip service to them. They manage to travel even when the travel budget is depleted, fill positions when a hiring freeze is in place, procure IT without going through central procurement, and so on. The problem with this behaviour is that many managers spend more time evading onerous controls than driving their organisations to higher performance.

1.5.1. *Opportunity*

The fact that many countries have similar reform objectives suggests that the opportunities are not entirely dependent on local situations. Some opportunistic conditions cross country boundaries, others do not. This section considers both types of opportunity.

1.5.2. *Timing*

Opportunities come and go. For some reforms, the right time has arrived, for others it has already passed. During the 1990s, Canada appears to have had significant success in rigorously reviewing its programs, but it made little headway when it undertook to rationalise its programs through the Public Expenditure Management System (PEMS) during the 1980s. Of course, there are material differences between the current and the previous approach, but they do not fully explain why one innovation has promoted the realignment of government program expenditures while the other one had little to show for the substantial investment made in it.

Innovations yield different outcomes, depending on when they are tried. The saying, “an idea whose time has come”, applies as much to government reform as to other innovations. Two decades ago, Canada invested heavily in building evaluation capacity in the Comptroller General’s office. It is generally thought that the impact on program and budget decisions was modest. About a decade later, Australia launched an ambitious evaluation strategy that has made a measurable difference in the reallocation of resources. Arguably, Canada learned from its earlier PEMS experience and has undertaken program review in a more effective manner, and Australia learned from Canada’s failure to implant an evaluation culture. But this cannot be the sole explanation of the earlier failures and later successes. Just about every country that tried to build a formal program analysis and review system in the 1960-1990 period failed. The Netherlands made little progress with a reconsideration effort that involved the Cabinet in selecting programs for re-examination; Sweden had little results from program budgeting, the United Kingdom installed and then discarded a program analysis and review system, the United States adopted an ambitious planning-programming-budgeting system, and other countries also introduced similar innovations. In my view, the earlier reforms may have been premature: voters and politicians were not yet convinced of the compelling need to halt the growth in government spending and to reallocate resources from lower to higher priorities. Although program reallocation still is difficult, the political mood of today has been much more hospitable to efforts to rearrange government programs and expenditures than it was during the post-war growth spurt.

1.5.3. *Government*

Elections and changes in government open or narrow opportunities for management reform. In fact, major changes in government organisation or programs often are launched by new governments shortly after taking office. The British reforms were initiated shortly after Margaret Thatcher became Prime Minister in 1979; they were extended (by means of the Citizens Charter)

a decade later by John Major shortly after he became Prime Minister, and redirected by Tony Blair after his election in 1997. Australia, New Zealand and Canada also adopted reform agendas shortly after new governments were inaugurated. Several factors explain the impulse to innovate at this stage in the political cycle: i) a new government is more inclined to change course than one which has held power for an extended period; it also has the energy and fresh ideas to break new ground; ii) when the old government is defeated at the polls, the election may be regarded by the successor government as a mandate for change; iii) in coalition governments (such as the Netherlands) the process of forming the government often entails negotiations among the coalition partners as to the policy changes and reforms to be undertaken. There definitely has been a trend to more detailed coalition agreements which spell out what the government will do during its tenure; iv) an incoming government may confront a crisis that requires immediate attention and makes big changes politically attractive.

One election does not make for lasting reform. Basic reforms that uproot established practice must have staying power beyond a single election, and preferably beyond a single government. The countries that have made the most headway in restructuring public management are those in which the reform process has been carried forward and deepened by successive government. Moreover, reforms are most likely to endure when they survive a change in government from one party (or coalition) to another.

In many countries, basic reforms started by one government have been continued by the next. A shift in political orientation from left to right, or in the opposite direction, has not interrupted the reform process. Perhaps the most interesting case of reform surviving political change has occurred in the United Kingdom, but the same pattern is found in other countries as well. The Thatcher-Major management reforms would be of little current interest if they had not been continued and extended by the Blair Government.

Political orientation has not been a reliable indicator of the pace or direction of reform. New Zealand's Labour Government introduced market-oriented reforms following its election victory in 1984. In some countries, a centre-right government has promoted management change; in others, a social democratic government has taken the initiative. Regardless of their political affiliation, ministers and senior civil servants have supported the drive for management improvement. Their leadership has spelled the difference between reform that is stillborn and reform that transforms the public sector.

1.5.4. *Ideas*

When leaders innovate, they often are propelled by powerful ideas that give them confidence that what they are doing is the right thing. Significantly,

however, ideology does not play a role in contemporary reform. Today's political leaders are looking for ideas and practices that promise to improve the services government is providing, not to redefine the role and purpose of government. They do not have to be *avant garde* to innovate; they can draw from a body of developing and accepted ideas concerning the organisation and operation of the public sector, including the following:

- Performance improves when managers are told what is expected of them and results are measured against these expectations.
- Performance improves when managers are given flexibility in using resources to carry out assigned responsibilities.
- Performance improves when operational authority is devolved from central agencies and departmental headquarters to operating levels and units.
- Performance improves when government decisions and controls focus on outputs and outcomes rather than on inputs and procedures.
- Performance improves when managers are held accountable for their use of resources and the results they produce.

Not all reform ideas are as widely accepted as those listed above. Some still are contested or untested. These include propositions that performance improves when: a) citizen-customers have choice in selecting the supplier; b) government services are out-sourced; c) public organisations are run along business lines; or d) service delivery is separated from policy-making. Although not all contemporary management ideas have been widely applied, this writer agrees with the observation of B. Guy Peters that "contemporary reforms are driven by ideas. ... This characteristic distinguishes the current round of reform from some of the tireless tinkering that has tended to characterise administrative reforms." As we shall see, ideas in currency have provided the strategic underpinning for transforming public management in industrial democracies.

1.5.5. *Innovators*

Ideas rarely sell themselves; they need promoters with sufficient authority to persuade leaders to risk new approaches. In the past, the reform agenda in many countries was set by special commissions or task forces established to study particular issues or problems. Typically, the commission would produce a well-publicised report containing a number of recommendations and then turn the implementing job to existing government organs. Some countries still draw innovative guidance from *ad hoc* entities, but the more likely source these days is from within government itself. The senior civil service has been a fertile source of reform ideas. Ireland describes the role of the senior civil service in the reform process.

In every country, the innovators have come from political echelons or the top ranks of the public service, not from operating levels. Strategic reform has not bubbled up from below, nor should it be expected to. The broad scope of reform requires perspectives, and power that are held either in central agencies or departmental headquarters. Top-down, reform, however, runs into problems if it is perceived by subordinate units as just the latest exercise in administrative centralisation.

1.5.6. Crisis

In public management, as in other endeavours, crisis can be a spur for change. When leaders become convinced that the course the country is on is unsustainable, they may embrace remedies that would not be tried in normal times. At least two countries (Finland and New Zealand) went through a serious economic crisis that called into question established policies and practices; at least one (Norway) has not experienced any significant crisis. Most of the countries have been impelled by a progressive erosion in confidence that the course they were on – progressive enlargement in the relative size of government, steadily rising tax burdens, stagnant or declining productivity in public institutions, and (in a few countries) a perceived decline in the public service performance – could be sustained. In other words, decline rather than crisis has been the number one motivating factor.

1.6. Strategy

There are many paths to management reform, that different governments have pursued similar objectives in different ways. This is not surprising, for management reform must comport with a country's political administrative values and traditions. In fact, one can discern as many strategies as there are countries, for even countries proceeding along the same general path combine elements of various strategies in different ways. Without claiming to be comprehensive, this section discusses four strategies: market-driven reforms that rely on competition, prices and contracts; managerial reforms that rely on the professionalism, skill and public service ethic of managers; program review which relies on policy analysis and evaluation to reallocate resources and redesign programs; and incremental deregulation that relies on ongoing review of rules and practices to streamline management and remove wasteful controls. The four approaches have some important common elements. All strive to make public services more efficient and responsive; all seek to strengthen accountability for results and resources; all encourage greater variety and flexibility in the provision of services. But even when they share objectives, the four strategies proceed differently. A market strategy would lead government to divest certain tasks or activities; it would favour the most efficient (or least expensive) supplier, even if the

outcome was a truncated, weakened civil service. A managerial strategy, by contrast, would seek to strengthen public service norms by giving rank and file civil servants a greater voice in running operations and in accommodating variations in local conditions. A program strategy seeks to optimise social outcomes by shifting resources from lower to higher priority programs. An incremental strategy looks for opportunities to deregulate and ease management rules.

Underlying the various strategies are different conceptions of the future role of the state. The market strategy draws a sharp distinction between the state as policy-maker and the state as service provider. It has a strong preference for living off the delivery of services to non-governmental entities or to operationally independent agencies. The managerial model allows a broader role for government in providing public services but wants these activities to be less hobbled by bureaucratic rules and more sensitive to the wants of recipients. The program strategy envisions a state whose primary responsibility is producing desired social outcomes within severe resource constraints. The incremental model seeks a state which continues to function along familiar line, but is less burdened by old rules and requirements.

Each country can be slotted into one or more of these categories. Some classifications are straightforward. The main thrust of New Zealand's reforms has been to establish market-like arrangements and incentives within government. Canada has pursued a program-oriented strategy and has made considerable progress in aligning public expenditures and program results. Germany has maintained an incremental approach for an extended period, making frequent adjustments in rules and operations to improve management. Ireland and several other countries have emphasised managerial reforms.

These classifications conceal an important feature of reform: most countries pursue more than one strategy. Each country's hybrid is distinctive. The United Kingdom, for example, has both market and managerial innovations; Canada uses both program and managerial strategies. In every country, however, one strategy usually is paramount. A country seeking to enhance public performance may turn to markets for some purposes and to public managers for others; it may also review program commitments in the light of political demands and resource constraints.

If the applications are hybrids, why be concerned with defining and classifying strategies? Why not consider each country's bundle of innovations on its own terms without fitting it into pre-set categories? The answer is that each strategy raises particular questions which should be addressed in assessing the prospects for success. In the market strategy, one must ascertain whether true conditions for competition have been established. Just labelling

something a market or a contract, or assuming that the means of providing a service is contestable does not make it so. In the managerial strategy, the key issue is whether adequate accountability mechanisms are established. In the program strategy, the key issue is whether government has the political will and strength to allocate resources and take other actions on the basis of a fundamental review of programs. And, finally, in the incremental approach, the overriding question is whether government can sustain interest and support for reform over an extended period. If these key questions are not addressed in a forthright manner, reforms that showed much promise at launch may fade away, leaving few traces that they were ever tried. This was the fate of many past management reforms; thinking strategically can help avert a similar fate for current and future reforms.

1.6.1. The market strategy

“If there is a single alternative to the traditional model of public administration favoured by contemporary politicians, academics and probably the public,” Peters writes with some overstatement, “it must be the market model.” Market-type arrangements have penetrated core public services in some OECD member countries, but not in most, and not everywhere in the same manner. Political culture has a role in shaping both receptivity to market-oriented solutions and the type of solution adopted. A fair assessment of management reform would conclude that marketisation has been much more widely applied in state enterprises and business-type activities than in basic public functions. For example, education still is publicly financed and provided in virtually all countries, and the use of market-type devices such as vouchers or alternative schools still is quite limited, though more extensive than a decade ago. In the core public sector, it has proven exceedingly difficult to establish true markets in contrast to simulated ones.

In this writer’s view, the main contemporary influence of business practices on government management innovation has not been in generating competition but in changing the concept of public organisations. For decades, the vertical integration of firms (internalising the production of components) was paralleled in the public sector by the functional integration of departments (combining in the same entity the various programs contributing to the same objective). Vertically integrated firms were as layered, hierarchical and bureaucratised as big government departments. In both, command and control systems ran from the top to the bottom and uniformity and compliance were enforced by central controllers who wrote the rules and monitored the actions of subordinates. Nowadays, however, vertical integration is widely regarded as rigid and inefficient and many large firms have been reorganised into semi-autonomous business units which outsource much of their production. A number of governments have followed suit,

breaking up integrated departments into small units and contracting out some functions.

Although the market strategy affects the form of government organisations, its principal objective is to create markets within government. This model is predicated on the expectation that consumer choice and competition will drive service providers to be more efficient and responsive. But competition and choice operate in two distinct domains: one is in the relationship between customers and suppliers, the other is in the relationship between government entities purchasing and providing services. The two types of markets – one external, the other internal – give rise to different issues. External markets, such as are created when government operations are privatised or contracted out, or when citizens are given the option of selecting their providers raise questions concerning the adequacy of information available to consumers, the differential impact of choice on the affluent and the poor, and the transaction costs of empowering consumers to select providers. Deeper concerns pertain to whether marketising public responsibilities might crowd out important social values such as equality and uniformity in the provision of services, a public service ethic and the sense of citizenship that one develops through government-provided education and other basic services.

Internal markets raise more complex questions, though ones not likely to receive as much attention because they involve transactions within government. These internal transactions may include the purchase of services by government or ministers from departments, purchases by departments from line or field units and purchases by departments from autonomous agencies. Even when the trappings of markets, such as contracts and prices, are introduced, the fact remains that relationships within government are not truly arm's-length. And because they are not, the gains from competition may be illusory rather than real.

New Zealand, which has advanced much further than any other country in establishing internal markets relies on a network of contracts to formalise relations between in-house purchasers and providers. It has performance agreements for department heads, fixed-term contracts for senior and middle managers, purchase agreements for ministers to contract for services at agreed prices from departments, and contracts by which departments purchase services from other government entities. A number of structural and operational changes have been made to institutionalise the contractual relationship, including: *a*) ministers have a free choice to purchase services from departmental or other sources; *b*) the outputs to be produced are specified in advance; and *c*) fulfilment of the terms of the contracts if monitored through reports and audits.

There is no doubt that New Zealand has been extraordinarily creative in building contracts into government. No other country has extended contractual relationships into so many areas of public management and program operations. But as creative as New Zealand's internal markets are, they may be weak substitutes for genuine markets. Real markets have actual rather than just potential contestability; real markets specify the unit cost of outputs, not just total costs; real markets allow redress if the contract has been breached. Several questions need to be considered in appraising the robustness of internal markets. To what extent do ministers actually purchase services from the outside sources rather than from government entities? Have ministers cancelled contracts because they were dissatisfied with internal suppliers? Is the amount paid by the government adjusted if the volume or quality of outputs varies from the contracted terms? What recourse does the government have if internal suppliers fail to fulfil the terms of their agreements? Do government departments have the requisite skills to negotiate contracts and monitor compliance? What are the transaction costs of maintaining an extensive network of contracts? What evidence is there that organisational performance has been improved? The answers to these questions should shed light on the suitability of a market strategy in other countries.

1.6.2. *Managerial strategy*

This strategy is predicated on the presumptions that "letting managers manage" by liberating them from *ex ante* controls on inputs and operating procedures maintained by central controllers (especially with regard to human and financial resources) boosts organisational performance. The driving assumption is that public managers want to do a good job, they are committed to the prudent and efficient use of public money, they care about the quality of services and whether recipients are benefiting, and they have a strong public service ethic. But, the argument runs, they have been held back from doing their best by rigid rules which enforce uniformity and retard managerial initiative. Take away these assumptions and "letting managers manage" injects a dangerous permissiveness, an "anything goes" mindset into the conduct of public business. Worse yet, it gives opportunistic managers license to pursue their self-interest at the expense of the government or citizens.

The management strategy sweeps away practices that once were regarded as bulwarks of rule-based public administration. At one time, standardising rules and procedures was regarded as a signal advance in government. All agencies were required to budget the same way, all had to abide by the same rules in hiring and paying civil servants, all were subject to the same procedures for buying goods and services, arranging

accommodations and travel, and so on. The bulging rule books were regarded as *prima facie* evidence of sound administrative practices; line item budgets dictated the number and cost of the myriad things purchased by spending units. Just about everything that cost money had its own rules and enforcement procedures. The fact that the rules circumscribed administrative discretion was regarded as a virtue, for civil servants could not be trusted to do the right thing on their own. They had to be monitored and controlled. Upholding the legality and propriety of administrative actions through central control, was the foremost objective of public administration.

The managerial ethic argues, however, that whatever laudable purposes the control regime may have served in the past, it has become counter-productive. The controls impel managers to care more about inputs than outputs, more about procedures than results, more about complying with the rules than on improving performance. A managerial strategy strips away most centrally enforced controls. One approach is to selectively discards rules and procedures that appear to be the latest, useful or most onerous; another is to broad-band various administrative rules (for example, reducing the number of civil service or budget classification). The fullest expression of managerialism is to give managers global budgets, with discretion to use the resources as they deem appropriate. In this arrangement, managers have a fixed budget for operating (or running) costs, they must keep within that budget, but they have freedom to decide how much to spend on salaries, travel and other expenses. They may still be required to comply with some residual rules concerning, for example, fair employment practices and competitive tendering of contracts. But most operating decisions are left to the discretion of managers. They no longer need advance approval from central controllers.

Many countries have elements of a managerial strategy in their administrative reforms. This includes the United Kingdom, Germany, Finland, Ireland and the Netherlands. Some of these have taken bold steps to devolve managerial discretion to the operating levels which provide direct service to the public; others still retain significant managerial authority in departmental headquarters.

In explaining the broad of appeal of managerialism, one is struck by a seeming anomaly. The present age is one in which trust and confidence in government is at a low level in many OECD member countries. Yet the managerial strategy depends on entrusting managers with greater discretion, on trusting them to be prudent, efficient and responsive in carrying out their responsibilities. What is the rationale for broadening managerial freedom at a time when there appears to be little confidence that managers will act in the public interest? Some governments feel that declining (or stagnant) operating budgets and a sense that the old controls do not work give them no choice but to loosen constraints on managerial discretion. Others believe that improved

performance will come with managerial freedom and will boost confidence in government. Whether because of the first motive or the second, today's governments take the position that the easing of controls must be accompanied by a strengthened accountability framework for managers. A vital part of the managerial strategy is the *ex ante* specification of performance targets or expectations and the *ex post* review of actual performance. "Letting managers manage" must be linked to "making managers manage."

The jury is out on whether investing in managerial performance will be repaid with higher trust and confidence in government. This writer is of the view that the low esteem of government has less to do with objective performance than with rising demands on government. It may be that when citizens want and get more from government, they nevertheless remain dissatisfied that they are not getting enough.

Like the other strategies discussed in this paper, the managerial strategy opens the door to difficult questions as to whether the reforms have, or are likely to, yield the expected results. One area of concern is the link between "letting" and "making" managers manage. It is much easier to fulfil the first part of the bargain than the second. It is much easier to remove controls than to enforce accountability. In fact, accountability frameworks – the specification of targets, reporting on results and audit of performance – still are relatively undeveloped in a number of the countries pursuing a managerial strategy.

The managerial strategy relies extensively on performance measurement. While considerable advances have been made in defining various types of measures, there is at best sketchy evidence that the behaviour and performance of managers has been significantly influenced by the new information. It is one thing to measure performance, quite another to manage on that basis. Moreover, most governments relying on a management strategy have had more success in measuring outputs than outcomes and they have tended to devise measures that put their performance in a favourable light. They generally have shied away from measures that challenge them to overhaul operations or to significantly raise their level of performance.

The managerial strategy relies on the assumption that civil servants are committed to the public's interest rather than their own. But are they always? What safeguards are there when self-interest takes over, when government employees behave opportunistically, exploiting their discretion to do as they please?

These concerns do not call the managerial strategy into question. Rather they indicate the need for careful assessment of what has been accomplished under the new regime, how managers have actually behaved and the effectiveness of the accountability mechanisms put in place.

1.6.3. Program strategy

This strategy is built on the idea that the most urgent task in reforming the modern state is ensuring that public resources are effectively allocated to achieve the fundamental objectives of government. From this perspective, the two previously discussed strategies – turning various tasks and responsibilities over to market-like institutions and entrusting managers with operating discretion and holding them accountable for results – apply mostly to the operational work of government. The program strategy urges that defining objectives and establishing policy should be accorded higher priority.

This is an old issue that will not be settled in the current round of reform. The issue is contested on many fronts: outputs *versus* outcomes, efficiency *versus* effectiveness, doing the right thing *versus* doing things right, centralisation *versus* devolution, top-down *versus* bottom-up reform, and so on. In the past, the emphasis was on strengthening policy capacity at the centre of government or in headquarters; today, most countries are focusing on operational matters.

Can the two approaches be melded together? Yes, but they rarely are. For most governments it is hard enough pursuing the limited reforms that one or another of the strategies dictates. Canada is one of the few, however, that has taken an eclectic approach, combining a substantial commitment to program review along with a wide-range of management initiatives affecting service delivery, citizen participation, deregulation, the civil service, financial management and a number of other administrative practices. But program review has been the centrepiece of the Canadian reforms. It was launched in 1994, at a time when the country faced serious financial and budgetary pressures. As one Canadian colleague observes, “program review addressed not only *pragmatic* questions of program design and delivery, but more fundamentally, *fundamental* questions of the role of the federal government, which anchored the ensuing changes to programs.” Although program review has not formally covered transfers to individuals or other levels of government, these have been separately reviewed in a parallel exercise.

Canada’s program reviews assessed each ongoing program in terms of six questions: does it serve the public interest?; is there a necessary and legitimate role for government?; is the current role of the federal government appropriate?; should the program be carried out, in whole or in part, by the private or voluntary sector?; if the program is continued, in what ways can it be improved?; and is the program affordable within the fiscal parameters of the government?

Canadian officials strongly believe that the reviews have made a significant contribution to the country’s successful fiscal consolidation. When the reviews were initiated, the federal government seemed hopelessly mired

in oversized budget deficits; barely four years later, the government reported that it had balanced the budget. Although the bulk of the reviews were concentrated in the first years, the government has taken steps to institutionalise the process and link it to expenditure decisions. Toward this end, it has established an expenditure management system to feed the results of reviews into budget actions. Learning from the unsuccessful program expenditure and management system tried more than a decade earlier, the government has built strong reallocation requirements into the new system with few exceptions, program initiatives have to be funded through savings in existing programs.

Some reform-minded countries initially focused on service delivery and operational efficiency and over time broadened their perspective to review program effectiveness and outcomes. Thus, a decade after launching the Next Steps initiative, the United Kingdom undertook a series of fundamental reviews. Canada, however, has moved in the opposite direction. After consolidating its fiscal position through program reviews and other policy changes, it set into motion more than half a dozen initiatives aimed at strengthening managerial capacity.

In considering the program strategy, one must be mindful of past efforts to link strategic objectives to budget allocations. These efforts include Canada's PEMS system mentioned earlier, PPBS in the United States, and the reconsideration program in the Netherlands. None was successful, though each had a temporary impact on budgetary procedures and decisions. Truly fundamental program review requires an enormous amount of time and information, fuels conflict and often produces relatively modest reallocation. It has been difficult to integrate in-depth reviews with the ongoing routines and procedures of budgeting.

Why should the results be more favourable this time? Perhaps because countries have learned from past failures, perhaps because there now is a stronger commitment to contain the cost of government by weeding out ineffective and low priority programs. In looking back at the PEMS failure, the Canadian Government perceived that while the allocations to envelopes (sectors) were supposed to be ceilings, they often were regarded as floors, adding to pressure on public expenditure. This time, therefore, the program review progress is much more explicit in demanding reallocations within fixed budgets. Moreover, contemporary program review does wrestle with fundamental questions that were slighted in earlier periods. These pertain to the role and functions of government, its relationship with the private and voluntary sectors and the future affordability of commitments undertaken when public resources seemed to be more abundant and confidence in public institutions was higher. The times may be ripe for a strategic realignment of government objectives and programs. If they are not, the program strategy will

not make much of a difference; if they are, the results will be different this time.

1.6.4. *Incremental strategy*

Mounting any of the strategies discussed thus far entails a substantial commitment of political and organisational resources and (in some cases) a leap of faith that the innovations will bring promised improvements. Understandably, therefore, some countries have taken a cautious approach, moving incrementally as opportunities become available. The obvious advantage of this approach is that particular reforms can be adopted when they seem the right thing to do and the reform process can be fine-tuned as circumstances and opportunities change.

German reform seems to fit this model. Whether because its federal makeup inhibits leapfrogging innovation or because the government has been preoccupied with unification, the country has adopted a series of measures aiming to streamline the state and reduce costs. There have been doses of privatisation and deregulation, new requirements that proposed legislation show projected costs, reductions in the number of federal ministries and in other federal entities, new management instruments focused on measuring costs and performance, and some efforts to decentralise responsibility for resources. These and other initiatives have been packaged into an “action program” to increase the effectiveness and economic viability of the federal administration. The aim of the reforms is to reduce the size of the state by identifying tasks which can be transferred to subordinate authorities or the private sector, or abolished altogether.

Germany notes that comprehensive reform of administrative apparatus was attempted in the 1970s, but many of the proposals made at the time were not implemented. The current modernisation program, by contrast, emphasises constant improvement. It “is carried forward in small steps (mosaic theory) and is not based on a holistic approach. Accordingly the ministries follow different concepts for their modernisation measures. ... If one tried to reform all elements of public administration which require change, it would be too time-consuming and demanding. ... A step-by-step approach is therefore necessary.”

Incremental reform has several potential drawbacks. One is that the many small steps might not add up to significant change; another is that reform will be directionless, propelled by expediency rather than by strategy; a third is that government may lose interest in the endeavour along the way. Incremental reformers who take one step at a time and allow the last step to determine the direction of the next one, can produce a lot of motion that signifies little. It is important, therefore, that incrementalists clarify at the

outset the aims of their reforms. It is also important that the reforms show sufficient progress to sustain support and an interest in government, and that they build on one another. The fact that Germany had the same government for an extended period may explain the staying power of its reforms. In some countries, the government of the day has lurches from one reform agenda to the next, without integrating the various initiatives into a coherent strategy.

1.7. Tactics

No strategy is self-implementing. As it embarks on a course to transform public management, a government faces myriad decisions on how the reforms should be carried out, by whom and when. It also must take steps to build support for, and interest in, the reforms. These and related tactical considerations often dominate the reform agenda; in some cases, they spell the difference between robust and tepid progress. This section briefly discusses a few of the many tactical issues that a government faces in implementing a reform strategy.

The pace and scope of reform are common tactical issues. One option mentioned earlier is to test-pilot all or some elements and defer decisions on full implementation until the results have been evaluated. At the other extreme, the government may mandate comprehensive implementation by all departments and agencies. Still other options are to implement reforms according to a staggered schedule (some agencies or elements the first years, other the second, etc.) or to allow each department to decide the extent and timing of its participation.

There appears to be less test-piloting in the strategic reforms than in past waves of reform. However, some governments have given departments discretion on restructuring their management practices. The rationale for this permissiveness is that management reform cannot succeed unless operating departments welcome the changes and have a say in how they are implemented. If reforms are forced on departments, if they are committed to the prescribed changes or if they feel that the changes do not meet their needs, only meagre improvement will be forthcoming.

Even when departments are entrusted with wide discretion in implementing recommended reforms, the government may consider assigning oversight responsibility to an existing central agency or an *ad hoc* entity established to fill this role. The finance department is the obvious candidate for this role, but not always the most appropriate. Its control of the purse strings can get in the way of encouraging managers to improve performance. But if the role is entrusted to a rival unit, the finance department may try to undermine the reforms.

In developing a reform program, the government may proceed by administrative fiat or it may seek legislative authorisation. Most governments have taken the first course, preferring the flexibility that administrative action gives them. A few, most notably New Zealand, have embedded their main reforms in law. But even countries that have taken the second course have found it necessary to make adjustments outside the ambit of the legislation. They have had to experiment and adapt in order for the reforms to be sustained.

Many tactics are country-specific and generalisations about the most effective approach are questionable. What works in one country might not in another. Perhaps the best advice one can offer on tactics is for the government to invest reform with sufficient institutional resources and political support, to have a firm idea of where it is heading, and to keep an open mind on how it should get there. If the current wave of reforms has stayed around much longer than previous ones, it is because governments have been adaptable and tactics have been moulded to needs.

1.8. *The path ahead*

Strategic reform takes time. Most of the countries participating in the project have been at it for a decade; the British Government is completing its second decade and much additional work and innovation lie ahead. In fact, there is no real end to the task of improving public management. As new problems arise and as novel ideas displace old ones, governments redefine their expectations. Successful reforms open up fresh opportunities, failed reforms impel governments to go back to their drawing boards and try again.

Regardless of the progress made thus far, all reforming countries face the task of institutionalising the changes they have made and preparing for the next generation of management innovations. All have to guard against lapsing back to their old ways, while building in capacity for continuing improvement. Most still have to work out an acceptable balance among the various strategies. All have to reconsider the role of central agencies and their relationship with operating units, and all have to strengthen the means of maintaining managerial accountability.

Beyond the current agenda lies a melange of issues and possibilities pertaining to the future configuration of public management. The leading questions here deal with the impact of emerging information technology on the delivery of public services, the potential for changing relations between citizens and state, the future makeup and role of the civil service, the boundaries of the market and public organisations, and the extension of the logic and instruments of performance management into core areas of governmental service. Although the distinction between current issues and the future agenda is somewhat arbitrary, it is useful to distinguish between

those reforms that lie within the current interests of national government and those that might emerge in the future. There is a high probability that just about all reformist governments will tackle the current issues, but a significantly lower probability that they will deal with potential future issues.

1.8.1. Reversion to control and compliance public management

No matter how much progress a government had made in dismantling traditional control mechanisms, it must be vigilant against retrograde reforms that restore the old order. The main risk is not that governments will throw their management innovations overboard and re-install discarded practices, but that in piecemeal fashion they will impose rules and procedures in response to particular problems. Relapse might be due to an actual or perceived abuse of managerial discretion, parliamentary demands for information and controls, or the unease of risk-averse public managers with performance-based systems. Each re-installed rule or requirement may be justified in its own right, but the cumulative impact may be to reintroduce compliance-centred management.

It is not easy to guard against a return to the old ways. There are two main approaches for dealing with this tendency. One is to concede that there is a natural inclination to add controls, and to periodically review the rules and purge those which are deemed redundant or inapt; the other is to institutionalise the precepts of managerial discretion and accountability in law and behaviour so as to discourage inroads. The first path bows to the inevitability of recentralisation, the second seeks to thwart it.

1.8.2. Continuous improvement

Improving public management should not be a one-shot affair, done once and for all. Lasting and sustainable progress requires that each reform build on the last, that governments learn from experience, that they search for opportunities to raise expectations and performance. But it is not easy to build this capacity into public institutions, many of which go through bursts of innovation and change, followed by pause and consolidation. This cyclical pattern enables government to transmit new rules and expectations down the ranks, instruct employees in innovative practices, acquire needed information and test new procedures and requirements. Governments which rush from one partially implemented innovation to the next suffer from “reform fatigue” and confusion. In some such countries, this writer has encountered senior managers pleading for breathing space to assimilate the last reform before the next one is urgently thrust upon them. Matters are made worse when each round of reform promises the same things but has distinctive nomenclature and procedures.

In markets, competition forces change. In governments, the prod often is a performance measurement system that periodically raises the targets to impel monitored organisations to do better. Using performance measures as an engine of change requires that the targets: a) be few in number, so that they send strong signals as to what is expected and provide a clear basis for assessing progress; b) challenge agencies to make changes in programs or operations that will enable them to meet targets; c) are jointly selected by each agency and the central authority responsible for overall government performance; d) are monitored and audited to ascertain whether the targets have been met; e) are part of a larger managerial framework that encourages agencies to improve performance. This is not a full itemisation of the characteristics of a performance measurement system, but each item above is especially relevant to the task of driving organisations to continuous improvement.

1.8.3. Balancing the reform strategies

This paper has noted that some countries have focused on operational management and others on program effectiveness. Ideally, the two strategies should go hand-in-hand, for programs depend on well-run organisations to achieve their objectives, and operations produce public good only to the extent they serve governmental objectives. The longer a country stays at the task of reforming public institutions, the greater the likelihood that having started with one of these strategies, it will gravitate to the other. Combining the two is not simple because they require different types of information and have different uses and perspectives, and engage different parts and levels of government. Assuming that a government intends to proceed on both fronts, it has to decide whether to combine the two strategies in a unified reform or to separate them. To this writer's knowledge, Australia is the country that has grappled most with this question. Beginning in the 1980s and continuing into the present decade, it has sought to integrate a financial management improvement program with program budgeting. The combined FMIP/PB initiative has made significant headway in realigning programs and in improving management, but the relationship between the two parts of the reform package has not always been easy.

1.8.4. The role of central agencies

One of the tensions between program and managerial strategies has to do with the changing role of central agencies, particularly those dealing with financial and human resources. These agencies once served as the central command and control posts of government, but this role is not compatible with the new managerial ethic. Some central agencies have retooled themselves to the drive for devolution and flexible management. But driving

reform from the centre in the name of decentralisation sometimes gives the wrong message to departments on the receiving end. Rather than hearing that they are to be freed up to run their own operations, they fear that the new performance regime is a ploy to get them to supply information to be used against them by central controllers.

Central agencies are in a quandary. If they allow each department or agency to pursue reform its own way, they risk getting very different managerial arrangements than the ones they wanted. If they intervene to dictate how departments and agencies should run their affairs, they risk being accused of violating the precepts of managerialism. Moreover, having divested many of the controls that was, for generations, the source of their power over operating departments, central agencies may be too weak to compel compliance with their views as to how government should be managed.

The evolving role of central agencies differ from country to country. In some, the Finance Ministry (or a similar organisation) has unrivalled authority over management matters; in others, the government has established a separate agency to oversee the reform drive. In some, the Finance Ministry has a firm sense of its role and relationship to operating units; in others, the Finance Ministry is going through an identity crisis seeking to carve out a niche that enables it to retain considerable administrative authority within the managerial framework. In all, the Finance Ministry (and other central agencies) face the task of prodding agencies to get on with the business of reform.

1.8.5. Strengthening managerial accountability

It was noted earlier that more progress has been made in devolving managerial authority than in enforcing managerial accountability. Dismantling old controls has proved easier than establishing new performance-based accountability. There is significant risk, therefore, that managerial flexibility will be discredited by misbehaving officials who take the new freedom as license to breach the public trust. Some abuses may be real, others only perceived; either way, they may impel governments to take rein in public managers by reinserting centrally enforced rules and standards. The indiscretions need not be major to spur this reversal; even minor lapses can impel ministers and parliamentarians to demand more control.

What should be done? Some, or all, of the following depending on the quality of accountability systems already in place: i) train managers and civil servants in their responsibilities under newly devolved arrangements. Do not take for granted that they know what is permitted and what is not; ii) review rules pertaining to employment, finance, contracting and other managerial actions to determine whether there are gaps that have to be closed;

iii) indoctrinate managers in the principle that they are personally and professionally responsible for good conduct in their organisations; iv) assess financial reporting systems, the quality of financial statements and audit practices, and take appropriate steps to elevate standards to acceptable levels; v) in countries which rely extensively on out-sourcing, develop a corps of public servants who are skilled negotiators of contracts with private parties and overseers of compliance. These skills are much more highly developed in business firms than in government departments; vi) improve performance reporting systems, including the audit of reported results.

1.9. *The next generation*

The current wave of management reforms will not be the last. Developments, already underway, will expand the envelope for novel, as yet untried, management arrangements. These including the diffusion of information technology that facilitates interactive communication within government and between government and citizens; rising expectations concerning the volume and quality of public services; the weakening of civil service norms and increased reliance on temporary, part-time and non-public employees; further encroachment of markets and competition onto the provision of public services; and adoption of practices that make performance measurement more a reality than a slogan.

These changes are both independent of one another and interconnected. Establishing remote, interactive communication between government and citizens covering a wide array of services and relationships may proceed on its own, but once it is in place, it opens the door to reconfiguring the civil service, bringing the market-type mechanisms into core public services and taking performance-based management seriously. Alternately, while the development of new technologies might speed up communication and enable remote interaction with citizens, it may do little to change the way governments might retain career-based civil service system, or that might rely on the overall labour market to obtain workers as needed.

In a leap of vision, one can foresee government of the future organised along very different lines than it is currently. A futuristic public service would work out of homes or out of communications hubs; it would consist of workers hired by business firms under contract with government; citizens would have broad choices in the public services they purchase; government departments would shrink to core political-policy functions; governments would adopt variable budgets, in which the volume of resources were linked to the volume of outputs and other measures of performance.

In the medium- to long-term, the direction taken by government will closely track the direction taken by business organisations. If the “virtual” firm

becomes the model of business organisations, it also will become, with some lag, the model of government organisation.

In other words, if one were able to foresee how the market sector will evolve, one would be able to foretell how the public sector will change. Lacking such foresight, this writer urges governments to attend to the near-term agenda and defer visionary plans until the future has arrived.

Building a Consensus for Fiscal Reform: The Chilean Case

by

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1. Introduction

The financial crisis that started in Asia in 1997 brought up a renewed concern over public finances in emerging economies. As most observers failed to detect creeping fiscal disequilibria, large public contingent liabilities, vulnerable asset-liability structures and time inconsistencies of fiscal policy, international financial institutions committed themselves to promote higher transparency and efficiency in the management of public finances. This has resulted in a stream of transparency codes, guidelines and best practice reports over the last couple of years that intend to prevent such failures in the future.

However, as the world economy enters a new phase of uncertainty and many emerging economies still do not recover from the effects of the crisis, progress towards the new public finance benchmarks is still poor. Fiscal reform appears as the only way to accelerate the pace towards fiscal transparency and efficiency in many emerging economies.

Fiscal reform has indeed been in the agenda of developing countries and international financial institutions for many years, with some success in removing gross distortions, like off-budget deficits from public enterprises or central bank lending to governments. Yet many problems remain unsolved while structural changes, like decentralisation, have added new pieces to the public finance puzzle.

Fiscal reform, having a medium-term scope, has usually taken a second place to the most acute problems of fiscal adjustment. But the effectiveness of such adjustments to solve long-term problems of public finances might have been limited. Expenditure cuts that concentrate on the discretionary component of budgets, resulting in cuts in salaries, investment programs and social services, may be not only unsustainable but can also put a threat to the effectiveness of public policies. In the case of social programs, this may also harm the ability of governments to perform their distributive role.

Modern thinking on public finance is addressing these issues. Macroeconomic theory is paying less attention to the short-term demand effects of fiscal policy than to long-term portfolio effects. Public sector balance sheets are replacing flow-of-funds charts and medium-term financial sustainability is becoming a central issue in the assessment of fiscal policy measures.

Likewise, budgets are now seen not only as a tool of macroeconomic policy, but also as playing a managerial and political role.¹ To public managers, budgets are a key source of incentives and constraints, as much as markets do so for private companies. In recent years, many governments have been changing financial management rules to enhance accountability and efficiency in public agencies.

Budgets are also a political device: they are prepared by the Executive, as a result of a negotiation between the Ministry of Finance and the spending ministries, and submitted for approval to legislatures and therefore require the support of many actors with different motivations and priorities. Budgets encompass resource allocations for a wide-range of activities required for the delivery of public goods and services and usually they result from extensive negotiations and agreements.

The key to successful public finance management is to balance the economic, managerial and political roles of public finances. It is, therefore, a matter of governance. Fiscal governance is poor when fiscal policy objectives are achieved at the expense of a collapse in public management; fiscal reform has little chance of succeeding when it does not reach the common sense of politicians and the public. Fiscal governance is strong when governments can deliver their fiscal policy in a sustainable way and when public funds do not only comply with macro limits but are also efficiently applied to the provision of public goods and services. Fiscal governance is not reflected in how deep a country can cut into its fiscal deficit, but in how capable it is to prevent it.

This paper describes the initiatives that have been implemented in Chile since the mid-1990s, which amount to a second generation of fiscal reforms aiming at strengthening fiscal governance.

2. Institutional arrangements and fiscal outcomes

Too frequently, external observers appear to rely on a strong and committed authority to sort out a country's fiscal troubles. But political will is not enough. Fiscal governance largely depends on the quality of institutions that shape public finance management.

Countries differ in their budgetary institutions and in their procedures within the three phases of the budget process: the formulation of the budget proposal within the Executive; the presentation and approval of the budget in the legislature; and the implementation of the budget by the bureaucracy. If such differences determine the influence of diverse interests and economic authorities over budgets, then we should perhaps turn to such differences to seek an explanation of why the fiscal performance of some countries is better than others". A study of the relationships between these practices might help

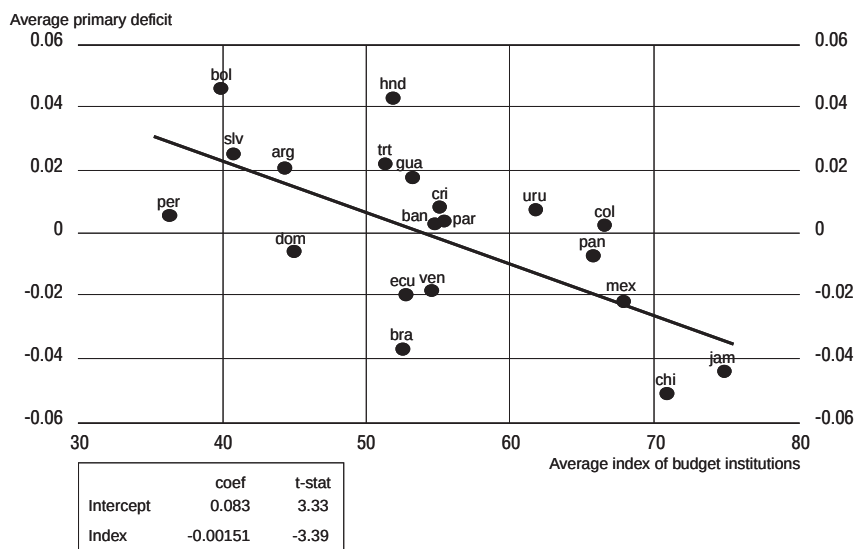
identify “correct” budgetary institutions that are able to ensure solid fiscal performance.

Milesi-Ferretti (1996) divides studies on the influence of budgetary institutions on fiscal policy into two main categories. On one side there are those that concentrate on fiscal regulations such as constitutional balanced budget amendments, international agreements, like the convergence criteria of the Maastricht Treaty in Europe, macroeconomic program requirements and ceilings on government borrowing imposed by the legislature. Such studies emphasise the usefulness of regulations in eliminating systematic bias in efforts to achieve balanced budgets, and in enhancing the need for budget discussions to focus on achieving the desired fiscal policy outcomes.

On the other side there are studies that focus on budget procedures and on how they give greater initiative and control to actors who represent the interests of the community as a whole *vis-à-vis* those that advocate particular interests in each of the stages through which a budget must pass. These studies seek to identify at each stage of the process those institutions that assign priority to the economic authority over the various ministries, parliamentarians, pressure groups or government agencies. Comprehensive analysis of these institutions would reveal whether a country’s budget system should be characterised as *hierarchical* or *collegial*. Hierarchical institutions are those that attribute strong prerogatives to the Prime Minister to overrule spending ministers within intra-governmental negotiations in the formulation and execution of the budget, and those that limit in a variety of ways the capacity of the legislature to amend the budget proposed by the government. Collegiate institutions emphasise the democratic rule in every stage, like the prerogatives of spending ministries within the government, the prerogatives of the legislature *vis-à-vis* the government and the rights of minority opposition in the legislature (see Alesina and Perotti, 1999).

In principle, hierarchical systems should result in better macroeconomic fiscal performance, in terms of capacity to enforce fiscal restraint, avoid large and persistent deficits and implement fiscal adjustments more promptly, than collegiate systems. Statistical evidence across countries confirms such hypothesis. Von Hagen and Harden (1994) find support for this hypothesis using several indices to rank fiscal institutions of all of the countries of the European Community from the most hierarchical to the most collegiate. Alesina, Hausmann, Hommes and Stein (1999) follow a similar procedure for a sample of almost all the Latin American countries and arrive to the same conclusion: more hierarchical procedures are associated with lower primary deficits, after controlling for several economic determinants of the government budget. Figure 1 shows the significant negative correlation between the average index of budget institutions and the average primary deficit for the 1980-1992 period.

Figure 1. **Budget institutions and fiscal outcomes**
1980-1992



Source: Alessina, Hausmann, Hommes and Stein (1999).

Both political science and empirical studies are leading to the conclusion that an efficient fiscal performance not only requires a competent economic authority with the capacity to analyse and define policies, but also adequate institutions to support its role. These institutions must be capable of ensuring the pre-eminence of the Ministry of Finance and the Executive branch during the budget-making process, or otherwise must be able to impose *a priori* restrictions on that process. Adequate institutions, particularly in terms of transparency and accountability, are important not only to support the job of competent economic authorities, but also to reduce their incentives to be fiscally irresponsible (see Rogoff, 1990). While reforms that reshape budget institutions are not easy, the effort would be worthwhile since the goal is one of the most valued assets in contemporary economies: powerful and stable means for controlling budget deficits.

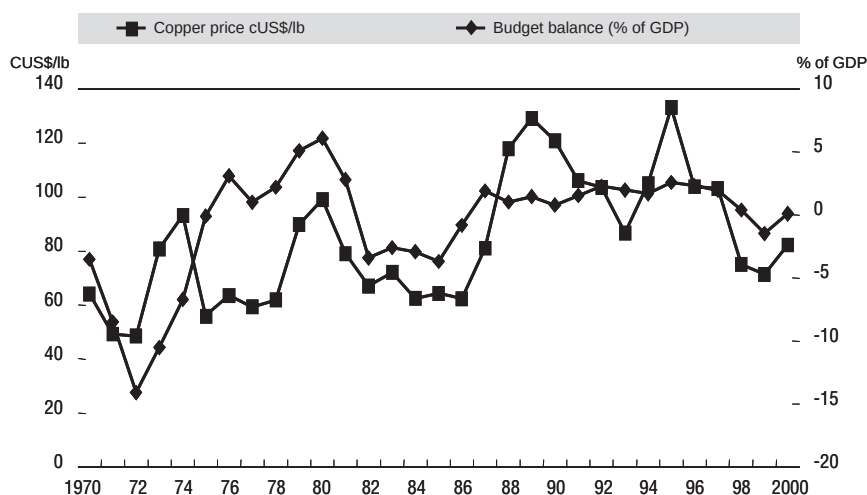
3. Chile's budget institutions

Chile has a first hand experience on the social and economic consequences of fiscal imbalances. These imbalances played a major role in determining economic volatility and sustained inflation that characterised the Chilean economy until the mid-1980s. The large share of fiscal revenues

generated by copper sales meant that public finances acted as a multiplier of the terms of trade cycle into the domestic economy. Figure 2 shows the strong correlation between the fiscal balance and the price of copper in the 1970-1987 period. The figure also shows that this correlation was reduced after 1987 through the creation of the Copper Stabilisation Fund, a mechanism which isolates most of the effect of copper price volatility on fiscal revenues.

Figure 2. **Central government budget balance and copper price evolution**

1970-2000



Source: Budget Office, Ministry of Finance, Chile.

At various times in the republican era, public finances turned into a political battleground. Such confrontations prompted a civil war at the end of the 19th century. Presidents elected under the 1925 Constitution, which usually condemned them to be in a minority in Congress, inevitably complained about the opposition's budget blocking tactics. Even the political crisis during the Government of Salvador Allende was reflected in serious conflict over the approval of the budget. For this reason, the Chilean system gradually furnished the Executive branch with greater powers over economic matters and public sector financial management.

Current budget institutions in Chile are determined by provisions of the 1980 Constitution and of the State Financial Administration Act of 1975, which establish that the national budget should be comprehensive, covering the various agencies and ministries of the central government, the judiciary

and the legislature.² The budget is also comprehensive in terms of the transactions covered, including all fiscal revenues and expenditures.

The preparation of the Chilean budget is done over a relatively short period of time, with tight deadlines mandated by law. This is accomplished on the basis of a highly centralised financial management system, based in the Ministry of Finance.

Budget discussion in Congress occurs within deadlines mandated by law: the latest date at which the Executive's budget proposal must be sent to Congress is 30 September and the discussion process must be carried out in no more than 60 days. The budgetary powers of Chile's Congress are highly limited. Congress cannot alter revenue estimates, increase expenditures nor reallocate resources between programs. It can only reduce line item expenditures that are not mandated by permanent legislation.

Only the Executive can propose changes to mandatory spending programs and Congress is not allowed to change the contents of the proposal; however, they can reject the government's proposals. Once mandatory expenditure programs are approved by Congress, it is not required that they are reviewed on a periodic basis. In the budget discussion, Congress appropriates funds for these programs each year. However, if actual expenditure deviates from the original estimates, the resulting differences are automatically funded. In addition to these restrictions, the Constitution establishes that if the discussion in Congress is not over and the budget law is not passed within the 60 days deadline, the Executive's original budget proposal becomes law.

Budget execution is highly flexible through provisions that allow the Ministry of Finance to adjust item allocations during the year. An important feature of this flexibility is the inclusion in the budget of a central contingency reserve to cover the fiscal costs of legislation passed during the year, as well as contingencies.

The Constitution imposes other constraints on fiscal management: borrowing from the central bank and earmarked taxation are strictly forbidden; transfers to state-owned enterprises require specific legal authorisation; permanent legislation dealing with taxation, Social Security, government jobs and financial management can only be considered at the Executive's initiative.

Given these arrangements, the institutional framework responsible for formulating and executing Chile's budget may be categorised as markedly hierarchical. This is confirmed in the study by Alesina *et al.* (1999) where Chile is included among the two countries whose budgetary institutions enjoy the most clearly established lines of authority and responsibility in Latin America.

4. Chilean budget institutions to the test

Chile's hierarchical budget institutions, however, were enacted under military rule and thus can hardly provide a test for consensus building for fiscal reform. The real challenge to their sustainability and effectiveness would come only in a democratic environment, as since 1990.

The memory of past fiscal instability made Chilean politicians quite supportive of fiscal restraint. The combination of a governing centre-left coalition firmly convinced that its credibility largely depended on its prudent handling of public finances, and a fiscally conservative opposition, generated a favourable climate to apply, build upon and deepen fiscal responsibility during the 1990s.

This is clearly reflected in Chile's fiscal performance during the 1990s. Table 1 shows that central government budgets recorded an overall surplus in every year, except for 1999. Overall surpluses averaged 1.3% of GDP during the 1990s and public savings grew as a share of GDP during most of the 1990s, to reach nearly 6% of GDP in 1996. This allowed a substantial reduction of total public debt (both domestic and foreign) from 47.2% of GDP in 1990 to 14.8% of GDP in 2000.

Table 1. **Central government 1990-2000**

As a % of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Overall surplus	0.8	1.5	2.3	2.0	1.7	2.6	2.3	2.0	0.4	-1.5	0.1
Current surplus	2.5	3.6	5.0	4.9	4.9	5.4	5.8	5.6	4.1	2.5	3.7
Public debt	47.2	41.1	34.0	31.6	25.6	19.5	16.7	14.5	13.9	15.0	14.8

Source: Budget Office, Ministry of Finance, Chile.

Prudent handling of public finances during the 1990s contributed to create a virtuous circle that, as shown in Table 2, benefited public funding in return. The cumulative growth rate of social expenditure in the 1990s was

Table 2. **Social expenditure 1990-2000**

Real annual growth rate

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Health	-4.5	17.8	16.9	12.1	10.2	4.2	8.6	6.0	8.2	3.1	8.4
Education	-4.4	12.3	15.0	8.6	9.1	11.7	12.9	10.2	11.4	6.9	8.4
Social expenditure	-0.9	9.2	10.4	9.6	6.1	7.3	9.7	5.6	7.6	7.8	6.1

Source: Budget Office, Ministry of Finance, Chile.

101%, and its importance in total public expenditure increased from 65% in 1990 to 70% in 2000. The sectors which exhibited the highest growth rates were health and education, with cumulative growth of 117% and 141%, respectively, during the 1990s. Government investment that had remained particularly low during the 1980s grew 172% in the same period.

Additional funding for social services and public investments allowed the government to implement many new programs and projects and to strengthen its distributive function during the 1990s. By the end of the decade, government transfers through social programs increased household incomes in the poorest 20% of the population by nearly 85%, while its net impact on the richest 20% was less than 1%. Government spending not only contributed to increase equity, in fact it was the only source of noticeable improvement in income distribution throughout the decade. It also contributed to reduce the poverty rate from 38.6% in 1990 to 20.6% in 2000 and the indigence rate from 12.9% to 5.7% in the same period.

There is no doubt that fiscal institutions supported this performance. While the government felt particularly accountable for its management of fiscal policy, Congress prioritised its role as an overseer of the Executive's handling of public resources. This kept a systematic pressure on fiscal discipline.

But the experience of the 1990s also revealed some shortcomings of Chile's budget institutions. First, Chile's public finance management, despite all its successes, remained fairly conventional, paying more attention to overall financial performance than to the results of the application of public funds, or the true economic cost incurred to obtain such results. In other words, this is a system that may be highly effective in controlling expenditure, but that does not necessarily facilitate or promote efficient management of public institutions.

Second, the hierarchical structure of the public financial system was not completely accepted by the different actors in the budgetary process. Ever since the country's democratic institutions were fully restored members of Congress complained at the limited role assigned to them in the budget approval process, and sought means to apply greater pressure on the Executive than is permitted under those regulations. For their part, line ministries resented the discretion that the Ministry of Finance enjoyed in drawing up the budget and the controls and authorisations required to execute it.

Third, the discretionary powers given to economic authorities did not guarantee that such powers would be consistently applied in the future. The same powers that helped the authorities to balance the budget might be used to unbalance it. The lack of institutional checks and balances generated

uncertainty over the future behaviour of authorities and prevented the country from fully reaping the benefits of fiscal discipline. In other words, since hierarchical budget institutions were not accompanied with accountability mechanisms over the authorities' management of public finances, the benefits of such arrangements would remain limited.

These problems became apparent by the mid-1990s and prompted a series of initiatives to strengthen public finance management. By 2001, such measures amount to a second generation of fiscal reforms aiming at strengthening fiscal governance in Chile into the 21st century.

5. Reforming public financial management in Chile: the 1990s

Throughout most of the 1990s, the government and Congress agreed to introduce new regulations and practices into the budget. Most of these measures were formalised as political agreements attached to the budget and, in some cases, written into specific amendments to the Budget Law. These reforms, together with the most recent ones implemented by the government of President Lagos, were designed to address each of the three shortcomings of the Chilean budget institutions identified in the previous section:

- Mechanisms to evaluate performance of programs and institutions were designed and incorporated in decision-making procedures to improve the budget allocation decisions and to make them more transparent.
- New management instruments were introduced to improve performance and to promote efficient management of public institutions.
- To limit the discretionality of the Executive over its command over public resources, several rules were established.
- To increase and strengthen the contributions of Congress to the budget discussion process, relevant background information was generated and distributed to congressmen, and commitments resulting from budget discussion were formalised.

In short, the second generation of fiscal reforms being implemented over the last decade aim to improve the Chilean budget institutions and the quality of fiscal policy by increasing transparency and accountability and by limiting discretionality of the Executive over its command over public resources.

5.1. Cash limits

In the early 1990s, Congress charged that budget flexibility provisions allowed the government to increase spending above authorised appropriations in the budget as long as it had the funding. In response to this claim, the Executive and Congress agreed to limit these powers by introducing a specific provision (Article 4) into the annual Budget Law establishing overall

cash limits for current and capital expenditures. According to these regulations, government can enjoy flexibility to reallocate resources among line items, but not to increase the overall amount or to transfer resources from capital to current expenditure.

5.2. Budget execution reporting

By the early 1990s, the government had no specific obligation to report on budget execution, other than to accountants at the Comptroller General's Office. This meant that both Congress and the public would learn about actual budget execution with a significant delay. The Ministry of Finance has since then agreed and committed to report budget execution on a quarterly basis and to report on the use of the central contingency reserve on a monthly basis. Starting in the year 2000, these reports were made available on-line in the web page of the Budget Office of the Ministry of Finance (www.dipres.cl). The Budget Office also started publishing full provisional financial statements at the end of the year, ahead of the statutory reports of the Comptroller's Office.

5.3. Performance indicators

Since 1994, the Budget Office has requested ministries and government agencies to provide quantitative and qualitative information on their performance in terms of the delivery of outputs and services. With this information, a system of performance indicators has been developed and they are included in the background information provided to Congress during the discussion of the annual budget. This system currently includes 537 indicators of effectiveness, efficiency, economy and quality in 109 government units. Despite some questionable attempts at using these indicators to support performance-related pay, the Budget Office has been cautious to avoid building a mechanistic connection between indicators and budget decisions. Instead, it has preferred to view the system as a means to strengthen accountability for results to the general public and to provide information to budget negotiations.

5.4. Program evaluation

In 1996, government and Congress acknowledged that indicators could only provide information on the evolution of performance over time but not on the effectiveness of government programs. For that reason, they agreed to further improve performance assessment in the budget process by developing a system of program evaluation. Since 1997 the Government Program Evaluation System has provided independent, *ex post* assessments of more than 120 programs. These evaluations are performed by a panel of experts from outside the public sector that can request information from the executing agency and commission specific studies to support their

assessments. These evaluations, which are carried out in a period of five months, follow the logical framework methodology to determine the consistency and capacity of the program to achieve its objectives. Conclusions and recommendations are then submitted to the Ministry of Finance, the Presidency and Congress to feed back into the decision-making process.

Starting in the year 2001, the Government Program Evaluation System has been improved by complementing the five-month long program evaluations with one-year long in-depth evaluations of programs. The objective of these in-depth evaluations is to generate an integrated assessment of the programs' results – understood as short-, medium- and long-term benefits of the programs – the efficiency and economy in the use of resources and features related to the management of internal procedures. The first two in-depth evaluations are currently being performed by the Departments of Engineering and Economics of the *Universidad de Chile*, perhaps the most prestigious university in Chile, and they should have been completed in March 2002.

5.5. Management improvement programs

Also, in the context of improving the public management in 1998 the government started the implementation of Management Improvement Programs (MIP). MIPs consist in several programs aimed to improve the public management by linking goal attainment to employees' monetary rewards.

After three years of implementation, the MIP system has been reviewed. As a result, during the year 2001, MIPs were redesigned to focus on the development of key management systems rather than in narrower performance targets, about which MIP can exercise little judgement and/or control. The key management systems were selected to guarantee a better global performance of the public institutions, mainly in terms of services provided to the citizens, working conditions and valorisation of public servants. The management systems translate into a matrix of key management systems and standardising progress stages. Public agencies identify current and expected progress, and performance is measured in terms of effective progress against these goals.

It is worth mentioning that special attention has been given to the gender perspective. For the year 2002 a new system named Gender Equity has been introduced to the MIP system. Its objective is that public services operate with procedures that promote equal opportunities for men and women in the delivery of outputs.

6. Recent developments

The reforms of the 1990s, built upon the inherited hierarchical budget institutions, already provided Chile with one of the strongest fiscal systems among emerging countries. Yet, by the end of the decade, it became evident that this might be insufficient to sustain fiscal discipline and effectiveness in a more turbulent environment.

In 1997-99, fiscal balances deteriorated by nearly 4% of GDP, moving from a surplus of 2.5% of GDP in 1996 to a 1.5% deficit in 1999. Public saving fell even more sharply, from 5.8% to 2.5% of GDP in the same period. This was mainly a result of the international financial crisis that halted fast growth in Chile and forced a recession in 1999, but it also reflected a more expansionary fiscal stance. Figure 3 shows how structural expenditure has been growing as a percentage of GDP since 1995 at a faster rate than structural revenues which have remained relatively stable. The structural reduction in the central government's surplus and a build-up of medium-term financial commitments meant that fiscal aggregates would not necessarily return to their pre-crisis levels in the upswing stage of the cycle.

The political climate also threatened to become less supportive of fiscal discipline. A string of elections stretching from 1999 to 2001 would be more closely contested between the Concertacion coalition and its right-wing counterpart and would make consensus building and co-operation on economic matters less likely than in the past.

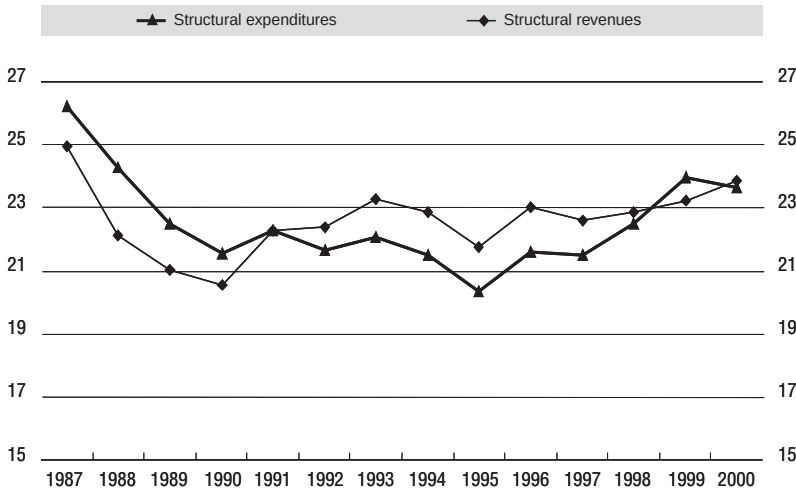
The Lagos Administration therefore attached great priority to deepening fiscal reform. During the years 2000 and 2001 this has translated into a bold set of new initiatives to improve medium-term fiscal programming, raise allocative efficiency, improve follow-up of budget discussions, and increase transparency and accountability. The results of which can already be observed in the improvement of the fiscal accounts in the year 2000. Indeed, the central government's overall deficit of 1.5% of GDP in 1999 was reverted to an overall surplus of 0.1% of GDP in 2000, and the current surplus was raised from 2.5% of GDP in 1999 to 3.7% of GDP in 2000. Figures 3 and 4 show that these improvements are due mainly to the improvement of the central government's structural accounts and not to an upturn of the economic cycle.

6.1. *Improving fiscal policy formulation and medium-term fiscal planning*

6.1.1. *A fiscal policy rule*

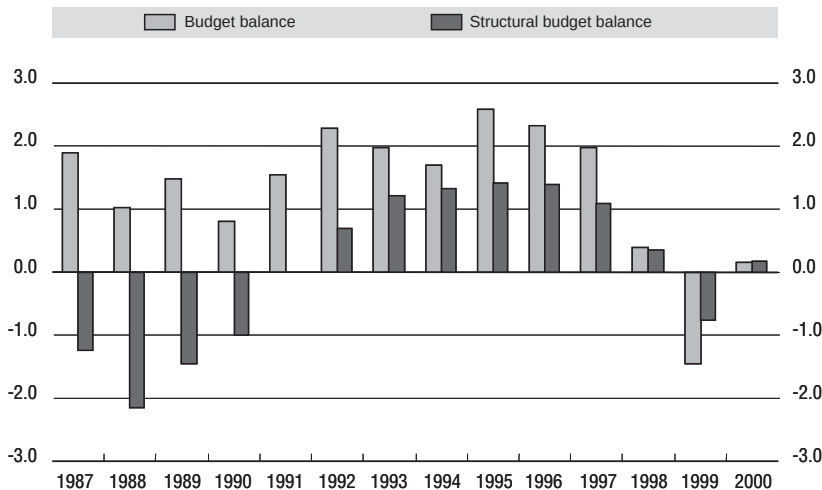
After 14 years of continuing budget surpluses in Chile, by the end of the 1990s nothing granted that such performance would continue in the future. As many observers criticised the conduct of fiscal policy in the

Figure 3. **Structural revenues and expenditures 1987-2000**
As a % of GDP



Source: Marcel, Tokman, Valdés and Benavides (2001a).

Figure 4. **Structural budget balance 1987-2000**
As a % of GDP



Source: Budget Office, Chile (2001).

late 1990s, the behaviour of the new government in exercising its broad discretionary powers over public finances was a major source of uncertainty among economic agents.

The Lagos Administration faced this challenge by committing itself to pursue a strict fiscal policy rule: starting in 2001 the government would generate a structural budget surplus equivalent to 1% of GDP (see Marcel, Tokman, Valdés and Benavides (2001b)).

The structural balance measure closely follows a well-established methodology developed by the IMF and the OECD. It aims at assessing the stance of fiscal policy by separating the cyclical variations from the more permanent components of the budget. Such separation not only provides more transparency into the conduct of fiscal policy, but also provides a sound basis to design and implement it. The fiscal policy rule base on a fixed target for the structural balance allows automatic stabilisers to operate in the short-run while keeping a medium-term focus in steering public finances. Indeed, the structural balanced budget rule is an effective instrument to face the politically induced deficit bias (see Alesina and Perotti, 1995) without the limitations of the standard balance budget laws in terms of the counter-cyclical role of fiscal policy and the dynamic optimal taxation theory (see Barro, 1979).

The structural budget balance of the public sector (SBPS), as applied in Chile, reflects the level that revenues and fiscal spending would reach if GDP were at its potential level and if the price of copper were at its medium-term level. Therefore, it excludes the cyclical and random effects of the two most important exogenous factors: economic activity and the price of copper. The SBPS is estimated by: a) making accounting adjustments so that the budget balance becomes a correct proxy of net worth change; b) estimating potential GDP and the medium-term copper price;³ and c) re-estimating fiscal revenues on the basis of GDP elasticities.

Applying this methodology to the 1987-2000 period shows that the structural budget balance followed a more consistent path than conventional balances (Figure 4). After a large drop in 1988, it gradually increased until the mid-1990s, when it stabilised around 1.4% of GDP. Between 1997 and 1999 it fell to a minimum of -0.8% of GDP in 1999, to recover to 0.1% of GDP in 2000. The estimate for 2001 is a structural balance of 0.9% of GDP and the budget for the year 2002 has been structured to achieve the 1% surplus target.

The 1% SBPS surplus stands out as one of the most strict fiscal policy rules under application in the world. This not only reflects the commitment of the authorities to strict fiscal discipline, but also some distinct features of the Chilean economy. These features include: a) the operational deficit of the central bank, originating in the bailing out of financial institutions in the mid-

1980s; b) substantial contingent liabilities, stemming from guarantees provided under the roads concessions program and state-guaranteed minimum pensions to affiliates of the private capitalisation system; c) the need for the government to contribute to raise domestic saving to fund investment needs without generating large current account imbalances; and d) the symbolic nature of fiscal policy as a benchmark to macroeconomic policy in Chile and a cushion against external volatility.

The implementation of the fiscal policy rule is expected to have three major beneficial effects. First, it will reduce uncertainty of economic agents over the conduct of macroeconomic policy and the risk of restrictive monetary policy, reducing long-term interest rates and sovereign spreads in foreign markets. This will stimulate private investment. Second, fiscal policy will play an effective counter-cyclical role by allowing full operation of the automatic stabilisers. And third, it will broaden the programming horizon of public institutions by avoiding the inefficient contraction of spending in recessive periods as well as over-expansions financed under temporary fiscal surpluses (see Ministry of Finance, 2001).

6.1.2. Medium-term financial programming

Building upon a methodology developed in the late 1990s, the Budget Office has started releasing medium-term financial forecasts (MTFF), covering a three-year period. Such estimates are mandatory under the 1975 State Financial Administration Act but they had never been developed or published up until now.

MTFF for the central government are prepared by the Budget Office as a financial projection of existing policies and regulations and therefore do not involve either negotiations or commitments to line ministries and programs. They are therefore presented in aggregate terms as part of the background information to the annual budget.

MTFF has proven to be extremely useful in recent discussions, particularly those related to the Law Against Tax Evasion and the 2001 and 2002 budget discussions. Indeed, MTFF showed that a tax evasion law was required to finance and implement all the proposals contained in President Lagos' government program. These forecasts have also revealed that even after a full recovery of the 1999 crisis, there would be a shortfall of public revenues due to a drastic reduction in transfers from public enterprises, given by the privatisation program of the late 1990s. Reverting this phenomenon will require paying special attention to the use of privatisation proceeds, increasing pressure on state-owned enterprises profitability, widening user-charging for public services and raising the profitability of public financial assets, including cash holdings.

6.2. *Raising allocative efficiency*

In order to break away from incrementalistic budgeting, the Ministry of Finance introduced new practices in the preparation of the 2001 and 2002 budgets. Inertial funding was strictly limited and ministries were required to reallocate at least 2% of their inertial expenditures.

Budgetary bids for new or expanded programs are required to compete for a central fund of resources, which is allocated according to the quality of the submitted proposals and their consistency with the government's priorities. Prioritisation is based on a logical framework presentation of competing initiatives. This new presentation format emphasises and encourages a more detailed analysis of the program itself by requiring the statement of the program's general goal as well as the enumeration of specific purpose, components and activities related to the implementation of this program.

The information on the main objectives and goals of public programs provided under the logical framework presentation not only allows for a better and more efficient allocation of the resources in the budget; it will also feed back into program evaluations in the future.

During the first two years of operation of this fund, USD 520 million have been allocated to finance 330 selected proposals. This mechanism has proven to be a transparent and efficient procedure to allocate the budgeted increases in spending.

6.3. *Raising accountability: closing the budget cycle*

Political agreements attached to the approval of the annual budget proved to be an extremely useful tool to foster consensus building for fiscal reform in the 1990s. But such agreements not only provide a sound political backing to break away from conventional practices and strengthen fiscal discipline; they have also a rationale in themselves.

If the political role of public budgets is due to a large extent to the network of negotiations and commitments that lie beneath them, strengthening and formalising these commitments may improve the quality of the budget process. Budgeting is indeed a repetitive game, and its outcomes may be improved by feeding back from one fiscal cycle to the next. This can be achieved through formal agreements that address issues that emerged during the discussion of the budget but have no direct effect on the annual appropriations.

On the basis of this rationale, the Lagos Administration paid special attention to the budget agreement that accompanied the approval of its first budget, the 2001 budget. In addition to the agreements covering traditional

issues like transparency and evaluation, the government supported two main innovations. First, the budget agreement 2001 included, for the first time, the commitment to develop specific studies on high-profile financial issues, like contingent liabilities, minimum pension guarantees and state-owned enterprises profitability. The results of these studies, that were either conducted directly by the Budget Office or prepared by private consultants, were presented to Congress at the beginning of the 2002 budget discussion. Second, it created a new stage in the budget cycle: prior to the discussion of the 2002 budget, the government submitted to Congress the information concerning budget execution, performance indicators, program evaluations and specific studies which allowed Congress to review the government's performance in 2000.

6.4. Improving transparency and accountability: the Public Finance Reform Program

To strengthen the transparency and efficiency in public management, the Budget Office has designed a program to modernise the financial management of the public sector. This program can be summarised in the following three main elements.

6.4.1. Improving the public sector accounting system

This includes the development of accounting systems that allow measuring, in a more accurate way, the real economic cost of the activities carried out in public institutions. Moreover, these accounting systems would allow a more effective control of the financial obligations acquired by the public sector. Although currently public sector accounting system is accruals-based, budget formulation and execution operates on a modified cash basis. Transition towards a modified accruals basis will include the development of a commitments control system and capital costs measurement.

6.4.2. Integrated financial management system

In mid-1999 the National Budget Office along with the General Comptroller's Office started a study to produce the Integrated Financial Management System (IFMS). The IFMS would create a single, complete and uniform information system that would support a more effective and transparent management of the public institutions. Moreover, IFMS would not only facilitate the generation of aggregate information but it also would allow the design of output and performance indicators that will permit a better evaluation of the results. Currently, IFMS is at a design stage and it is being tested, as a pilot scheme in five public institutions. Full implementation of the system is expected for 2004.

6.4.3. *Financial assets management*

Cash management currently operates in a highly decentralised way. On the basis of an annual cash program, the Treasury transfers monthly cash allotments to ministries and agencies that are then spent according to the existing budget appropriations. Liquid funds, both for the Treasury and government agencies are deposited in non-interest bearing accounts in the central bank and the State Development Bank. This system facilitates agencies' management but has a very high opportunity cost. The public finance reform program will device cash management and transfer of funds systems in order to minimise this opportunity cost without compromising financial decentralisation.

7. **Final remarks**

Regardless of the specific merit of any of the initiatives included in the budget reform program in Chile a valid question remains: Why should such initiatives enhance fiscal governance if the Minister of Finance is already a powerful figure?

The answer rests mostly on political economy grounds. The concentration of power over public finances in the hands of a single authority does not guarantee fiscal governance if: a) such authority is not accountable for its application of such powers; and b) if its concerns and priorities are not shared by other influential actors, be them politicians, business or social leaders, or the media. This is particularly true for a coalition government like Chile's.

The limited experience of the Lagos Administration supports this view. The introduction of a fiscal policy rule based on achieving a structural budget surplus of 1% of GDP has already changed the focus of the fiscal policy debate and has been welcomed by both sides of the political spectrum. While fiscal conservatives have seen it as a constraint over public expenditure in the future, spending-prone politicians have valued its capacity to generate a more stable and predictable environment for public policy programming. To the government, the SBPS has shifted attention away from expenditure/GDP ratios and short-term fine-tuning to a medium-term scope in fiscal policy monitoring.

This framework has facilitated the discussions of the 2001 and the 2002 budgets in Congress. Contrasting with recent past experience and with the pessimistic prospects founded on its coincidence with municipal elections in 2000 and with parliamentary elections in 2001, the budget discussions have been quite uneventful and they have been dispatched by Congress weeks before the constitutional deadline. Moreover, political consensus over the budget agreements were easily attained.

Of course, most of the initiatives in the budget reform agenda are yet to be implemented and tested. As it is well documented in the literature, fiscal rules may be easy to draw but more difficult to implement, and their actual effectiveness ultimately depends on their credibility, which is built over long periods of time.

Fortunately, fiscal reform in Chile can rely on the strong basis of the country's past record. As a matter of fact, fiscal reform in Chile now has a good chance of succeeding because it is not a device to overcome a fiscal crisis but to continue preventing it in the future.

Notes

1. See Marcel (1998) for a description of the different functions of the budget.
2. Although municipalities, the lowest level of government in Chile, are not included in the national budget, the effect of this exclusion in fiscal policy is almost null because they are not allowed to: levy taxes, run deficits nor borrow from the central government.
3. To assure transparency and non-discretionality, the medium-term price of copper is obtained by consulting a group of experts from the mining, the academic and the financial sectors.

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Regulatory Governance: Improving the Institutional Basis for Sectoral Regulators

by

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1. Introduction

In recent years, many countries, both within the OECD and beyond, have reappraised their regulatory policy framework to determine whether it meets the challenges of the new regulatory environment. For utility markets previously characterised by stability and slowness to change, these challenges are arising from rapidly developing technologies, converging industries, the internationalisation of markets, and more informed and discerning consumers.

The reassessment and subsequent realignment of the regulatory approach has sometimes been done on the initiative of the individual country or in the context of international regulatory developments – as with several European Union member states. While both the literature and the work of governments show strong analysis of regulatory objectives and of regulatory instruments, there is relatively little evidence of strategic critique and policy advice on the institutional setting for sectoral regulation. Yet, as every policy-maker and regulatory practitioner knows, institutional setting has a determining effect on regulatory service delivery.

This report aims to identify and examine some of the key issues in relation to the design of the institutional framework for economic regulation, particularly in the infrastructure network industries, such as telecommunications, electricity, gas, water and rail.¹ Its purpose is to generate discussion of regulatory institutional design and to set a framework for understanding and determining best practice for the governance of these institutions.² As such, the report is constructed around various matters that typically underlie the deliberations of the central government policy-makers who design the institutional framework within which economic regulatory functions are executed.

The principal focus of this report is the institutional design of the administrative system charged with economic regulatory functions. It is clear that institutional design issues are not informed only from the public management or the regulatory reform perspectives; rather they are related to many other factors across the wider economic, political and administrative spheres within which regulation is carried out.

This report considers the economic regulatory context – regulation whose primary purpose is to facilitate, imitate or enhance markets by correcting for entry imperfections and dealing with price, quality and reliability of service, supplier market entry and exit, and infrastructure investment. Institutional

design for other regulatory contexts (*e.g.* safety, public health, social or environmental regulation) is not considered in detail, except in so far as economic regulatory bodies are additionally charged with non-economic functions.³ Therefore, reference in this report to regulation should be understood to mean economic regulation, unless otherwise specified.

In the economic regulatory context, network industries represent the arena in which there has been the most recent and most rapid development in relation to regulatory frameworks. The rate of change in recent years in the regulatory environment for network industries – most notably in telecommunications, but also in energy, water, rail and postal services – across many OECD member countries has generated a base of regulatory experience that contributes to a better understanding of economic regulation at the horizontal level.⁴

The financial services sector also provides valuable economic regulatory insights. However, because financial markets are characterised by high levels of systemic risk, economic regulation of financial services is highly influenced by prudential considerations, often to be observed in the regulatory focus on the integrity of the financial system rather than on competition or consumers.⁵ Financial services regulation can also be highly motivated by macroeconomic policy, and in some instances is used as a tool of monetary policy. Although certainly economic, these prudential and monetary policy regulatory drivers are very particular to the financial services sector and do not typify economic regulation in the broader context; in particular, they can obscure the market-facilitating rationale for regulation. Therefore, this report primarily refers to network industries, rather than financial services.

This section has introduced the report in terms of background, purpose, focus and scope. In Section 2, the discussion progresses to consideration of the context of the report: the justification for economic sectoral regulation and developments in relation to the institutional setting for such intervention – specifically the trend in the transfer of regulatory functions from ministries to independent bodies.

Sections 3, 4 and 5 consider three elements in regulatory institutional design: independence, accountability and coherence. There is an examination of independence in the regulatory context that encompasses both the theory and many practical considerations in relation to the regulatory bodies' distance from government, industry and other stakeholders. This is followed by an exploration of the balancing effect of regulatory accountability and a reflection on the need to legitimise the regulatory process within the democratic system. The coherence of the regulatory institutional approach with existing political, administrative and judicial structures is also considered.

Section 6 considers the efficiency of the regulatory institutional design, with a particular emphasis on the flexibility-rigidity dynamic. The institutional design aspects of measuring the performance of regulatory bodies are also considered.

2. Economic regulation and network industries

2.1. Regulation – generic and sectoral

Regulation is an intervention between the parties to a transaction. Regulation, in the broad sense of the term, can facilitate transactions because it is the means used to provide the basic framework under which the parties can conduct their business in a secure environment. Such a framework includes the regulatory provision or guarantee of human rights, a judicial system, property rights, rules of contract and competition. Regulatory intervention of this kind is generic; it applies across the whole of the economy and society. Some of these regulatory interventions are so fundamental to the operation of a society and its economy that they are built into its political constitutions. Others are the subject of statute. More still are given effect through secondary legislation. They are all forms of regulation.

This report is concerned with a narrower definition of regulation. Its focus is regulation for a particular economic sector; rules that are specific to a certain group, or industry, or activity and that exceed those rules that apply to other groups in society or other transactions in economic life. This narrower concept of regulation constitutes not only intervention between parties to the transaction, but in fact, an interference with the manner in which events would unfold in the absence of the regulatory intervention. Viewed from this perspective, a regulatory intervention will complicate the transaction and give rise to costs, although it may be justifiable at least over a given time horizon.

Such intervention or interference is desirable – or in economic terms, efficient – only where it leads to an improvement in the outcome of the transaction and where the value of that improvement outweighs the costs involved.⁶ Measuring the improvement can often be difficult as the benefits may be manifest across one or more of a wide-range of fields – income redistribution, customer safety, public health, investor confidence, system integrity – and attributing a value to the identified benefits is a subjective exercise. Similarly, there may be problems in assessing the level of costs associated with the regulatory intervention. Firstly, the costs may be spread widely within the economy across the public sector, regulatees and consumers. Secondly, certain costs of regulation (*e.g.* reduced attractiveness of highly regulated areas to some foreign direct investment) are intangible and difficult to correlate correctly with the regulatory cause. Thirdly, costs may occur over time.

2.2. Economic regulation and markets

Economic regulation concerns those interventions whose purpose is related to improving the functioning of the market.⁷ In market economies, and certainly among most OECD member countries, economic regulation is a means of facilitating the functioning of a particular market with a view to increasing its economic efficiency. In non-market economies, by contrast, economic regulation is actually the controlling mechanism that substitutes for a true market situation.

The traditional economic rationale for regulation concerns the maximisation of **efficiency in monopoly markets**.⁸ The significant economies of scale and scope attaching to certain activities can mean that competition between several supply-side operators (at least within a given region) would involve a wasteful use of resources that could be avoided by a single supplier – the natural monopolist. However, economic theory demonstrates that monopoly markets are inherently inefficient because, in the monopolist's rational search for super-normal profits, potential consumer welfare is unrealised. The economic basis for regulating markets, therefore, is to help realise this welfare loss, and thus increase economic efficiency.

A further economic rationale for regulation is to deal with the **market failure** in relation to externalities. Some transactions give rise to societal benefits or costs that are not factored into the market's pricing mechanism; these benefits and costs are said to be external to the market. They concern the wider, third party effects of certain transactions that the principal parties are not economically motivated to consider as part of their pricing analysis. Externalities related to the system integrity and market confidence are an important consideration in the regulation of financial services.

A more recent justification for regulation concerns the correction of power or **information asymmetries**. These occur where one side of the market is more organised or more powerful and has better access to information than the other; typically, the discussion concerns a supply side monopoly or oligopoly, but it can extend to other situations in which one side is, for example, at a significant informational disadvantage to the other.⁹ In such instance, regulatory intervention can be merited in order to strike an appropriate balance between the interests of producers (cost recovery, profit-maximisation, increased market share) and the interests of consumers (ready access, quality services, reasonable prices).

Finally, the case is often argued for regulatory intervention in **facilitating market transition** – although the argument may be based more on public management tenets than on economics. It applies in markets that previously were monopolies (natural or otherwise) and that are moving to competition, whether in whole or in part. In such instances, the incumbent former

monopolist can use its dominant position to stymie or delay the market liberalisation process.¹⁰ A pro-active regulatory intervention in the market therefore may increase the effectiveness of the liberalisation programme. Often this intervention takes the form of the regulation of market entry, price and access to networks, with an emphasis on promoting competition.

2.3. *Deciding on the necessity of sectoral economic regulation*

A fundamental element for the successful operation of a regulator concerns the clear exposition of whether regulatory intervention – and, by extension, an institution charged with regulatory functions – is required at all. For most goods and services, the dynamics of the market combined with the facilities of basic economic framework laws, especially the competition law, are sufficient to deal with sectoral issues so that no special economic regulatory approach is needed.

In some circumstances, however, policy-makers come to an alternate conclusion.¹¹ They consider that the existing horizontal mechanisms are insufficient to permit market efficiency, ensure consumer protection or facilitate dispute resolution within their economic systems are insufficient, at least in the short-term. They argue that special instruments are required to help overcome the deficiencies of the existing legal and administrative systems in responding to the challenges of the relevant sectors. In other words, a sectoral regulatory response is required.

Policy-makers in different jurisdictions sometimes come to different decisions about similar situations, though. A notable example is New Zealand where, until recently, market forces, underpinned by the horizontal legal framework, were regarded as being sufficient for efficient operation of the telecommunications market; this contrasted with the view of most OECD member countries that their own telecommunications industries required special regulation at that stage (See Box 1). Even within a single jurisdiction, the assessment of the desirability for specific regulation can change over time; the fact that a newly-liberalised network market may have required specific regulation five years ago does not imply that such intervention will still be required in a further five years' time.

2.4. *Economic regulation of networks*

Regulation of the network industries or of utilities have been justified from one or many of the previous rationale underpinning the need to improve efficiency in imperfect markets. Traditionally, the network sectors have been characterised by the following traits:

- necessity for a supply/distribution network that had a large fixed element, that entailed high capital costs and whose life-cycle spans for decades;

Box 1. New Zealand's regulatory approach to network industries

In New Zealand, the approach to the regulation of network industries is based on the principle that access to essential facilities should be determined by negotiations between the parties rather than imposed by a regulator. Under this "light-handed" approach there are no price controls or other traditional forms of regulation nor are there industry specific regulators. Instead, the regime for network industries relies primarily upon general competition law administered by the competition authority, the Commerce Commission. This approach means that the courts play a greater role in the supervision of network industries in New Zealand than in most other OECD member countries that have sector specific regulation. Industry specific information disclosure rules, which are designed to make transparent the operations of firms with monopoly power and administered by relevant ministries, are also important in monitoring enterprises. The main institutional players under the regulatory framework, therefore, are the Commerce Commission, relevant ministries and the courts.

Electricity

The Ministry of Economic Development has general responsibility for energy policy (apart from energy efficiency, which is dealt with by the Ministry for the Environment) and for the development of the industry. Its specific responsibilities in the area of electricity include: compilation of statistics and projections; administering the rules on disclosure of information by electricity companies; developing rules and codes of practice relating to the safety, quality and measurement of electricity, and the promotion of health and safety in the electricity sector; and the registration and ongoing competence of electrical workers.

The Commerce Commission has been active in all aspects of competition law affecting companies in the electricity industry including: approval of mergers and acquisitions between power companies; authorisation of pricing mechanisms and other rules governing the wholesale market; examination of complaints regarding access to the network and other alleged cases of anti-competitive behaviour; and conducting educational programmes to inform and advise electricity companies of their obligations under competition law.

In 2000, the New Zealand Government announced plans to reform the regulatory framework for the electricity market. These include a reinforcement of the provisions that would allow government to regulate if industry performance is not satisfactory, a requirement to establish a transmission pricing methodology by the transmission company that will have to be approved

Box 1. **New Zealand's regulatory approach to network industries** (cont.)

by the government, and some provisions on electricity prices for small consumers.

Telecommunications

In relation to the telecommunications market, the Ministry of Commerce has the role of advising the government on the appropriateness of sectoral regulation, and the Commerce Commission oversees the telecommunications market based on the general competition law, the Commerce Act. In general, there is no sector specific regulatory requirement. However, there are some special obligations on Telecom New Zealand, "Kiwi Share Obligations", that are set out in the company's constitution and in effect regulate the price and availability of residential telephone service; in addition, telecommunications companies in New Zealand have established a Number Administration Deed mechanism to address future numbering issues.

While this light-hand approach would remain unchanged, the government powers to regulate the network industries would be reinforced. Earlier in 1991, the government issued a statement on its policy for competition in the telecommunications market, which threatened to impose sector specific regulation if the current system fails.

Source: IEA(2001) and OECD(2000b).

- a huge infrastructural significance – the electricity, gas, water, rail and communications industries being the networks underlying economic development;
- derived, rather than an intrinsic demand for many network services; and
- asymmetry of market power with usually one or few powerful supply-side operators and many unorganised parties on the demand side.

2.5. Evolution of the institutional approach to network regulation

As a result of the above combination of characteristics governments developed specific institutional approaches to regulate network industries – some of which are still dominant in a number of OECD member countries. Following significant nationalisation initiatives during the first part of the past century, network services were often delivered through state ventures. Ownership was deemed a key element of the regulatory framework and public monopolies tended to be regulated directly by the shareholding line ministry

through its influencing corporate and commercial decisions of the utility enterprise. The main rationales to put the public services beyond the scope of the private sector in many countries were the urgency to expand universal coverage and assure low prices of the services. Alternatively, in some countries the state control over delivery of utility services was effected through long-term franchise and concession arrangements with private monopolies. With the exception of the United States and Canada, where separate and independent utility regulatory commissions or boards involved in the regulation of private monopolies have existed for many decades, strict ministerial supervision of the market complemented the public sector involvement in service delivery.¹² Often a single line ministry was made responsible for the roles of policy-maker, service provider and market regulator for a given sector.

By the 1980s, the multi-function model of ministerial intervention in the network sectors was coming under criticism in some countries. On one hand, the shortcomings of state-ownership became increasingly visible. Of primary concern were management inefficiencies and structural rigidities that limited the exploitation of technological advances. Privatisation programmes were launched in an attempt to reduce fiscal pressures and refocus management of the state's ministries. On the other hand, the lack of regulatory transparencies related to direct control by the line ministry were exposed. The multiple roles of ministries in charge of formulating and implementing regulatory policy together with a variety of other social policies, (including those regarding sectoral development income distribution, and regional growth), fostered contradictions and conflicts in policies' aims. Moreover, the mix of economic, political and social policy considerations made it difficult either to distinguish or to evaluate objectively ministries' effectiveness and consequently created accountability concerns.¹³

The first notable deliberate amendment of the policy-maker/shareholder/regulator model of state involvement in utility markets was made in the United Kingdom. A simultaneous divestiture of the state interest in certain utility enterprises coincided with the establishment of dedicated utility regulatory bodies to oversee the operations of the newly privatised monopolies.¹⁴ Over the following two decades, many other OECD member countries have reconsidered their approach to state involvement in the network utilities and have reorganised their involvement in the sectors accordingly (see Table 3). In some cases, particularly in the earlier years, the selected route was monopoly privatisation, driven by the fiscal restructuring undertaken by many economies in the 1980s and the early 1990s. Central to the decision were the fiscal considerations related to the cost of state's continuing to provide inefficient network services and the revenue benefits of realising state assets and market rights. In later years, the stimulus for change has often been

Table 1. **A selection of sectoral regulatory and competition authorities in OECD member countries**

	Telecommunication	Energy	Financial sector	Competition authority
Australia	Australian Communications Authority (ACA) (1997); Australian Competition and Consumer Commission (ACCC)(1995); ¹ Australian Broadcasting Authority (ABA) (1992).	Australian Competition and Consumer Commission (ACCC)(1995). ¹	Australian Prudential Regulation Authority (APRA) (1998); Australian Securities and Investments Commission (ASIC) (1998).	Australian Competition and Consumer Commission (ACCC)(1995).
Austria	Austrian Regulatory Authority for Telecommunications and Broadcasting (RTR GmbH) (2001)(Formerly Telecom Control (TKC)(1997)); The Telekom-Control Commission; The Austrian Communications Authority (KommAustria).			<i>Kartellgericht</i> (Competition Authority).
Belgium	Belgian Institute for Postal Service and Telecommunications (BIPT).	The Electricity and Gas Regulation Commission (CREG).		<i>Conseil de la Concurrence</i> (Competition Authority).
Canada	Canadian Radio-television and Telecommunications Commission (CRTC) (1968).	National Energy Board (1959).*		The Federal Competition Bureau.
Czech Republic	Czech Telecommunication Office (2000); Council for Radio and Television Broadcasting (1992). ²	Energy Regulatory Office (2001).	Czech Securities Commission (1998); ³ Czech National Bank.	Czech Office for Economic Competition (1991).
Denmark	National Telecom Agency (NTA) (1991). ⁴	Energy Supervisory Board (1999). ⁵		The Danish Competition Authority; The Competition Council (<i>Konkurrenceradet</i>) Pre-1990.

Table 1. **A selection of sectoral regulatory and competition authorities in OECD member countries (cont.)**

	Telecommunication	Energy	Financial sector	Competition authority
Finland	Finnish Communications Regulatory Authority (2001) (formerly Telecommunications Administration Centre (TAC) 1988).	The Energy Market Authority (2000) (Formerly the Electricity Market Authority (SMK) (1995)).		The Finnish Competition Authority (FCA) (1988).
France	L'Autorité de Régulation des Télécommunications (ART) (1997).	Electricity Regulation Commission (2000).		<i>Conseil de la Concurrence</i> (The Competition Council) (1 December 1986).
Germany	Regulatory Authority for Telecommunications and Posts (Reg TP) (1 August 1996). ⁶		Supervisory Board for Financial Services (<i>Bundesanstalt für Finanzdienstleistungsaufsicht</i>) (May 2002).	<i>Bundeskartellamt</i> (The Federal Cartel Office).
Greece	National Post and Telecommunications Commission (EETT) (1998). ⁷	Regulatory Authority for Energy (1999).	Capital Markets Commission (1996).	Competition Committee (1991, strengthening an existing body).
Hungary	Communication Authority, HIF (1993).	Hungarian Energy Office (<i>Magyar Energia Hivatal</i> , MEH) (1994).		Office of Economic Competition, HCO (1990).
Iceland	Post and Telecommunication Administration (PTA) (1999).			
Ireland	Director of Telecommunications Regulation (ODTR) (1997). ⁸	Commission for Energy Regulation (2002). ⁹	Irish Financial Services Regulatory Authority (IFSRA) (2002).	Irish Competition Authority (1991).
Italy	Communications Authority (for telecoms, television, and publishing) (1997).	Energy Authority (1995).	<i>Banca d'Italia</i> (considered an independent authority only for its competition competencies); ISVAP; CONSOB.	Competition Authority (1990).
Japan			Financial Supervisory Agency (1998).	The Japan Fair Trade Commission (Pre-1990).
Korea			Financial Supervisory Commission (1998, unifying several separate bodies).	Korea Fair Trade Commission (1990, building on earlier bodies).

Table 1. **A selection of sectoral regulatory and competition authorities in OECD member countries** (cont.)

	Telecommunication	Energy	Financial sector	Competition authority
Luxembourg	<i>Institut Luxembourgeois des Télécommunications</i> (ILT) (1997).	Luxembourg Telecommunications Institute (LTI).		
Mexico	<i>Federal Telecommunication Comision Federal de Telecomunicaciones</i> (COFETEL) (1995).	<i>Regulatory Energy Comision Reguladora de Energia</i> (CRE) (1995).	<i>Banco de Mexico</i> (the central bank); the Banking and Security Industry Commission (<i>Comision Nacional Bancaria y de Valores</i>).	<i>Federal Competition Comision Federal de Competencia</i> (CFC) (1993).
Netherlands	Independent Posts and Telecommunications Authority (OPTA) (1997).			Netherlands Competition Authority, NMA (1998).
New Zealand				Commerce Commission (1986).
Norway	Norwegian Post and Telecommunications Authority (NPT) (1997). ¹⁰	Water Resources and Energy Directorate (NVE) (1986).	The Banking, Insurance and Securities Commission of Norway (<i>Kredittilsynet</i>) (1986).	The Norwegian Competition Authority (NCA) (1994).
Poland	Office of Telecommunications and Post Regulation (URT <i>ip</i>) (replaced URT (Office of Telecommunications Regulation, Oct 2000) on 1 April 2002.	Energy Regulatory Authority (1997).	The Bank Supervision Commission (1997); the Polish Communication Insurance Office; the Insurance Guarantee Fund; the National Insurance Supervision Fund; the Bank Guarantee Fund (1990, 2000); the Pension Funds Supervision Office (1997); the Health Insurance Supervision office (1997); the Spokesman of the Insured (1990, 1996).	Office for Competition and Consumer Protection (OCCP).

Table 1. **A selection of sectoral regulatory and competition authorities in OECD member countries (cont.)**

	Telecommunication	Energy	Financial sector	Competition authority
Portugal	<i>Autoridade Nacional de Comunicações</i> (ANACOM) (formerly ICP created in 1981).	<i>Entidade Reguladora do Sector Electrico</i> (ERSE).		The Competition Council.
Slovak Republic	Office of Telecommunications (2000).			
Spain	Commission for the Telecommunication Market (CMT) (1997).	National Energy Commission (<i>Comision Nacional de Energia</i>).	National Commission of the Securities Market, CNMV (1997, reformed).	<i>Direccion General de Politica Economica y Defensa de la Competencia</i> (Spanish Competition Authority); <i>Tribunal de Defensa de la Competencia</i> (The Spanish Competition Tribunal) (Pre-1990).
Sweden	<i>Post-och telestyrelsen</i> , the Swedish National Post and Telecom Agency (NPTA) (1994) (formerly <i>Telestyrelsen</i> , the Swedish National Telecom Agency, 1992).	Swedish National Energy Administration (1998).	Financial Supervisory Agency (<i>Fiansinspektionen</i>).	<i>Konkurrensverket</i> (Swedish competition authority) (1 July 1992).
Switzerland	Communications Commission (ComCom) (1997); Federal Office for Communication (OFCOM) (1992).		Federal Banking Commission.	<i>Commission de la concurrence</i> .
Turkey	Telecommunication Board (2000).	Energy Market Regulatory Board (2001).	Banking Regulation and Supervision Agency (1999); ¹¹ Capital Markets Board (1982).	The Turkish Competition Board (1994). ¹²
United Kingdom	Office of Telecommunications (OFTEL) (1984).	Office of Gas and Electricity Regulation (OFGEM) ¹³ (1999).	Financial Services Authority (FSA) (1986) under the Financial Services Act (renamed in 1997).	The Competition Commission; ¹⁴ The Office of Fair Trading (OFT).

Table 1. **A selection of sectoral regulatory and competition authorities in OECD member countries** (cont.)

	Telecommunication	Energy	Financial sector	Competition authority
United States	Federal Communications Commission (FCC) (1934).	Federal Energy Regulatory Commission (FERC) ¹⁵ (1977); different state public utility commissions.		Department of Justice (DOJ); Federal Trade Commission (FTC) (1914).

Note: The date corresponds to the year of creation or of last substantive reform.

In this table only autonomous ministerial agencies and independent regulatory bodies are listed. Other semi-autonomous institutions such a regulatory units within ministries or advisory bodies were excluded. For further discussion on the typology, see source below.

1. At the federal level.
2. Its powers were enhanced from 2001.
3. It has no rule-making authority but operates as an enforcer and monitor of the market.
4. Restructured with effect from 1 January 1998.
5. Created to replace the Electricity Price Committee and the Gas and Heat Price Committee.
6. The Regulatory Authority was set up as provided for by the Telecommunications Act, in force since 1 August 1996 but only took up its work on 1 January 1998.
7. Established in 1992 by Act 2075 under the name The National Telecommunications Commission (EET), EET actually commenced its operation in summer 1995. It was renamed as National Telecommunications and Post Commission (EETT) in 1998.
8. It was assigned regulation of postal services in 2000.
9. Formerly Commission for Electricity Regulation, CER (1999).
10. Established in 1987 as the Norwegian Telecommunications Regulatory Authority. It was assigned the monitoring of the postal market in 1997, hence the change of name.
11. Started to operate only on 31 August 2000.
12. Started to operate only in 1997.
13. Formed by combining the functions of the former Office of Gas Supply (OFGAS) and the Office of Electricity Regulation (OFFER).
14. It replaced the Monopolies and Mergers Commission (MMC) on 1 April 1999.
15. To replace the Federal Power Commission.

Source: OECD, various studies; IEA, *Regulatory Institutions in Liberalised Electricity Markets*, Paris; OECD (2002, forthcoming), *Governance of OECD Sectoral Regulators*, Paris.

associated with market liberalisation based on competition principles. Both scenarios – privatisation and liberalisation – demanded a reappraisal of the institutional approach to economic regulation of network markets.

Privatisation of state monopolies created a need for additional regulations to protect the consumer against the rational monopolist's search for super-normal profits, and to shield the economy from the inefficiencies to which monopoly operations – whether public or private. The privatisation of these old national champions without any unbundling of their activities secured them a huge market power. As these initiatives were accompanied with market liberalisation efforts for the sector to bring new players governments started to establish a fair arbiter to assure a level-playing field. With state shareholding powers no longer at its disposal in the privatised monopoly market, the line ministry often found that its existing capacities do not extend to the specialised, technical scrutiny required to oversee the private monopoly operator. Such supervision is particularly difficult if the utility enterprise is a vertically-integrated structure whose internal workings are non-transparent to the regulator.

Market liberalisation also impacted on the institutional approach required. A central issue is the need to separate the state's interest in the incumbent operator and its role in regulating the market, when this operator – often considered as a “national champion” – continues to be (at least partially) in public ownership. Market confidence, particularly among potential new entrants, is severely impaired if there is no delineation between the functions of shareholder and regulator, and this can jeopardise the success of the market liberalisation initiative. Even the perception of preferential treatment by the regulator of incumbents constitutes a strong deterrence to investment.

Other rationale for setting up independent regulators. In addition to the argument of distancing regulatory functions from the political process and increasing transparency in the simultaneous exercise of ministerial roles in an evolving market, some countries have justified the creation of new institutions on technical reasons. According to this rationale, the exercise of regulation is now so much more complex than previously that it is best carried out by an independent expert agency rather than within the ambit of direct ministerial control. A counter argument advanced by some countries, is that many complex and technical tasks are still undertaken directly by governments and that economic regulation is not so special that it is beyond the capacity of the core civil service operating directly under ministerial control.

Lastly, some governments have justified the development of independent regulators from a pragmatic viewpoint. Setting up independent regulatory

bodies have been considered a short-term strategies to avoid the inflexibility of the procedural and resourcing strictures that apply within government ministries. Often the creation of new institutions has been part of the policy advice provided to emerging countries needing to improve key areas of their public sector to attract foreign investment (see Box 2).

2.6. Designing the institutional framework

A central aspect in the design of a regulator is appraisal of the current institutional setting and the extent to which it meets new requirements, or whether it needs to be amended or even replaced with an alternative design. If the regulatory environment has changed significantly as a result of privatisation or market liberalisation, then it is likely that the existing regulatory institutional design will need significant revision. Often governments have designated the responsible line ministry to conduct such appraisal, impairing in practice its objectivity. In 1997, the United Kingdom tried to avoid such pitfall and commissioned the review to an *ad hoc* task force with a mixed membership. Transparency was further ensured by the publication of consultation papers before making policy decisions.

Coherence in the regulatory institutional redesign is even more important when a government embarks on economic structural reforms such as market openness and privatisation. Considerations of investor protection related to supporting market confidence and attracting foreign direct investment have influenced changes in regulatory institutional design.¹⁵ Furthermore, governments have often decided they need to ostensibly create new regulatory institutions at arm's-length apart from central ministerial structures to underpin their commitment to market stability, development and ethical behaviour of regulators.

2.7. Regulator's objectives

Lack of clarity of regulatory objectives has important implications in the assessment of regulatory performance (see Section 5.1). Not only do policy-makers need to set regulatory objectives – those high-level aims of regulatory policy – they need also to consider the criteria, priorities and outcomes for which the regulatory body itself is directly responsible and accountable. Moreover, the regulator's objectives should be subject to periodic review and its performance measured.

In general, the function of an economic regulator is to ensure that the market functions and in particular that consumers have access to secure services at a reasonable price. But if market failures occur, does the fault lie with the regulator or with the regulatory framework set down by the policy-maker? Sometimes it can be difficult to ascertain which is the case,

Box 2. Independent regulation in transitional economies

The rationale for regulatory independence can differ from country to country according to its existing economic, social, administrative and political circumstances. In economies that are coping with the introduction and embedding of fundamental structural changes, the regulatory framework for specific sectors such as the network industries often is linked to the economy's transitional status and to the condition of its existing structures of state.

Among developed economies, the purpose of regulation generally is related to consumer welfare. By contrast, the regulatory rationale in emerging economies is more often associated with protecting producer interests. Many transitional economies are dependent on private sector involvement – including foreign direct investment (FDI) – in the productive sectors and in the provision of the infrastructural services that underpin economic growth and development. Investors, however, want reassurance as to the security of their investment, the sustainability of the market, and the probability of an acceptable return; they are deterred by high-risk environments. Much of the World Bank's analysis of sectoral regulation and the need for regulatory independence is based on the particular challenges that face emerging and transitional economies in providing the economic and administrative stability to which private sector investment is attracted.

The establishment of regulatory institutions that are demonstrably distanced from the political process is often considered to be a critical step in dealing with these challenges. The creation of such bodies helps to engender confidence in a regulatory system that is objective, impartial and expert in the carrying out of its work. It also indicates a level of government commitment to breaking the link between regulation and the political cycle, and indeed, in breaking links with previous administrative structures. This can be important in circumstances where the existing public administration lacks the confidence of the market or even of the wider public. The establishment of new independent regulatory bodies can be a relatively speedy means of achieving investor confidence in the expertise, objectivity and ethics that apply to the regulatory system, without the necessity of awaiting the coming into effect of the wider-scale programme of public sector modernisation with which the emerging or transitional economy would also be engaged.

particularly if the regulator has been charged with multiple and competing policy objectives.

There is a variety of reasons for which regulators can be given a multitude of objectives rather than a clear, single, market-based mandate. In some instances, governments give insufficient attention to developing their vision of the purpose and objectives of regulation and this lack of clarity translates into the mixed range of functions that they transfer to the independent regulatory body. Occasionally, a government that wishes to avoid a difficult decision will offload a particular function to an independent regulatory body, regardless of whether the function is consistent with the existing objectives of the regulatory body.

Failure often arises when regulators have been given opposing objectives. Consider the case of an energy market regulator who is charged with promoting good environmental practice in the sector while expected to facilitate its expansion. The regulator may well make progress on both fronts, but to the extent that these objectives are competing rather than complementary, then trade-off decisions must be made. Because some of these trade-offs may not be transparent, it will be difficult to evaluate them, and hence to measure the performance of the regulator. A solution can be to provide the regulatory body with a set of parameters, together with clear priorities, accompanying its market-based mandate. These parameters could comprehend the social, regional and environmental policy that the government has set and within which boundaries the regulator is required to operate, but on which the regulator is not expected to make decisions.

Often, the regulatory institutions themselves take on additional objectives over time. An energy regulator, for example, may seek out new responsibilities in the environmental area related to energy efficiency and sustainable development in addition to the regulator's core competition role. Such "objective inflation" is a common feature of bureaucracies in general; the world of independent regulatory bodies may offer limited scope for "budget-maximising", but it does present opportunities for "bureaucratic empire-building".

Moreover, expansion of the independent institution's remit may also be inversely related to the need for economic regulation, which generally declines over time as competition develops in the regulated market. Rather than face extinction, regulatory bodies will advocate and assume additional tasks and functions that can help justify their continued existence.

Expansion of regulators' functions and objectives may be the result of collusion of politicians and regulators' interests. The resulting structure and split of responsibilities will cultivate poor public administration practices and

blur accountability. If, for example, an independent regulator is given a social policy objective, such as improving the welfare of categories of consumers,¹⁶ then a danger of duplication of effort between the regulator and the government agency charged with the social policy will arise. More significantly, the split in responsibilities on the policy will impact adversely on the overall fulfilment of a policy goal.

Whatever the motivation, recent experiences in OECD member countries have shown that there are three critical elements of the institutional design: independence, accountability and coherence of the regulatory approach.¹⁷ It should be borne in mind that consideration of these inter-related issues is undertaken in an iterative fashion through a form of hysteresis. For presentation purposes, however, discussion of the three elements in the following sections of this report is necessarily linear and sequential.

3. Regulatory independence and institutional design

3.1. A relative and multi-faceted concept

Regulatory independence is a matter of degree rather than absolute. Constitutional setting can impose limits on the degree of discretionary powers that can be devolved from the government to ministries and from the ministries to arm's-length bodies. Often regulatory powers can be exercised exclusively by the central government implying a strict hierarchy and accountability chain of command.¹⁸ Regulatory independence is constrained by the reality that those who are charged with regulatory functions must interact with market, political and societal players in the efficient exercise of their duties.¹⁹

Independence is also a multi-faceted concept. It usually centres on distancing the design and execution of the regulatory function from many of the political and administrative pressures of central government. In parallel, independence connotes an arm's-length relationship with the interests of producers, consumers and other parties within the regulatory domain, such as financial institutions and employees. There is a correlation between each of these relationships and the institutional setting from which regulation is delivered. Under this complex approach, the transparency of rules is paramount to assuring the independence in the exercise and effect of regulatory functions.

3.2. Independence, influence and institutional design

Regulation affects many players in the market and in the wider society. If the players are rational – or more likely, act within the realm of bounded rationality²⁰ – then they will seek to influence the regulatory process with a

view to benefiting their own interests. Typically, the incumbents want to retain market share, new entrants want low cost interconnection to existing networks, employees want to retain their jobs, shareholders want maximised share value, customers want access to high quality service at low prices, politicians want to retain office, citizens want reduced taxes and accountable institutions of state. Each of these interests is legitimate and attempts by the parties to further these interests through the regulatory process are not, *prima facie*, improper. The difficulty, however, arises when the regulatory system is influenced in a non-transparent manner that reduces societal welfare and unfairly privileges particular interests.

The benefit of institutionally distancing the regulator from interested parties is that it provides protection against capture of the regulator by interests likely to bias the regulatory process and hinder its effectiveness. Independence can also support impartiality and neutrality in the exercise of regulatory powers. The independence can be reinforced by transparency rules governing the exercise of the regulatory function.

3.3. *Independence from political and administrative influence*

As previously discussed, in the past 15 years the traditional institutional model has profoundly changed in many OECD member countries. Today a proliferation of separate specialist regulatory bodies indicates that ministerial control of regulatory functions has been greatly reduced and in many cases eliminated.

The independence aims at creating a distance between regulatory decisions – in the design as well as in the adjudicating phase – and administrative and political processes eminently focused on short-term political considerations. The longer term perspectives for regulatory decisions are linked to the capital-intensive nature of the network sectors. Usually investors need to be assured of a long-term commitment to regulatory stability. They need to know that the regulatory process is protected from the vagaries of the political cycle.²¹ For example, few governments facing a general election would give sanction to an increase in utility prices regardless of whether such an increase were economically justified. Indeed, fewer opposition parties would like to support such a measure if it required the backing of the legislature. Such issues are of particular significance in jurisdictions where the public or producers lack confidence in the expertise or the objectivity of the public administration.

A second factor relates to the confusion of roles that occurs when the regulatory authority is at the same time the sectoral policy-maker and the shareholder of market operators. For example, the government may confuse the motivations for its actions approving a project that provides a poor rate of

return for the utility company but which supports the government's regional policy objectives. Even where the government does not engage in deliberate cross-subsidisation, the public perception of regulation can be clouded by government's joint exercise of roles. The claims of regulatory bias – whether or not justifiable – may be even more patent when the state-owned operator is the historical incumbent inheriting strong “good will” and information on the market.

However, while the creation of an independent body removes the regulatory decision from the immediate political realm, it is not a guarantee of sufficient distance from all influences that would affect a regulating minister. Indeed, it can be argued that a technical regulatory unit within a ministry, or even a regulatory advisory body, may be more likely to generate apolitical regulatory solutions than an independent executive regulatory body; because the latter is publicly and directly identified with its own regulatory decisions and actions, it may be more reluctant to take decisions that are unpopular.

Strategic distance from difficult decisions. As in the case of central banks, independent regulators are sometimes important vehicles, for government and legislatures to pursue desired, but difficult or unpopular, policy direction. For instance, even when they accept market reform in principle, both the Executive and the legislature are often reluctant to be seen committed to the detail of reforms that will reduce market power of the incumbent operator – particularly if this market player is, or has been, a state-owned enterprise. Indeed, an independent regulator backed by government but operating, on a day-to-day basis, removed from the immediacy of the political milieu is less threatened by the electoral implications of different regulatory decisions. The Executive and the legislature are aware that they are less closely identified with the unpopular decisions that a market-liberalising regulator has to make.

3.4. Forms of institutional independence

There are several institutional models currently in use among OECD member countries that provide varying degrees of regulatory independence from the political sphere.²²

Where regulation still remains a ministerial function, its execution can be given a degree of independence by its separation from the sectoral policy-making and the shareholding roles also executed by the ministry. **Identifiable regulatory units** housed within central government ministries can gain an element of administrative – if not legal – independence in this way. This model injects some transparency into the regulatory process because pressures from the policy and shareholder functions become more apparent, at least to the regulating administrator if not outside the organisation.

In some administrative systems, regulatory independence is secured through the medium of **independent advisory bodies**. These bodies are established at arm's-length from the government to provide an external view to the responsible ministry that retains the executive regulatory powers. The function of the body is to provide advice, usually of an expert nature, to the regulating minister. While such bodies do not have decision-making powers, they can improve the independence of the decision-making process. In particular, if transparency rules allow their advice to be made public, the regulating ministry can come under public pressure to provide a justification for occasions on which it departs from the expert advice. Apart from their use in network regulation, such bodies are common in the area of health regulation where panels of medical and healthcare experts often are established to provide expert advice to regulating health ministers. However, independent advisory bodies may be vulnerable to capture, particularly if their members interpret their appointment as a representation of their professional discipline.

Another form of regulatory institution is an executive body, set at arm's-length from central government, but subject to powers of ministerial intervention – the **ministerial agency**. Typically, governments refer to such bodies as being autonomous. However, their independence of government is severely constrained if they are made subject to provisions which, for example, require ministerial approval of certain decisions (e.g. issue of licences), allow for ministerial direction in certain matters (e.g. access pricing principles) or designate a minister as the appeal body in cases of dispute.

Where the scope for ministerial intervention is removed, or at least restricted to the provision of advice or direction on non-economic matters, then the regulator is generally considered to be an **independent regulatory body**. In some cases, like in Italy, the independence can mean that the body reports directly to Parliament, short-circuiting the government and the Cabinet. Of course, regulatory bodies are never completely independent being variously subject to the legislature, government, industry, judiciary and the public in terms of governing legislation, appointment, financing, review of decisions and appraisal of performance – all matters relevant to the accountability discussion in the next section.

A further possible regulatory approach is that of **industry self-regulation**. However, the efficiency of this approach is correlated to the degree of market openness. In the monopolistic or nascent markets typical of the network industries – or even in some more developed utility markets where there are still natural tendencies towards oligopolistic behaviour – this approach tends to reduce societal welfare. The difficulty with this model is that the high degree of institutional independence from government, politics, consumers

and other interests is not sufficiently counter-weighted by the regulatory proximity to the industry's self-interest.

3.5. *Independence from regulatees*

In general, the regulator's relationship with the regulated industry is critical to the effectiveness of the regulatory process. A constructive working relationship between regulator and regulatee is necessary, but may hold the seeds of regulatory capture. While much of the relationship is contingent on the operational contact between the regulatory office and the industry, there are key aspects which are pre-determined by the regulatory institutional design.

Where there are few market players – as is typical of the supply side of network industries – the market operators tend to know more than the regulator about the state of the market, technological advances in the industry and the nature of their own activities.²³ Information asymmetry is therefore often a critical issue in the regulatory environment.

Even when there are many market players, information dependence has a bearing. If the operators organise themselves together, they can develop into a strong lobby group and can have an economic and analytical power matching or ever surpassing that of the regulator, regardless of whether the regulator is a ministry or an executive body. Technical complexities can reduce regulatory transparency, and can be used to screen market behaviour that is inconsistent with the principles of competition and consumer welfare. Technical arguments are commonly brought into play in discussions of security of supply, and it can be difficult for the industry-information-dependent regulator to discern the legitimate from the spurious invocation of such concerns as behavioural justification.

3.6. *Further sources of influences*

Apart from the obvious interests of the government and industry, there are several additional parties – financiers, employees, customers and others, including non-governmental organisations (*e.g.* environmental groups) who may seek to influence the regulatory process as far as their interest is concerned.

Financiers. In the case of the utility sectors, the interest of financiers stems from the high capital intensity of networks, and is likely to be associated with financial market reactions to the privatisation or market liberalisation policies that often underlie regulatory change. Depending on the economic climate, financiers may see change either in terms of new opportunities for investment or alternatively as the withdrawal from the market of the traditional government underpinning that, in most developed

countries, provides stability and assurance to financial backers. In the particular case of financial services regulation, of course, the financiers are also the regulatees, which intensifies their interest and influence in the regulatory process.

Employees and labour unions. Typically, employees are well organised in the traditional incumbent utility. Not surprisingly they view regulatory change as a complement to industry restructuring, and thus a threat to the security of their employment. Where the incumbent is, or has been, a state-owned enterprise, there is probably a history of employee involvement – either formal or informal – in business-related decisions. In neo-corporatist political systems, the staff unions in the utility industries are often strong players in the social and economic decision-making process, and are accustomed to the exertion of their influence and to its being reflected in national and industry-related decisions.

Consumers. Consumers are directly affected by the price, quality and access to services provided by utilities and thus by the improvements that regulation is designed to provoke. Nevertheless, consumers are seldom organised as an identifiable group.²⁴ The business customers are generally well organised usually in terms of trade or industry associations. However, retail-level, domestic or small business customers are less likely to form groups through which they can exercise influence.

Nonetheless, consumers of utility services comprise a very large sub-set of citizens and voters, and this put issues like utility prices high on the political agenda. When regulation is made more independent of government, however, the electoral channel for the manifestation of consumer concerns is removed. Both the designers of regulatory institutions and the regulators therefore often find themselves deliberately creating structures to increase consumer input into the regulatory process in contrast to their usual approach of trying to limit the scope for input from other, more organised, interested parties. Of course, this can be problematic too, particularly where consumer groups are co-opted in which case they may not be truly representative of the consumer interest.

3.7. Building independence into regulatory structures²⁵

Past experience in the design and operation of independent regulators provide preliminary indications on key tools and procedures that can ensure independence. As often the case a combine use provides a better protection against capture, though the political, legal and administrative context of each country modifies their need and practical setting. A rapid enumeration of the main instruments is made in the following paragraphs.

3.7.1. *Legal and cultural basis for independence*

Nominal regulatory independence is usually, though not exclusively, provided through the legal system. In many countries, independence underwritten by statute (i.e. primary legislation) usually has more significance than independence given by ministerial or even presidential or cabinet order (i.e. secondary legislation). Political and administrative culture is also important, as the practice, even by regulators themselves, of upholding institutional independence is stronger in some systems than in others.²⁶ Moreover, the internal culture as well as the perception by the outside world of the degree of independence of a regulatory body will be often marked for many years by the behaviour of a charismatic leader.

3.7.2. *Regulation by individual or commission*

There are two basic structures for a regulatory body: either an individual or a group leading the institution. The former model is identified often with the United Kingdom approach. Nowadays, the latter model is the more usual approach. In both circumstances, the person or group at the top of the structure assumes the legal personality of the regulatory body. There are many governance facets to the individual vs. group debate in regulatory design.

The prospect of **consistency** in the decisions of a regulatory authority helps to contain the level of regulatory uncertainty in the operating environment. A central concern on this issue is the timeframe across which consistency is to be measured. Although the decisions of a single regulator may be more consistent than those of a board over one term of office, there is likely to be a discernible shift of focus following the changeover of office from one single-person regulator to the next. Longer term consistency is more likely where there are regulatory boards whose individual members have staggered terms of office. Staggering the terms of appointment may also augment independence by breaking the potential coincidence between the term of office of regulatory commissions and the term of office of governments. Staggering of appointment may also limit the loss of corporate knowledge when regulators depart, and avoid the regulatory uncertainty associated with complete changeover in commission membership.

The **speed** of the regulatory decision-making process may also be affected by whether the institutional design involves an individual or a commission. In general, individuals have the potential to execute their functions more expeditiously than groups. Conflict and delay may arise where there is a board or commission and particularly when different governmental bodies appoint the members. However, the rate of decision-making is also contingent on the nature of the decision procedures and is constrained by the imperative to follow due process.

There are conflicting arguments about whether individuals or groups are more vulnerable to regulatory **capture**. The successful capture of a single regulator will be fully effective but probably more transparent than in the case of a board. In a group situation, the effect of the capture of some of the members will not be as complete, although it will probably be less apparent to the outsider and the capturing interest has a choice of persons on whom to exercise influence, some being more susceptible than others. It is also argued that the individual regulator structure leads to undue personalisation of the regulatory process, although there are many examples of commissions – regulatory and otherwise – whose chairperson is personally identified with that body.

The pool of suitable persons for appointment to regulatory positions, the level of financial **resources** available to support the board, or the size of the industry under regulation have also an impact on the appropriateness of a single or group structure at the head of the regulatory body.

3.7.3. *Variations on top-level regulatory structures*

There are several variations on the basic structural approaches to establishing regulatory institutions that try to combine the simplicity and efficiency of the individual regulatory model with the range and continuity of experience offered by the commission structure.

One possibility has been the setting up of a commission with both full-time Executive members and part-time non-executive members, similar to the normal structure of a board of company directors. This option allows for expertise at reduced cost while also keeping some of the top-level decision-making structure outside of the day-to-day operation of the body, thus reducing the potential for institutional self-capture. Nevertheless, this model may be more vulnerable than others to conflict of interest situations, as it can create additional challenges for the control of regulators' personal interests. Procedures for the management and control of potential conflicts of interest could have a particular pertinence in the context of part-time members who would be pursuing other activities in addition to regulating and adjudicating (see section below on regulators' interests).

Another option has been the establishment of a commission with scope for change in membership size. Such an approach has been adopted in Ireland for both the electricity and the airports regulatory bodies, and is proposed in the forthcoming amending legislation for communications regulation; the legislation in each case provides for the ministerial appointment of a commission whose membership shall be between one and three persons. This solution facilitates reassessment of the appropriateness of the individual/group structures in the light of changing circumstances. However, it might

detract from the independence of a regulatory body if the possibility of changing numbers of ministerial appointments were to be perceived as a leverage on an existing commission.

3.7.4. *Selection of candidates for regulatory positions*

In most cases regulators are protected from easy or undue removal so that independence is ensured. Consequently the selection of candidates and the design of the selection mechanism become paramount. Different approaches have been tried to guarantee a proper and efficient selection. Each of them having pros and cons. Following are some usual mechanisms:

- A variety of persons and bodies are charged with the responsibility of selecting candidates for top-level regulatory positions: the head of the administration, ministers, parliamentary commission or even opposition parties.²⁷
- A selection committee is organised to take a unanimous or majority decision. The committee can comprise members of the legislative, Executive and/or judicial branches of the state.
- Selection bodies formed with “eminent persons” similar to those for non-political administrative appointments are created.

Certainly, a ministerial selection mechanism will not improve the perceived independence of the successful candidates. On the other hand, the use of special selection committees also raises questions as to the objectivity of the selection process and the independence of the committee itself.

The means of selection of individuals for top-level regulatory positions is probably of more significance to their independence than is the method of their appointment. If the selection process is independent, then the appointment process is largely ceremonial and its politicisation will not detract significantly from the regulator’s independence. Nevertheless, the appointment process can also have an effect on regulatory status; regulators appointed by a head of state or government are perceived as being more powerful than those appointed by a minister, for instance.

3.7.5. *Skills and experience required*

Objective selection criteria for regulatory positions reinforce independence of regulatory bodies. Network regulatory issues often require extensive knowledge of regulatory economics and administrative and legal acumen and experience. However, it is debatable whether prior in-depth knowledge of the regulated industry or of regulation itself is of more direct relevance to a candidate’s ability to be a successful industry regulator. Will an experienced manager (in whatever field) or a relevant expert make the better regulator? There is unlikely to be a fixed answer. In selecting for positions on regulatory boards, a mixed approach may be adopted taking into account

dedicated expertise and generic management experience. However, sometimes having an overrepresentation of experts and specialists in the regulated field can lead to perceptions that the board members defend particular interests in a partial and non-objective way.

Another important issue concerns the difference between the skills required for an individual regulator and that sought in a member of a regulatory commission. In the former case, there is usually a strong emphasis on individual motivation and responsibility, and ability to take on leadership of the regulatory organisation. The latter case, on the other hand, requires strong skills in working as part of a team. The commission chair needs to have particular skills in chairing groups, and these requirements vary according to whether there is an even or an odd number of commissioners. Furthermore, if there is a provision for the rotation of the chair between the commission members (in order to balance the power between them over time), then it needs to be taken into account in the selection of the commission members, that all of them need a certain level of group chairing skills.

The requirements are not static though. Different phases of the regulatory process require different skill sets and leadership styles. In its start-up phase, for example, a regulatory institution can benefit most from a strong and charismatic leader who is ready to firmly carve out and defend the institution's mandate and assert its independence. Conversely, regulatory retrenchment will be assisted by a leader, whose perspective is broader than building and strengthening the institution, and who is willing to desist from regulating where the benefits of such intervention no longer justify the costs.

3.7.6. Term of office and reappointment

Constant or unwarranted dismissal of regulators can be seen as a profound breach of the principles of independence. On the other hand, the permanence in office of the same individual or board members may lead to rigidities and help develop an intimacy with stakeholders incurring the danger of capture of the regulatory institution. Therefore, many countries have fixed the term of appointment of regulators and bringing "new blood" to regulatory bodies is considered essential too. However, there is no optimal length of service for a regulator. Less than three years is probably too short, and over 10 years probably too long. Similar arguments can be made in relation to re-appointment. In practice, some systems limit the opportunity for the reappointment of regulators following the expiry of their initial term of office.

3.7.7. Removal from office

As a mechanism of imposing accountability, a provision for the removal from office of regulators is included in most regulator statutes. To balance the

need of regulatory independence, however, removal powers are frequently reserved to a limited range of circumstances – typically, personal incapacity, of grave misdemeanour. In general, regulatory independence is better ensured if the removal of a regulator requires the approval of the legislature.

3.7.8. Restrictions on personal interests

Possibility of conflict between their regulatory authorities and other interests of regulators and their staff is real in the network industries due to the very specialised knowledge and expertise required. Charged with tasks that have major consequences for the various stakeholders, the regulator's personal integrity is vital in reinforcing public confidence.

Increasingly, explicit provisions are written down to constrain regulators from pursuing interests in conflict with their regulatory functions during and after their tenure in the regulatory institution. In jurisdictions where public office ethics rules already exist, regulators are often subject to them and in some cases to additional disciplines regulating the financial interests and ethical conduct of regulatory appointees. A particular requirement set up by some governments has consisted in developing specific constraint on former regulators from undertaking potentially conflicting activities, such as employment within a regulated industry, during a fixed period after the expiration of a term of office. Compensatory financial arrangements are often required to offset such a restriction.

Finally, it should be noted that, while the potential for conflict of interest arises in relation to all regulatory appointments, the potential is particularly strong in the case of part-time regulatory posts. In such cases, the reasons for which individuals are considered suitable for appointment as regulators – such as their relevant experience – are also likely to be matters that can lead to activities of conflict of interest.

3.7.9. Resourcing

Financing and staffing are critical issues for the independence of any organisation and of regulatory ones in particular. The nominal independence of a regulatory institution needs to be underpinned by ready access to adequate resources, before it has real effect.

Adequate financing plays a central role in the overall efficiency and independence of the regulatory body. In some cases regulatory bodies are financed from central exchequer funds; in other instances the regulatory body raises its **funding** from levies or fees imposed on the regulated industry; a further option is the imposition of tariffs on consumption of the regulated good or service. Financial dependence on the government budget can detract from a regulator's political and administrative independence. Conversely,

regulatory financing by consumption taxes may make a regulator over-sensitive to short-term public opinion at the expense of long-term economic efficiency.

Even where regulatory bodies have secure access to finance, this may render them liable to pressure, for instance, from the central government or Finance Ministries that perceive the regulators' revenue-raising powers as a macroeconomic tool of government. In order to avoid such a situation, in some cases, the statute distinctly clarify the role of the Treasury department in relation to the funding of the regulator.

Just as the independence of a body is impaired by lack of funding, a regulator imposed with a too rigid **staffing** policy may not function effectively. The effective exercise of economic regulation requires access to expertise in several highly technical fields (*e.g.* pricing of interconnection charges and tariffs) which is often in short supply. Even in the case of a comparatively large pool of expertise, regulators often need to compete for the best technicians with wealthy private companies and other regulators. To countervail this situation, some governments and legislatures, like in Greece, have exempted some or all regulatory bodies from standard civil service pay and allow their employees to enjoy a higher payroll.

A number of different approaches to the staffing of independent regulatory bodies have been adopted under different circumstances. They have included direct recruitment of ex-ministerial staff, secondment of civil servants, secondment of regulated industry personnel and the medium-term hiring of expert consultants. Each of these arrangements creates different effects on independence, budgetary cost, administrative burden and flexibility of the regulator.

Securing the autonomy in the selection and hiring of its own staff and the power to set their terms and conditions (including pay) has been particularly critical in building confidence in the regulator of the market and of the parties affected by regulation. In transitional economies where the legal and market frameworks are very immature and where producers and consumers cannot wait for the general public service modernisation programmes to take effect, such arrangements have been used to overcome more speedily the weaknesses associated with the existing public service structures and systems.

3.8. Weaknesses of regulatory independence

Institutional independence is not a panacea for regulatory framework challenges. Independent regulatory structures have potential and inherent disadvantages that need to be taken into consideration in the design of a regulatory architecture.

First, the new body can be seen to be a feeble offshoot of the ministry. This perception is often linked to the independent regulatory body's distance from the central policy-making function – both as regards to the specific sectoral policy and other related areas, like competition policy – and hence, its reduced influence on policy development. Remoteness from cabinet can breed negligence of the regulators' authority from other strong political players in the executive or legislative branch. Ultimately, it can impair confidence in the strength of the body and in the significance of its work. The lack of market confidence in the institution, whose purpose is to overcome market deficiencies, in turn, precludes it from supervising and regulating the markets effectively.

Secondly, it can also be argued that, being smaller and more focused than a ministry, the independent regulatory institution is more vulnerable to capture. This again can be a matter of perception rather than reality, but in relation to regulatory capture, the mere perception of vulnerability often is sufficient to undermine confidence in the structure.

A third weakness of independent regulatory structures is, paradoxically, related to strength. There is a possibility that an independent agency can become too strong, or “too independent” though time and becomes a “governments in miniature”.²⁸ If unrestrained, an independent body may act beyond the role envisaged for it at the time of its establishment. A case in study is Canada, in which the degree of independence of many regulators has been progressively reduced and/or constrained by accountability measures and co-ordination mechanisms (see Box 3). For instance, bureaucratic inertia and strong lobbying by the regulator may provide it with a longer life expectancy than the one justified by the market conditions in the sector.

Moreover, additional risks can be associated with independent regulators, which may reduce longer term regulatory quality in vital infrastructure sectors:

Democratic accountability may be sacrificed. Too much independence is inherently incoherent with the concept of democratic accountability and it needs to be balanced with accountability mechanisms. Accountability can be maintained through various mechanisms, including executive oversight and powers of direction, strict procedural requirements, reporting obligation, public consultation and substantive judicial review.²⁹

Independent regulators may slow structural change, resulting in the loss of potential gains to consumers. Regulators are often established along sectoral lines and may tend to obstruct convergence between sectors and the emergence of new business models. It can therefore hinder technology advancement and impair market efficiency. Similarly, as regulators proliferate, other institutional rigidities may increase.

Box 3. Regulatory independence in Canada

Contrary to the trend of establishing independent regulators in most other OECD member countries, about 20 years ago Canada started to reduce the degree of policy-making powers of the independence enjoyed by its existing cohorts of fairly autonomous regulatory bodies.

Between the 1930s and the late 1960s, the Canadian Government progressively increased powers of specialised sectoral regulators until it had established veritable “governments in miniature” where regulators had a broad range of powers and instruments with which to regulate the energy, transportation and communication sectors. These bodies had both comprehensive regulatory decision-making powers and an independent capacity as primary policy-makers in those sectors. They possessed a mix of functions that included regulation making, licensing, adjudicative, quasi-judicial, subsidy or spending roles, policy, and policy-making and monitoring roles. Though supervised by the courts and the Cabinet, these regulatory bodies enjoyed considerable autonomy within the federal government.

During the last two decades the Canadian Government has largely reclaimed the policy-making powers formerly exercised by the independent regulators, moving the model toward one more typical of the ministerial accountability usually found in a Westminster-style parliamentary system. As a result there was a general reduction of the degree of independence enjoyed by these bodies. Today, only the Canadian Radio-television and Telecommunications Commission (CRTC) retains its former status and power. Its counterparts, the National Energy Board (NEB), which regulates the gas, oil and electricity, and the Canadian Transport Agency (CTA) have had their range of powers and functions contracted and their membership and staff greatly reduced.

The reduction of institutional autonomy has been accompanied by a rise in the accountability of ministers. Ministerial accountability to Parliament has been enhanced by requiring, amongst other things, that the minister, and not the regulator, tables its annual report in Parliament. Accountability to the public has also been enhanced by the adoption of extensive consultation with interested parties regarding proposed changes to regulations and through the widespread use of public hearings.

A reinvigorated competition authority comprising the Competition Bureau and commissioner, and the Competition Tribunal, has also strengthened the new framework. In transport, electricity and natural gas, the bureau has played an important role in bringing about pro-competitive regulatory reform through reducing the scope of sector specific regulation in favour of broader general

Box 3. Regulatory independence in Canada (cont.)

policies. The bureau's advocacy occurs (on its own initiative or on request from the regulator) through interventions before the industry-specific regulator as well as by providing policy advice to Parliament and to the government departments overseeing the industry in question. Also, the bureau can file submissions in support of greater competition and possibly participate in regulatory hearings and consultations conducted by the regulators. The Competition Bureau has also articulated a number of principles related to assigning and co-ordinating its roles and responsibilities with those of various regulators.

Source: OECD (2002, forthcoming), Regulatory Review in Canada, Paris.

Government-wide coherence of policies may be reduced. Independent regulators may contribute to the inconsistency among governmental agencies and policies, in particular in the case of its interacting with the competition authority. As sectors restructure and become more competitive, sector-specific issues become less important *vis-à-vis* general competition issues. Ideally this requires a transfer of powers to the overarching competition authority but inertia and resistance from the regulator is likely to impede the transition.

4. Designing regulatory governance for accountability

Experience in several OECD member countries indicate that the development of independent regulators can be balanced by important and more efficient accountability mechanisms. In this section, the adequate balance between these two central aims will be explored.

4.1. Independence and accountability

There are many parties to whom regulators can be made accountable: the industries they regulate, the Executive who establishes them, the legislature who makes their governing legislation, the judiciary who applies the law of the land, the consumers of the regulated industries, the citizens who constitute the political society from which all administrative power originates. The challenge for regulatory institutional designers has been to make the regulatory system simultaneously accountable to each of these parties according to their interests, without compromising the operational independence of the regulators that sets them at a remove from the interested parties.

Accountability provides a restraint on regulatory independence and a means of remedying the democratic deficit created in devolving regulatory functions from the centre of political power.³⁰ However, it is also true that accountability is a means of underpinning regulatory independence by integrating the regulatory function into the existing structures of state and giving regulators not only the duty, but also the right, to make account of themselves.³¹ This integration, if successful, can countervail the weakness of independence arising from the regulators' remoteness from the centre of the government as noted previously.

4.2. Updating the accountability mechanisms

Accountability concerns the obligation to explain, answer for, and bear the consequences of the manner in which one has discharged duties, fulfilled functions and utilised resources.³² When regulatory functions are moved from the policy-making centre of government and into independent institutions there is usually a severing of the political accountability mechanisms that previously applied in respect of exercise of the regulatory function delegated to representatives of the people such as the legislative or ministries. In theory, once an independent body is charged with a set of regulatory objectives, then the relevant minister should stop to be answerable to government, Parliament or the electorate for such matters.

A consequence of setting up independent regulators is thus a reappraisal of existing accountability mechanisms and the development of new suitable ones. Those old and no longer suitable mechanisms that do not lapse of their own accord should be deliberately dismantled; if they remain, they will compromise the independence of the new institution because they will blur the link between responsibility and accountability. New accountability mechanisms then need to be built in order to ensure that the safeguards to accountability and to regulatory independence are in place under the new regime.

The accountability mechanisms for new regulatory institutions are however extremely tricky to establish. New and unexpected moral hazards arise through the regulatory intervention and liberalised markets.³³ For instance, in the event of a regulatory failure in a regulated market, who should be made accountable: the market players who exploit regulatory rules, the regulators who made those rules in the first place, the politicians who, conscientiously or not, created the regulator as an escape from taking difficult decisions? In markets that are liberalised, the regulator may take over from the *ex state monopoly* the responsibility for ensuring universal services without the budgetary means. But in a situation of supply interruption and a reduction of supply of universal service, neither the government nor the regulator should expect the private regulatees to continue acting as an agent of the state, but rather as a free market player operating within the bounds of the

regulatory rules.³⁴ In fact, as the regulatory framework becomes more complex and responsibilities are shared between law-makers, ministers, regulators, judges and competition authorities, it is harder and harder to assure a proper accountability of the network of entities.

Basically, accountability of the regulatory process can be ensured through mechanisms related to each of the three branches of government: the Executive, the Parliament and the judiciary. Administrative accountability concerns how, as a government-sponsored process, regulation should comply with fair and transparent procedural practices, reporting systems and controls. Accountability through the Parliament ensures that the regulators are answerable not only to the government of the day, but also to the broader spectrum of the political democracy. Accountability through the judicial system can help ensure the impartiality and the probity of the regulatory process.

4.3. *Administrative accountability*

Quality of regulation. Regulators are responsible for their final product: a regulation of high quality. Some governments have made the regulators subject to regulatory policies or incorporated in their status quality criteria for their rule-making processes. For instance, most of Canada's sectoral regulators need to comply with the Federal Regulatory Policy (fundamentally alike to the *OECD Recommendation of the Council on Improving the Quality of Government Regulation*),³⁵ which provides the guiding principles for the development of regulations and imposes certain requirements, including that:

- regulatory authorities demonstrate both that a problem or risk exists and that federal intervention is justified;
 - all possible means – whether regulatory or non-regulatory – of addressing the problem or risk have been considered;
 - stakeholders – industry, labour, consumer groups, professional organisations, other governments and interested individuals – be consulted on all phases of the identification of problems, and the development of the regulatory solution;
 - intergovernmental agreements be respected and that opportunities for intergovernmental co-ordination have been exploited;
 - benefits and costs of the regulatory interventions under consideration be assessed, that the benefits justify the costs, and that limited government resources are used where they will do the most good;
 - adverse impacts on the economy are minimised;
 - systems are in place to manage regulatory resources effectively;
 - compliance and, when appropriate, enforcement policies be implemented;
- and

- the regulators have the resources for monitoring compliance and enforcing the regulations.³⁶

Procedural transparency. OECD governments have also developed several methods of improving the transparency and hence strengthening the accountability of the regulatory process operated by independent regulators. They often include requirements relating to decision-making processes such as public consultation procedures, publication of information and the application of formal freedom of information laws.³⁷

Transparency rules are important in underpinning regulatory accountability. They allow an independent regulatory body to demonstrate its independence and thereby boost public and industry confidence in the regulatory process. Transparency rules are also an effective deterrent to regulatory capture. And even where capture is avoided, they can provide an avenue to independent regulators for publicly revealing any inappropriate pressures exerted on the regulatory process. It is for this reason that some regulators have opted, on an administrative basis, to make their regulatory operations more transparent than formally required by their legal framework.

On the other hand, procedural transparency rules are an unusual accountability mechanism in that generally they are non-prescriptive concerning to whom the accountability is to be rendered. For example, a requirement that a regulator should make publicly available its decisions and their reasoning makes the regulator accountable to whoever might have an interest in a decision. This is achieved without either the policy-makers or the regulator having to specifically identify and report to each of the interested parties, who vary over time and according to the matter under consideration. General rules concerning notice and comment arrangements, such as those in effect in the United States, or pre-publication requirements, such as those in Canada, have similar effects. In this regard, advances in technology and the growing use of Internet facilities reduce the costs associated with information dissemination and publication. They however do not solve problems arising from over-consultation and information overload, which do not necessarily improve the quality of the decision-making.

Reporting to ministers. For many independent regulators, and in particular for ministerial agencies, the responsibilities are often split between minister(s) who is in charge of regulatory policy and framework design and the independent regulator who is responsible of implementing the policy within the framework.³⁸ In such cases, the accountability mechanism usually takes the form of the preparation of an annual report by the regulator to the policy-setting minister(s) or the Cabinet. In order to preserve independence of the regulators from its reporting agency, however, many countries have provided

the possibility for the regulator to make public the report at the same time of its submission to the political authorities.

Financial control and audit. Compliance with good financial practice by independent regulatory institutions is a central safeguard against any abuse prompted by an unchecked institutional situation. In most OECD member countries, independent regulators are subject to the auditing apparatus and the strong tradition of financial control and audit procedures applicable to budget funded institutions. In the case of independent regulators that are self-financed by fees or fines from regulatees, countries have opted for additional auditing by and/or reporting procedures to private or public accounting institutions.

4.4. Accountability through the Parliament

Parliamentary oversight is a mechanism through which regulators are held accountable to the legislative branch of the state. Usually it takes place through two routes: presentation of reports and evidence to committees.

Parliamentary oversight mechanisms. A typical instrument used in Ireland, Italy and many other countries is to require presenting periodic reports to Parliament, either directly by the regulatory body itself or through the relevant ministry. Such presentation of reports may not be a rigorous accountability mechanism in itself, particularly if it only involves sending a copy of a report to the parliamentary library. Moreover the lack of adequate technical or personnel capacities on the Parliament side can weaken this requirement (see below). However, it does send out an important symbolic signal that the regulator is in a clear reporting relationship with the Parliament and identify the right of Parliament to take an interest in regulatory matters.

In some jurisdictions, regulators are called on before parliamentary committees to give evidence on developments in the regulatory arena. The parliamentary power of calling regulators to account for their actions and policies – generally in public and in a question and answer format – is sometimes specifically stipulated in the legislation establishing the regulatory body. While explicit statutory provision is not always necessary, these hearings need clarity to avoid a potential conflict between regulatory independence and a parliamentary scrutiny motivated by an economic situation or prompted by interest groups.

Influences on effective oversight. The effectiveness of parliamentary oversight is contingent on several factors including the culture of parliamentary oversight, the legal framework for exercise of the oversight, the availability to Parliament of adequate resources to facilitate its undertaking of the oversight task, and – more generally – parliamentary interest in regulatory affairs.

In the most general terms, parliamentary participation is often required in establishing the legal basis for independent regulatory institutions. Parliament thus secures the legal basis for overseeing the general performance of those regulatory bodies. The extent to which such power is executed depends, of course, on the conventions ruling the relationship between the Parliament and the Executive.

In relation to parliamentary resources, the two core issues are probably time and research assistance. In certain cases, a third issue arises concerning access to technical expertise. In the normal course of events, the availability of parliamentary time for the consideration of sectoral regulation is often quite limited. Many countries have increased it substantially, by the extended use of parliamentary committees. It is argued that a selected committee, which can probe regulatory and sectoral developments and build up some expertise in such matters over time, is more suited to discuss regulatory affairs, than a plenary session of Parliament, which is more adept at political debate. On the other hand, countries like Ireland have found that the availability to parliamentarians of research and administrative assistance in overseeing regulatory issues – or, indeed, any other developments that the Parliament is charged with overseeing – is a basic concern in exercising effectively Parliament's oversight powers.

Parliamentary interest in regulatory oversight is often correlated to the ebb and flow of the electorate's interest in the affairs under regulation. In addition, experience has shown that, the interest and commitment of the parliamentarians increase as the committee builds up expertise in the subject matter and in the exercise of oversight powers in general.

Designing parliamentary oversight of regulators. Policy-makers involved in designing the regulatory architecture are well aware of the effectiveness of the Parliament as a channel of imposing accountability and a check on an unbridled independence. However – perhaps for protocol reasons related to the separation of powers between legislature and Executive, or perhaps because their remit is regulatory institutional design and not design of the general structure and institutions of the state – they are often constrained from assessing formally or commenting on the matter. For example, a line ministry whose task is to develop regulatory policy is probably not at liberty to comment on the capacity (or willingness) of Parliament to undertake effective oversight of the regulatory process. Yet, it is important to note that such factors must be taken into account in designing the regulatory framework.

Some civil servants, who have been constrained from formal consideration of these issues in designing the regulatory framework, have developed alternative mechanisms. In systems, where the political Executive is a subset of the Parliament, the relevant minister is in a position to comment

on such matters at the political level and to have such comment taken into account as part of the administrative level consideration of regulatory design. In some presidential systems, the executive branch has included the legislature in the policy-making process through a consultation process either formally with the legislature itself, or informally through contacts with the political groups represented in the legislature. Such an inclusive approach, in most cases, has helped consider the issue of parliamentary oversight in designing the regulatory framework.

4.5. Accountability through the judicial system

Balanced regulatory governance can provide for mechanisms to ensure that regulatory decisions are in compliance with natural justice and with the law of the land, without creating a shadow regulatory system that undermines the formal institution (see below). The matter of regulatory appeals is important to regulatory accountability and can be split into two parts: review of the legal compliance of regulatory decisions and actions, and appeal of regulatory decisions on the merits of the case.

Judicial review. Legal systems vary across OECD member countries in terms of the scope of and procedures for judicial review. It is thus difficult to prescribe general practice for the subjection of independent regulators to the scrutiny of the courts in relation to their compliance with the rule of law in the execution of their functions, the exercise of their powers and the fulfilment of their duties.

In principle, regulatory bodies are subject to less stringent judicial review than are other institutions of the state within the jurisdiction. The danger is undermining regulators' authorities and independence through the creation of a super-regulator in the judiciary (i.e. a judge) functioning as the regulator of last resort of the sector. Especially in countries where independent regulatory bodies are relatively new and need to earn industry and public confidence, specific procedures have thus been set up to regulate the circumstances and manner in which they are subject to judicial review. In addition, in some jurisdictions, where a general administrative law in this regard does not exist, there are detailed provisions in the regulator's statute governing the relationship between the regulatory body and the courts.

There is an important debate concerning the status of regulatory decisions while under judicial review: do they stand or are they suspended? This is a matter that varies among jurisdictions with important consequences for the efficiency of the regulatory system. If, for example, a regulatory decision is automatically suspended when application is made for judicial review, then market players might be tempted to use the review provisions to delay implementation of regulatory decisions where such delay would afford

them market advantages over other players. Conversely, if decisions stand while under review, should the regulator or the state be exposed to compensation claims from market players who suffer a loss by acting on the basis of regulatory decisions that are later found to be legally unsound?

Appeal on merits. An appeal of a regulatory decision on the merits of the case extends the review of the decision beyond whether it was properly legal to whether it was correct, given the facts. Appeal on merits is a fundamental procedure whereby the facts of the case are reheard and subject again to adjudication.

The existence of a system of substantive appeal has significant consequences for the operation of the regulatory process. If the sectoral regulator is to no longer have the final word in deciding on economic regulatory issues, the question needs to be addressed as to who should have such power: the ministry, thereby eroding the regulator's independence; the courts, who are competent in matters of law but usually not in economic analysis; or a special appeals body with relevant expertise? The latter option is probably the preferred one, but it can raise its own problems regarding the constitution of the appeals body, its independence, and its procedures.

A system that allows widespread appeal of regulatory decisions on their merits can seriously undermine the regulatory body should the appeal body become the *de facto* regulator. As with judicial review, there is also the possibility that the instigation of appeals could be used as a delaying tactic to postpone the effective implementation of regulatory decisions.

These disadvantages need to be balanced against market players' right to redress for regulatory decisions that are unfair, although procedurally and legally not incorrect.

The review/appeal system. A fundamental test of the review/appeal system for regulatory decisions is the extent to which its design leads to improvement in the regulatory decisions. Because regulatory decisions often hinge on economics rather than law, and involve matters of degree rather than absolutes, it can be difficult to assess whether an appeal system improves the outcome. For example, is an appeal body's determination that an interconnection price should have been set at USD 3.20 any better than the regulator's initial decision that it be USD 3.10? Are the costs arising from the time taken for the appeal process justified by the change wrought by the appeal body's determination?

One regulatory review/appeal framework experimented recently consists of establishing the explicit provision for strong judicial review, combined with a restricted provision for appeal of decisions on their merits. The scope of the latter provision was limited to a list of specific categories of case deemed by policy-makers to merit this means of redress. Such a system makes it clear

that regulators are always accountable for the legal correctness of their decisions while, except in limited circumstances, acknowledging and deferring to their expert technical analysis on questions of regulatory fact.

Interaction between the regulatory and judicial systems. In systems where regulators have quasi-judicial powers, often regulators are required to have relevant expertise and experience for this judicial role. Similarly, in those countries the procedures of regulatory institutions are framed by principles generally underpinning judicial procedures within the jurisdiction.

In countries where a provision for referral of regulatory issues to the courts exist, a significant issue affecting the efficiency of regulators concerns the capacity of the courts to deal with such matters. In this sense, capacity can relate both to the courts' time involved in dealing with regulatory cases in view of their existing workload, and the judiciary's understanding of the economic issues underlying sectoral regulation. For governance reasons discussed in the accountability section, some countries have addressed these issues as potential barriers to regulatory effectiveness. Typical initiatives have included the creation of a specialised unit within the judicial system, the appointment of additional judges, and the training of the judiciary in economic and regulatory issues.

5. Designing regulatory coherence and integration

Regulatory institutions need to fit into the political, administrative, social and economic environment and be in accord with the governance system within which they operate. This does not prevent the new institutions, though, to impose and challenge aspects of the existing set-up. A central element of good regulatory design depends thus on a clear statement on the purpose, objectives and scope of the regulator, the time frame and yardsticks for measuring progress on achieving regulatory objectives, and the modalities for its independence and accountability.

5.1. Objectives, timeframe and regulatory withdrawal

Economic regulatory bodies have a variety of functions. In most cases, only some of them are purely economic, others are social and others are administrative. The regulatory time horizon for each of the types of function differs. Theory indicates that the need for sector specific economic regulation decreases over time when the market becomes competitive. And in some cases this has happened. There are examples where the regulatory body withdraws progressively through mergers with other regulators and/or a reduction of powers from intervening in sub-markets as the market moves progressively to competition.

However, there are rarely cases where the regulator withdrew or sunset entirely from its regulatory activity. There are important political considerations involved of course but an equally important reason is that in most cases economic regulation is not the only matter with which the regulatory body is engaged. In the case of a telecommunications regulator for example, apart from its core economic responsibilities, in many cases, it also involves:

- management of scarce national resources, such as the allocation of radio spectrum;
- administrative tasks that underpin the operation of the particular market, such as management of the telephone numbering system; and
- social policy implementation, particularly in relation to universal service and other public service obligations imposed on the regulated industry.

The need for the exercise of these functions will not necessarily reduce over time. It is possible that some of them (*e.g.* managing an integrated numbering system) become more complex as the market develops and competitive forces emerge as experience across OECD member countries has shown.

Policy-makers in OECD member countries have started to realise the importance of the issue of regulatory withdrawal. Different strategies and mechanisms have been explored. Regulatory withdrawal can be automatically provoked by fixed sun-setting provisions in the legislation establishing the regulatory body. However, setting a fixed life-span for a regulatory body, anticipating the advent of competitive markets by the end of the period may lead to unforeseen results, if no contingency is made in case the market liberalisation process resulted merely in a move from a monopoly to an oligopoly. In addition, the rate of compliance with regulations may decrease as the sunset deadline approaches.

Countries have also found that external and periodical reviews of the institutional structure help challenge the necessity of continuation of regulatory activity beyond the stage where the efficiency benefits of the intervention exceed the costs associated with the interference. This can be achieved through a set of institutional flexibility tests that focus on examining whether the circumstances have changed and thus an adaptation of the regulatory body is required. Lastly, an alternative mechanism can be the decision of the regulator itself to desist from continued intervention in a market, or it may be a policy decision from the central government effected by a legislation that removes the regulator's power to intervene in that market.

A key consideration in the issue of regulatory withdrawal concerns the assessment of the level of competition in the network industry market. For instance, in contrast to the telecommunications case discussed above, some

economic regulations will continue to be required in the energy market in respect of management of the transition network, which is still considered to be a natural monopoly. Similar circumstances apply, at least on a regional basis, in respect of both rail and water. Furthermore, any market that is only partially liberalised gives rise to potential difficulties in managing the interface between the market's segments with or without competition. If problems within the interface reduce societal welfare, then they need to be managed, whether that be done by a sectoral regulator, a competition agency or otherwise.

As mentioned before, it is worth noting that so far there are few, if any, examples of instances where regulatory withdrawal – whether effected by prior provision for sun-setting, the introduction of new legislation or the regulator's decision to desist – has resulted in total abolition of the regulatory institution. More commonly, regulatory withdrawal involves the merger of regulatory institutions, or perhaps loss of regulatory scope, change in institutional mandate, or constraint on independence. In addition, real life examples of regulatory withdrawal are mostly related to sub-markets. The typical case is the cessation, in a few countries, of continued economic regulation of long distance telephone calls after a certain level of competition has been achieved in the sub-market.

5.2. *Scope of the regulatory institution*

Regulatory institutions have been established to focus either on an industry, a group of related industries comprising a sector, or a group of sectors. Trends among OECD member countries show that industry level regulation, where it has existed, is currently giving way to **sectoral regulation**.³⁹ This enables a single institution to regulate a group of related industries in a manner that does not constrain the emergence of competition between converging industries whose former distinctions become blurred as a result of technological advances. It also helps to reduce the distorting effect that occurs when potential competitors are subjected to different regulatory regimes according to their industry. Sectoral regulation also simplifies the position of a single firm, operating in a number of related markets, which otherwise would have to be subject to several regulatory bodies.

Although it can be argued that healthy competition between institutions may foster beneficial regulatory innovation, a multiplicity of regulatory institutions has been associated with inefficiencies due to duplication, contradictions and a too narrow mandate. Furthermore, narrowly focused regulatory bodies are often more vulnerable to capture by interested parties than are regulatory bodies with a wider remit.

Some countries have thus created **generic utility regulatory bodies** with responsibility across a number of utility markets: an approach sometimes being taken at state level within the United States (see Box 4). In a relatively small economy, regulators of this type present an efficient method of regulation that reduces the administrative burden and budgetary costs associated with creating a number of distinct regulatory offices. A multi-utility regulator facilitates also the sharing of learning and experiences across the different operational fields within the body, and creates synergies in enforcing activities. A single generic regulator has also been regarded as an effective way of maximising the application of specialised network regulatory expertise, especially when such expertise is in short supply or when its price (i.e. salary) is high, as the regulatees compete with the regulators for the hiring of such resources.

As discussed, where markets develop over time, the rationale for regulatory intervention declines. At that stage, the arguments for housing multi-sectoral regulatory responsibility within a single independent institution might gain even more support. Alternatively, it may be considered appropriate to transfer the residual regulatory functions to a line ministry.

There are some difficulties with the generic utility regulatory model, however, including the argument that it can give rise to an unwieldy regulatory structure that is unlikely to sufficiently tailor its regulatory approach in response to the different needs of the various industries within its ambit. A stronger but less discussed argument against multi-sector regulation is that the regulatory body can become too powerful – perhaps rivalling a small ministry in its scope. Especially if its cross-sectoral ambit spans the policy remit of several ministries, a multi-sector regulator may grow more independent than originally intended as a result of its blurred accountability lines to several ministers.

Coherence between sectoral regulators. Multi-utility issues – matters simultaneously affecting different industries regulated by different regulatory bodies – are difficult to handle in the context of a number of bodies each with an industry or sector specific regulatory interest. This situation is exacerbated by powerful convergence forces driven by technology and mergers of industry participants. Governments have grappled, for instance, with questions on how the various regulatory institutions deal with the regulation of a commercial venture running both telecommunications cables and gas pipelines. Lack of coherence and co-ordination among the regulators leads to uncertainty for industry and investors. Policy-makers need to take into account such matters when designing the institutional framework. If the institutions are not designed in such a way that they are able to cope with multi-utility developments, the regulatory structure may actually hinder over time technological and market development.

5.3. Regulatory authorities and competition agencies⁴⁰

Designing the interface between sectoral regulation and general competition rules is an important consideration concerning the regulatory environment and the performance of network regulatory regimes. In general terms and in most OECD member countries, competition law usually applies on a *post hoc* basis whereas much sectoral regulation is applied *ex ante*. Yet, in theory sectoral regulation needs to be built on competition principles.⁴¹ Across OECD member countries, two basic approaches have been taken addressing the issue: housing of both sector specific regulation and competition enforcement functions in a single institution; or separate institutions carrying out sector-specific regulation and competition law enforcement

Joint competition and regulatory body. One method of managing the overlap between competition law enforcement and sectoral regulation has been to situate both functions within the same body. This institutional arrangement reflects a vision of sectoral regulation as a transitional phase in the move from restricted markets to liberalisation and competition. The structure has some significant advantages. It facilitates the eventual regulatory retrenchment; it provides a sense of security to the regulatory staff, who do not need to fear that regulatory forbearance will deprive them of their employment, as there is a possibility of their being re-deployed to other areas within the competition/regulatory body.

Internalisation of the conflict and tension between competition and regulatory functions through the co-location of them in the same body has however not always produced the desirable outcome: transparency may be reduced, competing viewpoints are hidden and debate may be suppressed. Consider, for example, a corporate merger proposal in a regulated industry. A joint regulatory structure will tend to reduce the transparency in relation to a conflict of perspectives between the competition law and the regulatory rules; the former may find the proposed merger acceptable because it does not break the rules on abuse of market dominance, whereas the latter may wish to reject the proposal because it hinders vertical dismantling (“unbundling”) of the significant market players.

A further issue in relation to having a joint competition/regulatory body is that giving a body this breadth of scope can lead to the emergence of a very powerful agency. The political reservations about the creation of such agencies at arm’s-length from central government have already been referred to above.

An example of this model is to be found in Australia at the federal level where the agency charged with competition law enforcement also has responsibility for some economic (but not technical) regulation of various

network sectors. In the Australian case, the concentration in one organisation of power across competition and sectoral law is balanced by the fact that the institution does not have rule-making power (see Box 4).

Separate competition enforcement and sectoral regulation. Most OECD member countries have adopted a different model from the Australian one though: one under which competition law enforcement and sector-specific regulation are carried out by separate institutions.⁴² This approach raises a number of issues, mostly related to effective co-ordination of approaches among the respective bodies.

Firstly, there should be a clear delineation of the respective roles of the competition agency and of the sectoral regulators at the policy level. In this regard, a number of countries have clarified the delineation through statutory provisions laying down the principles as to when competition rules are to apply in the regulated sectors.

Secondly, governments have developed pragmatic mechanisms to facilitate the co-ordination between the competition law and the sectoral rules in order to ensure that they do not create undue regulatory uncertainty for market players. To a large extent, relevant institutions themselves should work this out in the course of their interaction, but the policy-makers have an important role in making sure that necessary legislative provisions are in place to support the institutions in this regard. For example, some countries have introduced legislations to allow competition bodies to share confidential information with sectoral regulators, or to allow one body to defer to another in taking action in a particular case. Ordinances and directives have also clarified the extent to which it is desirable to mandate the bodies to consult with one another in matters of joint relevance.

As an interesting development, the United Kingdom has recently taken this approach. In 2000 it granted to several of the utility regulatory bodies concurrent jurisdiction with the competition body in the application of the competition law. It also established a committee comprising representatives from all these institutions as part of the arrangements for managing the co-ordination among the agencies.

Reflection of ministerial portfolios. The scope of a regulatory body often mirrors the distribution of policy remits at central government level.⁴³ This distribution at the central level translates into the type of relation and the degree to which an integrated approach is taken between competition law enforcement and sectoral regulation. In states where sectoral policy is institutionally separate from competition policy, in most cases, there has been a predisposition to sectoral regulation's being assigned to agencies that are separate from the competition agency.

Box 4. Cases of multi-sectoral regulators

The Australian Competition and Consumer Commission (ACCC).

The Australian Competition and Consumer Commission (ACCC) was formed on 6 November 1995 by the merger of the Trade Practices Commission and the Prices Surveillance Authority.

An independent statutory body, the ACCC is responsible for administering and enforcing the Trade Practices Act 1974 and the Prices Surveillance Act 1983. The TPA is the primary regulatory mechanism for dealing with anti-competitive and unfair market practices, including misuse of market power, secondary boycotts and anti-competitive mergers. The PSA provides for the surveillance and monitoring of prices in industries identified for prices oversight by the government. While the ACCC is responsible for enforcing the TPA, individuals and companies may commence their own legal proceedings and seek damages and other remedies against parties that allegedly breach the TPA.

In addition to its core “competition” function, the ACCC has a number of key “economic regulatory” functions including responsibilities in relation to the terms and conditions of access to certain essential infrastructure facilities such as telecommunications, gas and electricity and in monitoring prices in industries where competition is weak. Under the general or “economy wide” access regime for essential infrastructure facilities established under the TPA, the National Competition Council (NCC) advises the government as to rights of access and, where these are established, the ACCC acts as an “arbitrator of last resort”. That is, the ACCC has the power to arbitrate access disputes and determine the final terms of access (including price) if access seekers and owners of essential facilities fail to reach a commercially negotiated settlement. More specific “economic regulatory” functions are performed by the ACCC under the access regimes for telecommunications and for gas transmission pipelines (with the exception of those in the State of Western Australia). The gas role includes monitoring compliance with ring fencing obligations and approving access arrangements (covering services, reference tariffs, trading and expansions) in accordance with an industry code. The ACCC also plays an important regulatory role in the electricity industry, including setting revenue caps for electricity transmission networks. It also has a quality of service monitoring role in respect of airports.

Other significant aspects of economic regulation, such as the granting of licences are typically administered by industry specific regulators or by more general government regulators. Technical regulatory issues that do not have a significant competition element are typically administered by industry significant competition element are typically administered by industry specific

Box 4. Cases of multi-sectoral regulators (cont.)

regulators or may be subject to goods and services standards set by Australia's principal standards organisation, Standards Australia.

The California Public Utilities Commission (CPUC)

Under the Californian Public Utilities Code of 1912, the CPUC has a general mandate to supervise and regulate all utilities within the state including telecommunications, natural gas, electricity, water, railroads and marine transportation.

The CPUC regulates the rates and services of privately owned utility companies. It is responsible for ensuring that California's utility customers have safe, reliable utility service at reasonable rates, for protecting utility customers from fraud and for facilitating a healthy economy for the state. In pursuing these goals, the Commission establishes service standards and safety rules, and authorises utility rate changes. It monitors the safety of utility and transportation operations, and oversees markets with a view to inhibiting anti-competitive activity. In its efforts to protect consumers, it governs business relationships between utilities and their affiliates, prosecutes unlawful utility marketing and billing activities, and resolves complaints by customers against utilities. It implements energy efficiency programmes and public service programmes in relation to utility rates for low income customers and utility access for customers with disabilities. It oversees the merger and restructure of utility corporations, and enforces the California Environmental Quality Act for utility construction. The CPUC works with other state and federal agencies in promoting water quality, environmental protection and safety. It also intervenes in federal proceedings on issues that affect California utility rates or services.

Source: "Creating Effective Regulators for Public Utilities", Michael Cosgrave, speech at the Beijing Workshop of the APEC-OECD Co-operative Initiative on Regulatory Reform.

5.4. Political jurisdictions and market openness

The organisation of regulatory institutions – as bodies of the state – reflects nations, state, provinces and even municipalities boundaries rather than trading areas. An inevitable element of the regulatory framework is that mismatch between the boundaries of political jurisdiction and the scope of the market impacts on effective sectoral regulation. A phenomenon intensified by globalisation.

Federal and regional systems. The fit between regulatory bodies and other institutions is further complicated in countries that have a federal system of government. In such instances, regulatory institutions are often organised at one of three levels: individual state; group of states sharing a common interest;⁴⁴ or federal level. Countries with a federal system tend to have many more regulators than would be the case in a non-federal jurisdiction. A key issue in these countries has therefore been the development of appropriate co-ordination mechanisms between the various bodies. The co-ordination necessary for a well functioning free market between levels of government has tended to reflect not only the remit of each of the bodies, but also the relative ranking in the hierarchy of institutional structures.

Related problems have arisen in non-federal countries where inadequate institutional arrangements for co-ordination among municipal, regional and national level structures hamper the effectiveness of the regulatory process. For instance, overlap, contradiction inconsistencies between sectoral regulators' remit and those of local regulators in charge of local regulations (such as environmental and planning approval ones) create difficulties when managing grids. In some countries, sectoral regulators must also co-ordinate with municipally owned utilities.

International context. The effects of increased trade liberalisation, freedom of establishment and free movement of capital between countries have reached utility markets – although at a later stage and at a slower rate than markets in traditionally traded goods and services. This trend has been facilitated by the development of technologies in several of the former non-traded utility sectors. The internationalisation of markets presents a particular challenge to regulation at the national level. If the government's position is to support the international liberalisation of markets, for example, then the manner in which regulation is delivered – including the institutional framework – needs to take account of this policy.

Even where sectoral regulation is not designed to actively promote the internationalisation of markets, the phenomenon has raised questions not yet answered. Which regulatory authority has jurisdiction over internationally traded activities? Which regulatory body has jurisdiction over industries that have negative or positive externalities for other countries? These are not new problems; they have been encountered before in cases of different rail gauges across national borders, downstream pollution by upstream industries on international rivers, and the lack of international recognition of education and qualifications. Furthermore, the international dimension of markets will continue to impact to incorporate this on regulatory approach. International co-operation between regulators and competition authorities has been considered as an essential first step.

Box 5. **WTO and EU framework**

National approaches to sector-specific regulation are often linked to international agreements. Though not focusing on institutional building, the box looks at two such sets of rules adopted on a collective basis by groups of states: the WTO Agreement on Telecommunications Liberalisation, and the EU provisions on the opening of the electricity market, as both agreements bare indirectly on independent institutional approaches

WTO Agreement on Basic Telecommunications Services

The World Trade Organisation's Agreement on Basic Telecommunications Services, which is an annex to the Fourth Protocol of the General Agreement on Trade and Services (GATS), commits participating countries to open their telecommunications services markets. This agreement took effect on 5 February 1998, although several countries were allowed to delay implementing the terms of the agreement until 2000 or later. All WTO members have endorsed the agreement.

By becoming party to the agreement, countries commit to a set of regulatory principles. These principles include the prevention of anti-competitive practices of suppliers; the ensuring of interconnection with a major supplier at any technically feasible point in the network under non-discriminatory terms, at a transparent manner and at cost-oriented rates; that universal service obligations should be administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined by the member; the public availability of licensing criteria; and that allocation and use of scarce resources should be carried out in an objective, timely, transparent and non-discriminatory manner. In addition, countries make specific commitments to open up their telecommunications services markets. These specific country "offers" vary, but ultimately the objective is a completely open market.

Article 5 (entitled "independent regulators") defines the nature of independent regulators in the WTO context: "The regulatory body is separate from, and not accountable to, any supplier of basic telecommunications services. The decisions of and the procedures used by regulators shall be impartial with respect to all market participants."

EU Internal Electricity Market

The Council of the European Union adopted a directive on the internal market for electricity (EC 96/92) on 19 December 1996 and came into effect three years later.

Box 5. WTO and EU framework (cont.)

The directive provides for the progressive liberalisation of electricity markets within the EU. By 2000, the largest users accounting for 30% of consumption had the right to choose supplier. This percentage has to increase to 35% in 2003. Some member states are accelerating the pace of liberalisation in their markets.

Access to the network is via a transmission services operator who must be separate (at least as a separate business unit) from generation and distribution businesses. EU member states can choose from three different procedures for access including “regulated third-party access”, “negotiated third-party access” and “single-buyer” system. There are two options – the “tendering” procedure and the “authorisation” procedure- for adding generating capacity.

The directive provides that member states may impose public service obligations to ensure “security, including security of supply, regularity, quality and price of supplies and ... environmental protection.” It permits member states to impose a requirement that up to 15% of fuels to be used in the generation of electricity come from indigenous sources.

Because the cross-border transactions are a major bottleneck in the development of the internal EU electricity market, the EU Commission has also launched an initiative – known as “the Florence process” – to establish common rules for cross-border transmission within the EU that are consistent with the development of the internal market.

Source: IEA (2000).

For instance, the World Bank established the International Forum for Utility Regulation (IFUR) on an informal and voluntary basis to serve as both umbrella and catalyst for these kinds of initiatives.⁴⁵

The European Union is also an example of a group of nations who, in addition to creating a free trade area, has also addressed regulatory approaches to sectoral regulation. It is interesting to note that EU regulatory developments in the utilities sectors have been directed at the adoption of common principles and some harmonisation of national rules. For the most part, however, the rules remain national and the EU has not yet created a sup-national sectoral regulatory institution, so differences of approach still remain among its member states (see Box 5).

6. Assessing institutional effectiveness

6.1. An ongoing requirement

The effectiveness of regulatory institutions is not a matter for consideration at a fixed point in time. Rather it should be assessed both at the design stage (albeit in the abstract) and again in the light of experience of implementation and of dynamic environments. Regulatory structure that is considered adequate at the design stage will not necessarily continue to perform satisfactorily if there has been a significant change in the operating environment. The regulatory scene is dynamic so that the responses should not be static.

As the case of Canada illustrates (see Box 3 above), setting independent regulation does not foreclose central government's ongoing involvement in regulatory affairs. Although government may no longer be the regulator, it is still the policy-maker and has this important role of steering the development and regular updating of the framework within which independent regulators are to operate. For instance, as competition develops in different areas of the economy, the range and degree of regulation required necessitate a constant and periodic review by the government.

6.2. Regulatory review

Regulatory institution is a “means” and not an “end” of state intervention. The institution is merely a tool of regulatory policy, but not a policy objective in itself. The higher level objectives of the policy (see Section 2.7) are thus the crucial outcomes to be monitored. A consequence of this is that the more opaque, the bigger the ambiguity and/or the larger the number of objectives the regulators is assigned the more difficult and discretionary the measurement of the performance of the institution will be.

However, as regulatory environment evolves, objectives may change over time. Either the objectives have already been achieved, either they have become obsolete or due to the rapid rate of change in regulatory arenas a new economic situation has emerged. When this happens the institutional regulatory approach needs to be reassessed with a view to determining its continued appropriateness. Some countries have thus established a formal system of periodic review of regulatory policy.

Ideally, such review involves an evaluation of past regulatory performance, an analysis of the regulatory environment, and the refocusing of regulatory direction and objectives to meet the needs of the present and the future.⁴⁶ Nonetheless, performance reviews are fraught with data problems and value conflicts. For instance, should performance be measured in terms of prices and quality of outputs in the utility market or innovation of market participants? How to measure the optimum degree of competition? Is the size

of market players' profits an appropriate indicator? How to evaluate transparency and accountability are the regulators? Furthermore, assessment of the effectiveness of regulatory institutions has been vulnerable to problems inherent to institutional and bureaucratic processes: inertia, agenda creep, empire building by budget maximising bureaucrats. Lastly, the confidence on the review's results is related to the objectivity of the reviewer. If the review is built on self-assessment, and external parties have not been called upon to participate, the outcome may be less than optimum.

More focused reviews, such as the one launched by the government of Ireland, tried on the other hand to identify the general governance aspects of the creation of new public sector entities (see Box 6).

Another dimension of reviewing regulators' performance focuses on the value added for taxpayers. In these cases, reviews may concentrate on the fiscal costs of the institutional structures compared to a system based on line ministries. Sometimes the expenses associated with an elaborate system of independent institutions may not be justified by its benefits. In such a case, the interests of taxpayers or the levied utility consumers need to be taken into account in assessing the continued appropriateness of the institutional model and whether an alternative – including, possibly, reversion to the line ministry model – is warranted.

6.3. *Measuring performance of regulators*

In order to assess the performance of regulators, governments have developed some key tools and methods. In many OECD member countries, regulatory institutions regularly publish their strategy statements and other documents to report on progress and to map their future course of development. These reports can also increase the focus of the regulator's management and staff and enhance transparency of the regulatory process. They can, in fact, become the information building block where performance assessment systems can be devised. The reports provide important insights into the general performance of the body and answers a whole set of relevant questions: Is the direction of the regulatory body's work in alignment with the desired policy direction for the sector? Is the regulatory body setting up a realistic set of targets for the desired pace of liberalisation, or for the assurance of a certain degree of public service? Are these targets being achieved?

Another commonly used instrument for monitoring performance of institutions among OECD member countries is the preparation and publication of annual reports of progress, medium-term strategy statements or even annual work programmes. These tools have often provided an

Box 6. Ireland's review of the regulatory framework

In September 1999, Ireland's Minister for Public Enterprise launched a public consultation process on the governance and accountability aspects of the framework for regulation of the communications, energy and transport sectors – the network industries – in Ireland. By that stage, Ireland had two independent regulatory institutions for these vital infrastructure sectors: the Director for Telecommunications Regulation had been established two years earlier and the Commission for Electricity Regulation was just a few months old. Also, plans were at an advanced stage for the introduction of independent regulation for aviation (airports), and proposals were under consideration for independent regulatory arrangements for the postal services, gas and public transport areas. The minister considered that the time was appropriate to review the institutional and governance arrangements for these new bodies with a view to ensuring that they were appropriate to the needs of the sectors and consistent with the existing structures of state.

The need for the review stemmed from the significant changes that had been taking place in the network industries in Ireland – particularly in relation to market liberalisation, some changed ownership arrangements and the introduction of independent regulation. Within the regulatory arena, the governance mechanisms – the set of systems, structures and processes by which regulation is carried out – were transforming. It was recognised that the transfer to independent statutory bodies of regulatory powers involved a delegation of power from the centre of government, and that the interests of democracy demanded that such delegation of responsibility to regulators be accompanied by clear and defined accountability mechanisms.

In March 2000, the Minister for Public Enterprise published her document, "Governance and Accountability in the Regulatory Process: Policy Proposals", which identified accountability issues arising from governance changes in the regulatory process and considered some methods by which these issues could be addressed. The policy proposals drew on the views expressed in the submissions received in response to the public invitation to comment. They were also informed by the experience that had been gained in the independent regulation of utilities in Ireland, and by relevant international experience. Matters discussed in the paper included:

- achieving the optimal balance between the independence and the accountability of regulators;
- rectifying the perceived democratic deficit in relation to transparency and means of redress in the regulatory process; and

Box 6. Ireland's review of the regulatory framework (cont.)

- how regulatory structures should reflect the regulatory needs of the relevant sector.

The proposals contained in the paper are being effected in sector-specific legislative measures that the minister has been bringing forward for the regulation of the various individual sectors within her scope. The legislative measures further advance the principles that govern regulation in these key sectors that are at the core of Ireland's economic infrastructure.

The paper strongly emphasised the importance of the line ministry's putting in place arrangements to maintain an overarching perspective on regulatory policies and principles. It also identified the need for a formal mechanism for periodic review at national level to ensure that the rationale for utilities regulation be kept to the forefront of regulatory policy. It was proposed that these review mechanisms would involve all the other interests concerned, *e.g.* other ministries, regulators, the competition authority, the consumer affairs office, industry and employee interests, utility customers and community groups. Given the changing nature of technologies and evolution in markets, it was concluded that the formal reviews should take place on a regular and systematic basis, possibly every three to four years, though some aspects of telecommunications might require more frequent review.

Source: Department of Public Enterprise (2000), Department of Finance (2001).

important input into the performance management process but on the other hand they fall short of providing objective benchmarks of regulatory performance as they are mainly based on self-generated targets and reports.

7. Conclusions

The past decade has witnessed the proliferation, across OECD member countries and beyond, of independent institutions in charge of the regulatory supervision of vital economic sectors. This trend has been most evident in relation to the network sectors that provide the communication, power and transport infrastructures that support economic and social development. Increasingly, governments are deciding to separate economic regulatory activities from the other functions of central government and to delegate them to new arm's-length bodies. These independent regulatory institutions are now key players in the economic life of many countries. They are involved in facilitating market liberalisation, reducing market inefficiencies and correcting market failures.

This report has examined some of the reasons for the creation of independent economic regulatory institutions and why many governments and international agencies now consider them particularly desirable (at least over a certain time horizon) for the network sectors. Regulatory accountability has also been discussed in detail, primarily in terms of its balancing effect on independence. Institutional coherence has emerged as the third critical consideration in the design of the regulatory framework.

The differing political, administrative, economic and social circumstances of countries and of markets means that there will be no universal best practice model for regulatory design. However, this report's consideration of theory and practice in the establishment and functioning of independent economic regulatory bodies, may provide a starting point from which to develop some "good practice principles" that can inform policy-makers involved in the design of independent regulatory institutions in the future.

Notes

1. This report constitutes the first output in the *Regulatory Governance: Improving the Institutional Basis for Sectoral Regulation* project. Several other areas of current OECD work, including projects that come within the Horizontal Programme on Regulatory Reform (e.g. studies of the role of public agencies in the administrative framework, the interaction between competition policy and sectoral regulation, and individual economic sectoral developments) are of particular relevance. Knowledge and insights from such projects can contribute to an enhanced understanding of the institutional dimension of economic regulation.
2. In the past few years, OECD has been studying different aspects of institutional design, see OECD (1999), OECD (2000a), and OECD (2000b). The recently published IEA (2001) *Regulatory Institutions in Liberalised Electricity Markets*, merits particular mention.
3. There are, of course, aspects of the institutional approach in the economic regulatory context that are of direct relevance to the other, non-economic, regulatory situations and in relation to which some of the analysis in this report will be applicable.
4. The discussion in this report is intended to be generic, although many of the illustrations of regulatory institutional design issues are drawn from either the telecommunications or the energy sectors, which have been the main focus of the OECD's existing body of regulatory analysis.
5. Kay (undated), "Why regulate securities".
6. For a discussion of the costs and benefits associated with regulatory intervention, see Hahn (2000).
7. This report does not intend to imply that economic regulation is an autonomous intervention carried out in isolation from other political, social and administrative life. On the contrary, economic regulation is informed and,

in part, influenced by these neighbouring domains. The discussion in this report concerns regulatory bodies and functions whose *primary emphasis* is economic; this is not to suggest that their sole concern is economic or that they are devoid of secondary emphases that lie outside the economic sphere.

8. Eberlein (1998).
9. A power imbalance can also be weighted in favour of the demand side, perhaps in the form of a monopoly.
10. The horizontal rules (e.g. competition or anti-trust law) underpinning the market can be invoked to resolve this problem. However, new market entrants will be disadvantaged relative to the incumbent if it takes a long time for the horizontal remedy processes to come into effect.
11. This discussion is limited to circumstances of an objective rationale for economic regulation. It does not extend to circumstances, such as those described by Stigler (1971), where regulation is introduced by captured politicians at the behest of a self-interested industry.
12. In the case of the United States, the history of independent regulatory institutions dates from 1887, when the Inter-State Commerce Commission was set up to limit the discriminatory pricing by railway companies.
13. The lack of transparency of rationales also made it difficult to evaluate the performance of the service provider.
14. See Pollitt (1999) for details of developments in the United Kingdom regarding network ownership and regulation over the last 20 years.
15. The interests of producers and consumers are different. If both investor protection and consumer welfare are economic regulatory goals, they will conflict at some stage, thus complicating further the regulatory agenda.
16. The economic argument for regulation of monopolies (and oligopolies) is based on removing the inefficiency associated with the loss of consumer welfare that is inherent in the monopoly market structure. A distinction should be made between the economic concept of “consumer welfare” in this context, and the general idea of the “welfare of groups of consumers”, which, in relation to networks, is often associated with network access and pricing of categories of consumer based on income, location or level of social inclusion.
17. These three elements are the key to any institutional architecture; their significance is not confined to the regulatory context.
18. For this reason, some countries (e.g. the Czech Republic) require constitutional change in order to permit the establishment of an independent regulatory body.
19. “Utility regulation is not undertaken in an academy. Regulators must contend with pressures and demands from diverse stakeholders.” Gray (1998).
20. Simon (1957).
21. For discussion of policy credibility, with particular reference to the regulatory context, see Majone (2000).
22. For details of the institutional setting for *electricity supply* industry regulation in each of the member countries of the International Energy Agency, see IEA (2001). Details of the institutional framework for *telecommunications* regulation in the OECD member countries can be found in OECD (2000b).

23. Kay (2000).
24. For exploration of the reasons for the non-formation of interest groups despite an obvious interest shared by a large number of individuals see Olson (1965).
25. The following discussion draws heavily, but not exclusively, on Chapters 3 and 4 of Department of Public Enterprise (2000).
26. Smith (1996).
27. The legislation governing some regulatory commission appointments in the United States limits the number of commission members that may be affiliated to the same political party. See IEA (2001), p. 93.
28. See Shultz and Doern (1998).
29. See Majone, G. (1993) *Controlling Regulatory Bureaucracies: Lessons from the American Experience*. EUI Working Papers in Political and Social Sciences, European University Institute, Florence, Italy.
30. For a discussion of democratic deficit in the context of utilities regulation, see Ferris (2000).
31. Majone (1994).
32. Department of Public Enterprise (2000), *op. cit.*, p. 1.
33. Jacobs (1999).
34. It is interesting to consider the diversity of opinion as to causality of and culpability for the recent problems in relation to California's regulated electricity market. See, for example, AEI-Brookings (2001).
35. OECD (1995). The purpose of the checklist is to help improve the quality of regulatory interventions by providing a framework for analysis of the problem, the justification for action, the need and level of government involvement, the benefits and costs involved, and the likely repercussions of taking a certain course of action. The checklist can be applied at several levels within the regulatory process. In this instance, its use is advocated for the high-level, periodic evaluation of the continued need for government-sponsored regulation of a network sector, and the suitability of the approach and the institutional setting for any such intervention. (The checklist is also suitable for use by regulators themselves in relation to specific regulatory interventions. In such cases, it would also help to ensure also that regulatory decisions have been subject to a form of impact assessment and take account of alternatives to direct intervention approaches).
36. See Canada Federal Regulatory Policy, www.pco-bcp.gc.ca/raoics-srdc/
37. See Everson *et al.* (1999), pp. 46-51, for a discussion of procedural methods of ensuring transparency, with particular reference to statutory provision in this regard in the United States (including the *Administrative Procedures Act*, the *Freedom of Information Act*, and the *Government in the Sunshine Act*).
38. The model is simplified for discussion purposes. The split of responsibilities between ministerial policy formulation and regulatory policy implementation is seldom so precise in reality, given the dynamics of the formulation-implementation-review loop that generally applies to policy development.
39. This trend is particularly evident in the energy sector. In some countries (e.g. the United Kingdom) the separate electricity and gas regulatory bodies are

merged into a single energy regulator. In other countries (*e.g.* Spain, Ireland) the remit of the existing independent electricity regulator is extended across the energy sector.

40. See OECD (1999).
41. Some of the challenges facing the sectoral regulator who is under pressure to facilitate the speedy move of a market from monopoly to a competitive state is discussed by Kahn (2001).
42. OECD (1999).
43. For a general (*i.e.* not a regulatory specific) discussion of the determining effect of existing political structures on the creation of new structures, see Moe (1990).
44. The United States has several examples of multi-state regulatory approaches to water regulation, including the Mississippi Delta Project and the Tennessee Valley Authority.
45. www.worldbank.org/html/fpd/psd/ifur/index.html
46. For instance, see the recent initiative in the United Kingdom (Better Regulation Task Force, 2001).

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The New Russian Budget System: A Critical Assessment and Future Reform Agenda*

by

*Jack Diamond ***

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1. The importance of a budget system law

One of the major challenges faced by transitional economies has been to adjust institutions that were designed to function in a planning environment to function in an increasingly market-oriented environment. One of the most important of these institutional reforms has been the restructuring of the budget system. The latter should be interpreted quite widely to encompass the institutional framework as well as the administrative procedures that determine the means whereby resources are transferred to government, how the use of these resources is prioritised and directed to agreed policy objectives, and then subsequently managed, controlled, monitored and reported on. Such systems must be defined in terms of a legal framework.

This legal framework can consist of the Constitution, organic budget law, and financial rules and regulations issued by the legislature or the Ministry of Finance. The approach can vary widely between countries. The United Kingdom and other common law countries rely on financial regulations, established administrative and parliamentary practices to determine the budget system. Civil law countries, on the other hand, such as France and Germany, have codified their legal framework and have their budget system determined by an organic budget law. Transitional economies, lacking a suitable administrative and legal basis for establishing a market-oriented budget system, have found the latter approach more suitable.¹

One cannot underestimate the importance of this legislation for the improved governance in transitional economies. A central purpose of such budget system laws is to provide a framework for accountability of a government's use of public funds. Three essential elements of accountability require to be covered in the law. The law should prescribe rules which govern the production of an annual fiscal plan, which relates government revenues and expenditures to the economic outlook, and secondly, an annual budget which articulates this fiscal plan and requires the formal approval of the legislature. The third element is the successful execution of the plan in line with the annual budget authorised along with an annual set of public accounts presented to the legislature which show actual spending compared with authorisations and reflect the overall financial position of the government. By assigning responsibility for each of these three tasks and

determining the information required to judge the success in accomplishing these tasks, a budget system law tries to ensure accountability.

Recently, Russia, like many of the economies in transition has reformed its budget system by drastically changing the legal framework for budget management.² This budget system law, or budget code, first came into effect in FY 2000 and comprehensively covers all issues of fiscal management. This paper offers a critical appraisal of the new Russian budget system, critically examining the processes of budget preparation, budget approval and budget execution prescribed in the law. In this review certain weaknesses are identified and recent attempts to address them are described. In conclusion, the paper offers an agenda for the further reform of the Russian budget system.

2. The budget preparation process

The procedures for budget preparation, as laid out in the budget code, are described in Annex 1. It is evident that the budget code describes a system which has parallels in OECD member countries. For example, the starting point is a macroeconomic framework; a top-down approach is described, with a budget to be formulated within clear macro-fiscal rules (see Box 1).

Box 1. Fiscal rules governing the budget process

Article 92 of the budget code stipulates:

- The federal budget fiscal deficit shall not exceed the total amount of budget investments and expenditures required to service the public debt.
- The budget deficit of a member territory of the federation may not exceed 5% of the revenues of the member, net of financial support of the federal budget.
- The deficit of a local budget may not exceed 3% of the budget revenues, excluding financial support from higher levels of government.

2.1. A number of features of the budget preparation process should be noted

2.1.1. The timetable for budget preparation

The budget preparation process described in Table 4 is evidently very detailed, with strict deadlines. This is partly due to the lengthy budget

approval process (see below) and also to the Duma's envisaged input into budget preparation. However, the consequence is that budget preparation must commence very early in the preceding year. Thus the first detailed budget by functional classification is prepared by end April, and by economic classification by early May, with the draft budget sent to the inter-agency commission, which resolves disputes in budget allocations, for approval by early June. While the budget code does envisage that expenditure and revenue (as well as financing) estimates in the budget are rooted in a macroeconomic framework, the need to adjust this framework in a sometimes rather unstable and volatile environment implies perhaps major adjustment of the framework on which the budget should be based throughout the preceding year. In any case the Ministry of Finance's attempt at "top-down" aggregate control, based on affordability as assessed from a macroeconomic perspective, is further constrained, first, by the need to accommodate the Dumas's preferences in budget plans, and, second, by the two-step process by which budgets are prepared. The first step is to define aggregates in terms of functions, but then turn to the line ministries to give bottom-up details in economic terms. This weakens the Ministry of Finance's ability to constrain the line ministries, compared to total expenditure guidelines or envelopes, normally set as the first step in the budget preparation process encountered in most OECD member countries.

2.1.2. Institutional weakness in the budget preparation process

The Ministry of Finance as an institution remains relatively weak in terms of the basic skills of budget preparation. This is partly an information problem. Centrally, the Ministry of Finance typically has very limited information about the expenditure base, a reflection of the old Soviet system that considered this primarily to be the responsibility of the line ministries. Information on outputs is not management-oriented and hence is largely irrelevant. The lack of relevant information at the centre implies more power for the line ministries.

In part, the problem in budget preparation arises from the organisational structure of the Ministry of Finance. The Ministry of Finance has a central budget department, the Budget Policy Department (BPD), which is mainly a consolidator of the budgets of budget institutions. The line ministries in preparing budget details deal directly with "branch departments" of the Ministry of Finance, which act as intermediaries with the BPD. In the past some of these branch departments have seen their role as advancing the case for more resources for "their" particular line ministry or spending agency. Thus those involved in budget preparation in the Ministry of Finance have tended to view their function as collating (or even endorsing) "bottom-up" budgets from line ministries and, therefore, have tended not to supervise, let

alone control, the process. Perhaps, as a consequence, those departments in the Ministry of Finance concerned with budget preparation have a limited capacity to challenge the affordability, desirability, and costing of individual expenditure policies.

2.1.3. The quality of budget estimates is doubtful

There are many reasons to suspect the realism of budget estimates. After several years of seeing their budget plans disrupted by cash rationing, budget institutions no longer have an incentive to take budget preparation as a serious exercise. Moreover, there are severe information constraints on producing good estimates. In the absence of up-to-date information on budget out-turns, even in a preliminary form, those preparing budgets take the last budget as their starting point, not the latest or estimated out-turn derived from the treasury system. Thus, one unrealistic budget becomes the starting point for the next. There is no established budget review function in the Duma, for example, in following up the external auditor's reports on the annual accounts that can really challenge the Executive's budget. This, too, may have generated less careful attention to budget preparation procedures.

2.1.4. A poor organisational budget classification has complicated the process

Transparency in budget formulation has been disadvantaged in a highly decentralised system with too many spending units (SUs) supported by the budget, with loose supervision from a line ministry, and a cumbersome appropriations structure. A critical feature for budget preparation is the continued reliance on an imperfect functional classification – a mixture of the Soviet-style planning branches and more internationally recognised functions – for the appropriation structure. An individual SU may receive resources from one or more main functional appropriation heads. A more transparent and accountable system, as in OECD member countries, would base appropriation approval on individual SUs or line ministries. Also, the absence of an OECD-style program classification (not the quasi-functional system used under the old Soviet system) that can readily generate activity-based costing and analysis is a significant weakness. The number of SUs presents a problem in its own right, as discussed below.

3. The budget approval process

The budget is approved in four readings:

- The first reading, gives the broad framework of the federal budget, including macroeconomic forecasts, fiscal policy guidelines, and the

principles governing interbudgetary relations, as well as external borrowing and other loans. Article 198 of budget code allows 30 days to complete this from the date of submission.

- The second reading then presents the total expenditure of the first reading broken down by summary groups of the functional classification (“*razdil*”), including the level and distribution of transfers to the territories, and the total development budget. Article 205.1 of the budget code allows 15 days to complete this after completing the first reading.
- The third reading presents expenditure by *razdil* and “*pod razdil*” (subsections of the *razdil*) and by line ministries. This reading includes details of federal “targeted” programs as well as the investment program, protected items, federal government guarantees, and details of external borrowing and loans. Article 206.2 of the budget code allows 25 days for this after the passing of the second reading.
- The fourth reading approves the budget in general and is distributed by quarters. Article 208.1 of the budget code allows 14 days for this stage.

Some features of this process deserve comment.

3.1. Complexity of the process

The approval process is unnecessarily complicated by, first, the number of stages, and second, the need to legislate quarterly expenditure allocations. Most budget systems have two, or at most three, readings of budget legislation. The stages in the approval process should ideally be regarded as moving in increasingly detailed levels of the budget, from the macro-framework, to broad functional classification to a detailed budget. However, the existing approval procedure is set up to complicate such a progression. At the first reading, the legislature has powers to submit the document to an arbitrating Conciliation Commission and return it to the government for revision. Even with approval of the first stage, amendments can be proposed by “entities with legislative initiative entitlement” to select Duma budget committees, and a Conciliation Commission can arbitrate agreements. Thus, in practice, successive stages risk reopening the fundamental budget strategy, leading to delay, *ad hoc* decisions, and potential deadlock.

3.2. Unrealistic timetable

The budget code seems to support the view that the legislature should play a major role not only in the formulation of budget strategy but also its details. Although this is the United States’ model, it should be noted that it is not the model in most OECD member countries. While the formal approval procedure based on detailed budget scrutiny allows power for the Duma

committees to fundamentally reformulate the budget if they so desire, the time limits allowed would not seem to permit this to be accomplished. Article 211 of the budget code specifies that in case the approval process fails to deliver the budget by 31 December, then the Duma may, in the first quarter of the year, pass a law financing first-quarter monthly expenditures equal to one-twelfth of the previous year's budget. However, the question remains whether the budget timetable is compatible with, and supports, the basic view of relative responsibilities between the legislature and the Executive.

3.3. *Comprehensiveness of the budget*

From FY 2001 there is explicit treatment of extra-budgetary funds (EBFs) in the budget, although the large amount of off-budget activity of budget institutions is, in principle, incorporated in their budgets but not separately identified. While no statement of contingent liabilities, tax expenditures or quasi-fiscal activities is published with the budget, a statement of federal government guarantees is presented.

3.4. *Transparency of government policies underlying budget allocations*

The approval process does not facilitate the normal prioritisation of policies and their formulation into programs to be included in the government. This arises from two weaknesses in the Russian budget process, compared to OECD member countries:

- Lack of a clear medium-term budget framework

The Russian authorities have appreciated the advantages of a medium-term budget framework, in the sense of a rolling forecast of fiscal aggregates for the budget year plus two forward years. While work has begun on such a framework, progress has been difficult owing to the unsettled economic environment. Its absence, however, implies that the medium-term implications of current budget decisions, and their sustainability, cannot be addressed.

- Lack of a program basis to the budget

It can be doubted whether budget estimates are classified and presented in a way that facilitates policy analysis. The budget basically is presented and approved on broad functional groups (*razdil*), and their subgroups, various categories of expenditure. However, this *razdil* breakdown of the budget is far from ideal in identifying government policies and the programs that underlie these policies. The *razdil* classification reflects the more detailed functional budget classification as a mixture of the old sector breakdown, inherited from the previous planning environment, and the internationally accepted functional breakdown. The subfunction level (*pod razdil*) should contain

programs, but these are ill-defined and often mixed with economic categories. As a consequence, it is difficult to work from policies to programs, subprograms, and the consequent activities of each budget institution, as well as to differentiate new from old policy initiatives. In addition, a list of “targeted” programs is approved as an attachment to the budget, as is the breakdown of the functional expenditure by the totals allocated to each budget institution.

4. The budget execution process

Annex 2 summarises the various stages in budget execution. It must be remembered that the budget is executed through a rather decentralised budget system. Of the nearly 100 main budget institutions (line ministries and other important agencies with their own chapter in the budget), many supervise a large number of second-tier budget institutions, which, in turn, supervise third-tier institutions. All subordinate units report back directly to their supervising line ministry which, in turn, reports back to the federal Ministry of Finance. Apart from this line of subordination, the federal Treasury System operates a vast network throughout the federation, incorporating 89 regional offices, and under them, many branch offices – in total around 2 240 federal Treasury offices exist in the federation, employing around 50 000 employees. At the beginning of 2000, all but the Ministry of Defence (MOD) had its budget executed through this Treasury network, and, as indicated below, there are plans to complete the Treasury’s coverage in the near future. As shown in Box 2, the budget code strongly supports the Treasury System.

4.1. A number of features of budget execution should be noted

4.1.1. Budget is prepared and approved on a functional basis, but executed on an agency/SU basis

For the release of funds to implement the budget, the Ministry of Finance indicates the broad aggregate funding levels to line ministries, and they, in turn, indicate the SU allocations to the Treasury. The Treasury then groups these SU allocations by their regional distribution (i.e. the region/branch Treasury office that will handle the processing of payment orders). This dichotomy in information flows has contributed to poor information on budget execution – reporting tends to be late and incomplete and lacks analytical meaning.

4.1.2. Reporting has become more difficult for budget institutions

The Treasury System is incomplete in its coverage, with some SUs still operating their own bank accounts, although most now have their payments

Box 2. **Key elements of the Treasury System supported by the budget code**

1. Treasury's central role in budget execution
 - Article 215: Specifically states that budget execution will be through a Treasury System and that the Treasury shall act as cashier for all budget administrators and make payments from budgetary resources on their behalf.
2. The Treasury Single Account (TSA)
 - Article 216: All receipts and expenditures to be credited/debited to a single budget account.
 - Article 236: Forbids the placement of budget resources in bank accounts.
 - Article 244: The federal Treasury is in charge of all accounts of the federal government.
3. The Treasury General Ledger (TGL)
 - Article 240: Budget account to be based on a single chart of accounts, organised by the budget execution authority, with approval of government.
 - Article 256: Records of all transactions of federal government to be maintained in a general ledger, maintained on the basis of the approved chart of accounts.

made on their behalf by the Treasury. In the past, they produced the basic data, executed their budgets through the banking system and had banking data available as a basis for budget execution reports. Now, since they execute their budgets through the Treasury System, the Treasury is the main source of this information. However, whereas responsibility for reporting on budget execution has changed, the Federal Treasury (FT), owing to administrative constraints and lack of comprehensive computerisation, often finds it difficult to provide timely consolidated reports.

4.1.3. *The large number of budget users complicates budget execution*

Ambiguities have arisen regarding the definition of a budget organisation, as well as the legal rights and obligations of such organisations. By FY 2000 there were around 17 000 budget recipients, including different types of organisation.³ First, there are pure "SUs", subordinate to a ministry, funded out of the budgets of these ministries on the basis of their planned

revenues and expenditures, entrusted with the management of government assets, and whose operational liabilities are recognised and assumed by government. Second, there are budget recipients which are SUs by their legal status, but which have large sources of off-budget funds. These are more autonomous units than the first category, but still predominantly carry out government policies. Third, there are units that are largely entrepreneurial, but receive budget support for part of their operations, for example, to fund certain federal needs. This support is specifically indicated in the budget. It should be noted that the number of budget recipients that receive appropriations as separate line items in the budget law is much smaller than the total number of SUs. The latter include subordinate budget organisations that receive their budget funding indirectly through their supervising budget institution. The total number of SUs is not known, but in FY 2000 it was estimated at 50 000 in the civilian part of government and at least 5 000 in the defence sector. In terms of budget execution procedures, these different units are treated equally.

4.1.4. Budget institutions have legal rights that limit Treasury control

The budget code gives clearly defined powers to adjust the budget in line with revenue availability (Box 3). Article 238 of the code gives institutions the right to total funding of approved commitment levels, which would seem to curtail the Ministry of Finance's ability to cut back spending if available resources were less than planned. Moreover, the Civil Code Article 120 gives "legal entity" status to budget institutions, protecting their right to operate bank accounts for "own-source" revenues and to enter contracts without Ministry of Finance approval, which further curtails the Ministry of Finance's ability to cut back spending. However, recent changes in the budget for FY 2001 have introduced three new clauses, which define the uses and restrict the powers of budget institutions to use "own-source" revenues. The federal Treasury is working to remove clauses of the budget code, such as Article 163, which defines the rights of budget institutions to receive funding irrespective of budget cutbacks.

4.1.5. Chart of Accounts and budget classification systems require to be restructured

The Chart of Accounts (CoA) is the basis of the TGL and should be able to generate management reports on budget execution, as well as for other user needs. The reports so generated should be timely, accurate and complete. From this perspective, the present approach to the Treasury CoA has a number of weaknesses. The CoA used by budget institutions for their basic day-to-day accounting and submission of annual accounts, or so-called "analytical accounting", is supplemented by the Treasury's "synthetic accounting". The latter attempts to summarise and consolidate the accounting of budget

Box 3. Powers to adjust the budget within the fiscal year as contained in the Budget Code

Article 212: Government can propose changes to the budget whenever revenues exceed the approved budget target by more than 10%; requires parliamentary approval (elaborated in Article 260).

Article 213: Procedures to be employed in case of revenues falling below the approved budget target by more than 10%, requires parliamentary approval (elaborated in Article 258).

Article 224: Expenditures can be deferred without changes to budget outlays for up to three months provided such deferment does not exceed 10% of budget outlays for the quarter (elaborated in Article 259).

Article 229: If receipts are below approved budget target by no more than 5%, the Ministry of Finance has discretion to introduce cuts in spending; if more than 5% but below 10% of approved budget outlays, the government has discretion to introduce expenditure cuts.

Article 230: If parliamentary approval is delayed, following procedures in Article 213, the Ministry of Finance has the power to cut expenditures on a *pro rata* basis until such approval is obtained.

Article 231: The Ministry of Finance has discretion to freeze expenditures, that is, reduce budget commitment limits, available to a budget institution if conditions on which the commitment was originally based are not met (e.g. if used for non-eligible purposes).

Article 234: The Ministry of Finance has powers of reallocation (virement) between sections, subsections, earmarked items and types of expenditure, within 10% of the budget allocations of chief budget administrators (ministries) (elaborated in Article 261).

institutions through a CoA that does not fully reflect the budget classification and aggregates budget revenues and expenditures. Although substantial effort is devoted to the detailed analysis of borrowing (which again does not follow the budget pattern), below-the-line financing transactions tend not to be clearly distinguished from revenues and expenditures. Often the basis of accounting lacks consistency and clarity, combining an accrual basis for certain items and a cash basis for others. These synthetic accounts combine “flows” (i.e. payments and receipts) that are zero balance accounts, and “stocks” (i.e. balances of liabilities and assets) with balances carried from one year to another.

4.1.6. *Fiscal reporting is onerous and lacks management focus*

There are two channels of reporting: first, from the SUs, forwarded via their ministries or regional Treasury offices (RTOs), and second, from the SUs, via their ministries to the Ministry of Finance branch departments and Budget Policy Department. Reports from the RTOs are received monthly and annually, and give details of both revenues and expenditures covering revenues and expenditures by classification codes indicated in the annual budget, total funds spent during the course of the month details of other non-cash offsets, and details of the earmarked funds spent. Other reports received quarterly give details of the funding of expenditures on a cash basis; they cover civilian ministries and the MOD.

There are some 24 separate reports required to be submitted by budget institutions to the Ministry of Finance. Most of these reports are quarterly (typically only for the last three quarters of the year) or annual. Only one report is monthly, reporting on the execution of approved expenditure limits by type of spending, and is perhaps the most clearly relevant for budget management purposes. The extensive list of reports implies that the burden of SU reporting to the FT is very heavy. This flow of information is generally transmitted in paper form and not electronically, even in the Moscow region where most SUs are computerised. The result is that reporting is an extremely costly effort in time and resources, not only for the SUs but also for the FT, which must key in and process this data, adding to the chance of error and to delay in consolidation. The compliance orientation and the detail required means that the processing and consolidation of such data takes a considerable period of time.

5. Financial operations and planning

In the 1990s faced with a deficiency of resources to meet approved budget appropriations, the financial operations of the Treasury assumed major importance. These are based on a monthly financing plan that is prepared each year based on the budget, and in the absence of an approved budget this has been based on the previous budget. Using the annual law on the federal budget, the BPD prepares limits on monthly expenditures. The procedure is detailed and cumbersome, and begins by determining the limits by *razdil*, or branch functions, and by *pod-razdil* (subfunctions). When government has approved this functional distribution, this is then distributed to ministries. The ministries then determine what is the SU limit at the Regional Treasury Office (RTO) level. The Treasury is informed of the detailed limits and sends a block listing of such limits to each RTO for the SUs located in that area. The RTO in turn breaks down this block listing for each local training office (LTO) for the SUs in its area. With the approved aggregate limits, the main department of the FT then begins to prepare a provisional cash flow table

identifying daily the taxes and other receipts expected and the priority expenditures that must be met.

The system of Treasury funding is outlined in Box 4.

Financial management in the Ministry of Finance is relatively undeveloped. Forecasting is obviously difficult in the present environment. Forecasts are rather short-term, generally only for a month ahead, relying primarily on past trends and levels attained in the immediate past, and concentrating on revenues. Cash management is admittedly constrained by external factors. The revenues are transferred from the BOR collection accounts to the operational FT accounts every five days. This lag implies that

Box 4. The system of Treasury funding

The government approves a monthly cash plan for each LM or higher level budget administrators at the beginning of the year, which is drawn up by the BPD. It is understood that the LMs have the right to spend according to this cash plan.

The LMs prepare detailed payment registers to their subordinate SUs, which gives them authority to incur spending, consistent with these monthly financial limits.

The SUs submit payment orders to the LTOs and RTOs. If funds are available, and the requirement is within the authorised allocation then the FT office makes the payment.

If inadequate funds are available, priority is given to registered commitments and other priorities of the LMs. If these cannot be met, the SU must request its LM to approach the Ministry of Finance in Moscow to make funds available.

In the central FT, the availability of cash is examined as well as projected inflows in the near future, and decision is made whether each payment can be made in full or in part. If payment is agreed, funds are sent to the relevant FT office to execute payment.

In the past, under severe fiscal stress, the monthly limits were set lower than the agreed budget, and often the cash available could not even meet the monthly financial limits. This implied that the FT was operating a daily cash-rationing system. However, with the improvement in the revenue position, at the end of FY 2000, although expenditures in certain areas exceeded the original budget allocations, there was no cash rationing, and indeed savings were transferred to the FY 2001 budget.

substantial cash balances are unavailable to the FT on a regular basis. Owing to the lack of development of the banking system, the FT finds it difficult to operate zero balance accounts. As a consequence the FT leaves substantial cash balances on account at the regional Treasury offices to cover expenditures in the regions.

Other financial management operations, such as debt management, is outside the FT's mandate. Debt management is somewhat fragmented. The Securities and Financial Markets Department in the Ministry of Finance makes the decisions, gives the Treasury projections of debt service in advance of the financial year (as well as short-term projections), and records all such transactions, although the payments are executed by the Treasury. For external debt, the Foreign Credits and External Debt Department makes the decisions, negotiates the loan and keeps records. The FT relies on the BOR for supervision of all subsequent cash flows, but they monitor the deposit of all receipts to the government account.

Some features of present financial planning arrangements should be noted. First is there is tendency to degenerate from financial planning into cash rationing. It is not difficult to appreciate that in the recent past, problems of revenue shortfall, coupled with difficulties in projecting future revenue and expenditure developments, have made financial planning very difficult. In such an environment the present system of cash releases has transformed into rationing out limited resources as they came in, according to strict administrative rules determined by political priority. Second, relationship with the BOR has not been smooth. According to the BOR law, the BOR is supposed to maintain all the accounts for "the budget" and handle all budgetary payments. However, there is nothing in the law or supporting regulations that mentions the Treasury or even Ministry of Finance. As a consequence the FT/Ministry of Finance have no special client status at the BOR and little influence in the way payments are made or classified. For example, the classification system of the BOR used for the payment orders of budgetary accounts is based on the old Soviet classification, with revenue classifications that now lack relevance.

6. Some recent developments

The budget code is in its infancy, it will require some years before it can be implemented in its entirety. At the same time, the adoption of the budget code in FY 2000 made the future strategy for reforming present budget practices much clearer. The following review of most recent initiatives indicate the direction of this reform strategy. It also reveals that to date reform initiatives have focused far more on improving budget execution processes, to

the neglect of the other phases of the budget process, and have focused on strengthening compliance and meeting stabilisation needs.

6.1. Resolving the arrears problem

In the past, arrears have arisen from a number of sources: i) fiscal indiscipline in powerful ministries, entering into commitments that exceed their approved budget allocations; ii) commitments made within budget allocations but below commitment levels set by the BPD; and iii) commitments made within BPD limits but without Treasury cash backing. Ideally, the approach to avoiding new arrears should be multifaceted: arrears arising from the first two sources may at least partly be addressed by more realistic budgeting, and arrears arising from failure to provide sufficient resources to meet commitments can be addressed by better financial planning. These ultimate solutions have not been fully implemented. However, as a first step, the need has been recognised for a system for monitoring, and then controlling, the commitments that are being made. Recognising that it is not possible to control spending without controlling commitments has led to first registering commitments (concentrating first on a narrow band of contracts and then widening the coverage), with the presumption that the information will be eventually used to control commitments, so that payment orders can only be processed against registered commitments. By Order No. 806 dated 15 July 1999, a system for recording commitments at the Treasury was introduced for several ministries for selected spending codes.⁴

This is a significant first step toward building a database of commitment records. Over a period of time, if registration is implemented diligently, it may be hoped that the suppliers will become aware that the FT will not meet payments in excess of the commitments and will become reluctant to supply those SUs, which are unable to ensure the FT's stamp of approval on their contract. However, in implementing this reform a number of problems have become apparent.

6.2. Addressing problems in controlling commitments

At present the responsibility for undertaking commitments is not clear. As indicated previously, the relation between a ministry and its subordinate unit is defined by the Civil Code Article 120, which defines a subordinate institution generally as “an organisation established by an owner to undertake social tasks in the social sphere financed by the owner according to a budget” where, most significantly, “the owner bears responsibility for all liabilities arising from this organisation.” Significantly, this legal problem implies that the FT cannot control the liability, rather they can only record.

At the same time, commitments are often ill defined within the budget. It is unclear whether the federal budget represents a complete list of

commitments. At present, the liabilities of the government often arise from entitlements from other legislation. In Russia such entitlements are prolific, covering almost all spheres of life. There is some agreement that the quantification of these entitlements is difficult, and any attempt to limit these provisions is not easy. Another complication is that the Budget Code (Article 238) appears to recognise that all appropriations can be committed and that a budget institution has the right to commit up to the total approved for it, regardless of resource availability.

The approach to registering and controlling commitments presently has a strong compliance orientation. However, such information should be an important input in budget management, both to budget preparation and setting commitment limits, as well as to financial planning. This cannot be taken lightly. In approving a commitment the Treasury is making an implicit guarantee of funds available to meet that commitment in the future. In turn, this requires strengthening its ability to track payment orders against contracts and improving cash management/financial planning. Both require improving the information base on commitments, which fundamentally will require the registering of commitments to be a component of the accounting system. Part of the problem is that the commitments undertaken by SUs are covered by off-budget resources, making it difficult to determine accurately the extent to which expenditures are uncovered because the FT has no verifiable information on the level of off-budget receipts. Recognising this problem has led to measures to gain control of these “off-budget” resources.

6.3. *Integrating off-budget resources in the budget*

The off-budget activities of budget institutions expanded as pressures in the 1990s on their regular budgets have increased. These off-budget resources of budget institutions arise from many sources – entrepreneurial activity, grants, licenses, fees and charges, rent and interest income, etc. It is also possible for budget institutions to hold foreign exchange accounts arising from earnings overseas. The right to receive such compensation and undertake such activities is usually granted through various laws. For example, the Law on Education allows educational institutions to have accounts in banks to deposit these receipts. In 1999 it was estimated that these own-resource accounts were equivalent to 15-22% of total budget expenditure, although there is as yet little solid data in this area. So substantial and important are these activities that it is difficult to separate them from their statutory role, thus generating great possibilities for cross-subsidisation and misuse of public funds. Although this problem appears to be larger and growing at the lower levels of government, attempts are under way to integrate these activities into the budget at the federal level.

The budget code is explicit in prohibiting off-budget accounts – such revenues and their related expenditures should form a regular part of a budget institution's plan of revenues and expenditures, and any surplus balances arising from such activity should be transferred to accounts in the FT (Article 254.4). The code does allow an exception to this in the case where funding is below budget limits (Article 254.6). However, when the federal law of the budget code was passed, it exempted budget institutions in the health, cultural, science and education fields, thereby preserving existing laws. This, combined with the fact that the Ministry of Defence (MOD) organisations are also allowed to maintain off-budget revenue sources, means that a major part of “own-source revenues” were exempted from the budget code provision.

In the FY 2001 budget, three articles were added that strengthened the position of the FT in ensuring that: i) off-budget revenues are fully registered (including from SUs in the areas of health, science, culture and education); ii) deposited in FT accounts; and iii) allowing the FT to refuse payment for unregistered contracts even if partly funded from own-source revenues.⁵

6.4. *Expanding the coverage of the federal Treasury System*

The extension of FT operations is being attempted in a number of areas that remain outside its control – the MOD, EBFs and local budgets. The largest exception to the FT's coverage is the MOD. The Russian defence establishment operates as an enclave that is independent of the rest of the budget and normal budget practice. This is manifested in many ways: the MOD has a separate budget classification and a corresponding different accounting system; treatment of Social Security payments on salaries is covered separately under the federal budget on behalf of the MOD; a large number of social SUs exist under the defence umbrella, paralleling and even overlapping other parts of the budget; and a number of military-related agencies have become semi-autonomous or “civilian” and placed off budget (e.g. Federal Defence Road Building Directorate).

In 1998, the MOD and the FT began two pilot projects in the Privolzhski military (Samara) region and the Baltic fleet, whereby the FT processed MOD payment orders. The lessons learned from these pilot projects indicated the large number of transactions which could result from the inclusion of the MOD in the FT system, possibly overextending the FT's present processing capacity. The present plan is to transfer the MOD to the FT in phases. The first, starting 1 January 2000, has already resulted in the Main Military Budget Department (MMBD) of the MOD opening an account in the central FT from which budget appropriations are allotted to lower level units. The MMBD has also opened an account for centralised procurement in the RTO of the City of Moscow. Also, from 1 July 2000, the progressive transfer of the second level units of the MOD to the FT for processing payment orders was completed.

Thus it is estimated that by end FY 2000 the FT operations covered about 60% of MOD expenditures.

By end FY 1999, there were five major funds at the federal level – Pension Fund, Social Insurance Fund, Fund for Medical Insurance, Employment Fund and the Road Fund. By Article 7 of the FY 2001 budget, most EBFs were eliminated. The new CoA includes new heads of accounts for the three main EBFs – the Pension Fund, the Social Insurance Fund and the Compulsory Medical Insurance Fund. Although technically inside the budget and under the FT, these funds have in the past used their own classification system and have followed their own accounting rules. This implies that the true integration of these funds will take some time to be technically consistent with the Treasury's ledger system.

The FT at end 1999 covered local budgets, of which 3 239 are serviced for revenues (either entirely or for part of revenues), and 413 for expenditures in specified categories. Apart from receiving lower level revenues the FT is responsible for the sharing of "regulated taxes." To execute the federal budget and the lower level budgets the FT must operate with six basic accounts, which are opened throughout the system, implying significantly over 2 000 accounts for the FT alone. In addition because regional and local governments are not integrated into the FT system, additional sets of control accounts at commercial banks are held on regional and local government accounts. These vast numbers of accounts hold significant balances, and are difficult to manage.

In theory, lower level governments enter the FT only on a voluntary basis, although in practice there is a current trend in government policy to extend more central control over the regions and hence greater pressure for them to enter the system. At the same time, suppliers (especially of utility bills) have insisted that the local government enter the Treasury System before they sign contracts. The recent need of local governments to conform to the budget code, and the imposition of a common classification system, have meant that local governments have turned to the FT to do this for them. There are indications, therefore, that the FT will most likely have to expand its operations in respect to regional and local governments. Processing revenues may not be too difficult, but processing lower level expenditures is likely to prove problematic, even though the FY 2000 budget has increased FT responsibilities. At present while there are around 50 000 SUs in the FT system (excluding the MOD), it is estimated that at the local level there could be as many as 120 000 units.

7. A future reform agenda

Clearly, the Russian authorities have taken significant steps in recent years toward establishing a transparent fiscal management system, and the new budget code provides the overall legal framework in which to further develop such a system. From the perspective of future budget system reform a two-stage strategy is perhaps in order. In the first stage the budget process should be improved by introducing more transparent, internationally accepted standards, both in budget preparation and execution, for all government operations. In the second stage, there should be a move away from the present high degree of centralisation in budget management toward a more decentralised approach in giving budget managers more scope to manage within strict accountability arrangements. In this stage, once compliance and stabilisation controls are in place, the priority will be to improve the efficiency and effectiveness of government operations.

7.1. *Measures to improve transparency in budget preparation*

Many of the problems in preparing a realistic budget arise from the deficiencies of the prior stage within the budget cycle at which strategic options for the budget are clearly defined and reviewed, and binding decisions are made on overall budget strategy. Several factors contribute to the ineffectiveness of this stage:

- Lack of clarity in the respective roles of the Executive and legislature in budget formulation. The budget code makes provision for fundamental remaking of the budget by the legislature, yet the latter lacks either the technical support or the necessary time within the budget cycle to undertake this role.
- The process of budget formulation is relatively centralised, with central agencies playing a relatively direct role in determination of allocations, including the use of centrally fixed expenditure norms.
- The substantial deviations between budgeted and actual expenditure levels give little incentive for budget agencies to invest time and effort in realistic costing of policy options and preparing budget projections.
- At no stage in the process is there a transparent statement of budget strategy linking proposed policies, objectives and broad budget allocations in a comprehensive manner (preferably more than a year ahead) that would facilitate clear decisions on what can and cannot be financed.

Again, these factors reflect the failure to review the strategic role of the government, and the fundamental problem of the lack of clear expenditure policies underlying budget allocations. As a result, the present basis for budget estimates is not transparent and does not ensure the connection

between budget authorisation and the real obligations of the government. A better definition of the expenditure estimates is required, for instance, by the BPD fully including registered commitments when formulating budgets. Transparency is further obscured by the budget being prepared and approved on a functional basis and largely executed on an agency or SU basis. This has contributed to the fact that most of the information produced by the budget process is late, incomplete and lacks analytical meaning.

A two-part strategy seems feasible. Firstly, for preparing the budget standards for revenue and expenditure estimates in the budget require to be developed modelled on international practices. These standards would be based on a clear definition of existing policy expenditure commitments and a methodology to ensure that ongoing costs of government services are fully estimated and realistically related to the macroeconomic framework. For this purpose a manual on modern costing methods would prove useful.

Secondly, political approval of the budget should be improved by reducing the number of main budget units and SUs to encourage internal priority setting; presenting the budget for approval on a ministry/SU and program basis rather than the functional/ministry basis at present; on the same basis developing a system of monthly and quarterly reports aimed at performance review and supporting analysis of current year's budget; and presenting estimates of tax expenditures with the budget document.

7.2. Measures to improve transparency in budget execution

7.2.1. Making the government payroll more transparent

Government employment and hence the payroll, is one area which lacks a coherent strategy, hence undermining sound budgeting. The government has acknowledged the need for reducing employment levels and improving public employee compensation. However, there is no real definitive data on the government's payroll. In addition, the wage bill is distorted by provision of a wide-range of benefits in kind – free apartments, medical clinic privileges, personal cars, subsidised meals, spa and resort services, etc.

Although these practices raise important issues of transparency, there appears little interest in the Ministry of Finance in taking initiatives in this area. As a result of the unreliable banking network virtually all government employees are paid in cash on the basis of information submitted by a decentralised payroll unit in the line ministry. This essentially manual system is inefficient, and vulnerable to fraud, and does not provide information to the Ministry of Finance. Payment of salaries and wages constitutes over 23% of the government's non-interest expenditure in the 2000 budget. If the payroll is not computerised, control over such a large component of government expenditure will remain ineffective. A possible strategy would be to develop a

standardised software package for payroll preparation, using the Social Fund Number as common identifier for payroll purposes. Russia should develop a standard manual on payroll preparation for all budget institutions.

7.2.2. Improving the accounting and classification of government operations

For effective public expenditure management, the accounting system must be reorganised to serve as a timely provider of management information on budget execution. The chart of accounts (CoA) is the backbone of the accounting system. If it is not structured to capture the transactions in full budget classification format, then the FT will continue to have to rely on the reports of the SUs to monitor actual budget execution. In the past this has been slow and unreliable, and since they cannot be independently verified, their completeness or accuracy is suspect. A major reform of the accounting system in the Russian Federation involves changing over from the present decentralised system to a centralised system.

In the latter system the information will flow from the FT to the budget users, tax authorities, etc. and not *vice versa*, as at present. The government's transactions will be captured according to Budget Code, only once, then entered automatically in the CoA by the computer software, avoiding the necessity of recompiling the data for reporting on budget execution. Of course, budget institutions will have to do their own detailed accounting operations – the keeping of detailed inventory for assets purchased and disposed of (*e.g.* for control and fiduciary purposes) and records for non-financial data (for management purposes to construct physical work-rate indicators, etc).

The Treasury development project, implemented with the financial assistance of the World Bank, will establish such a centralised accounting system, based on a CoA meeting international standards. This will require modifications to the present CoA, which presently does not fully reflect the budget classifications. The structure of the CoA aims to satisfy the needs of budget users in complying with detailed accounting regulations in producing their year-end accounting reports, and accordingly seems to treat accounting and fiscal reporting as two independent functions and are not inter-related.

7.2.3. Complete the development of the Treasury System

A major step in the development of the Treasury System was taken with the approval of a federal Treasury development program by government resolution (No. 677) of 23 June 1999. The objectives of this program are to: implement a TSA in the BOR; centralise all government operations in the FT accounts; ensure implementation of a uniform accounting and reporting system based on a single accounting and budget classification; develop,

implement and facilitate an integrated Treasury computer/communication system interfaced with the BOR settlement network. Apart from the establishment of a network of regional and local FT offices, the three other pillars of a fully operational Treasury System are only partially established: a general ledger accounting system (GLS), a Treasury Single Account (TSA), which consolidates government cash resources, and a system of integrated financial management which minimises the cost of government financing and guides the speed of budget execution.⁶

Accordingly, the overall development of the FT's capacity should be encouraged, and to this end the authorities have developed a longer term Treasury System modernisation project, with World Bank loan funding. In the interim it will be important to establish the fundamentals of FT operations, which will focus on three main elements, touched on previously. Firstly, complete the development of a GLS (operated by the FT and integrating the accounting carried out in SUs) that will record all stages of expenditure, from appropriation, commitment, verification and payment. Implementation will depend on computerisation of FT and development of the interim system. Secondly, create a full TSA. Complete the coverage of the Treasury System, by inclusion of all security ministries, and the off-budget activities of budget institutions, closing the associated accounts and transferring them to ledger accounts in the Treasury. Third, develop a system of reports, to support a financial planning capacity that will construct rolling three monthly cash flow forecasts, to guide the commitment limits of SUs and to adjust borrowing in line with cash flow requirements (see above). These developments will only prove effective if there is a concurrent effort to upgrade government financial management skills.

7.2.4. Develop government financial management capacity

The procedures for distribution of budget allocations, and for setting limits on spending of the ultimate users of budget resources, are fundamental to proper budget management and the avoidance of payment arrears. Allocations are determined by the approved budget for the main budget institutions, which in turn prepare quarterly breakdowns of these appropriations for each of their subordinate units. Following this initial allocation there are two important subsequent stages: the incurring of commitments and actual cash payment to settle these commitments. The responsibility in this area is divided between the BPD and the FT.

The BPD sets the level of commitments, by quarterly allocation of the annual appropriations, which is carried out at the level of economic classification. It also sets cash expenditure limits each month by aggregates to each ministry. The FT checks and approves the line ministries' proposals for breaking down their aggregate cash limits into spending limits for their

subordinate SUs. These limits, prepared by detailed economic classification, are based on cash-balance reports from the BOR received every five days.

There are three main problems with the present approach. First, there is no guarantee that the commitment levels set by the BPD can be covered in cash by the FT. If the latter monthly spending limits have been exhausted, payments have to be deferred, even if commitments have been made within the approved commitment limit. Rather than commitment limits being the binding constraint on spending, the present practice favours limits on cash payments – in the past, the consequence has been a build up in arrears. Second, the BPD by setting the monthly financial limits by aggregates causes additional problems to the FT when this is used as a method to limit expenditures below the levels authorised for commitments. The FT has to monitor budget execution by composition of expenditure (economically classified) and the shortfall in financing has to be distributed by the FT among the various items at the economic classification level – either arbitrarily or based on the SU's preferences. It is difficult, therefore, to make expenditure cuts according to broader government policy priorities. Third, the FT system of cash rationing by setting spending limits every five days prevents the line ministries and their SUs from longer term planning of their budget execution and undermines their capacity to meet payments already committed within the commitment limits.

To overcome these problems, it is important to change the point of expenditure control away from the final cash-payment stage to the commitment stage. The poor revenue performance in past years may have necessitated such extreme cash-rationing measures, but with the improvement in the fiscal situation since FY 2000 it is important to move toward a system that will control expenditures at the commitment rather than cash stage. The FT's cash-management system should be replaced by release of funds on a monthly basis to match the expected level of payments related to the commitment limits, so that ministries and their SUs are assured that cash recourses would at least match the commitments. This approach calls for the introduction of financial planning based on budget execution plans from line ministries and the development of a cash-flow forecasting model within the FT, based on information (forecast collections for the remainder of the year) from the Tax Ministry, Customs Committee, External and Internal Debt Management Departments and the Department of International Financial Institutions, as well as the data on actual collections and cash expenditures received from the accounting system.

7.2.5. Strengthen the external audit function

To support a reform program in public expenditure management it is essential to establish external checks on budget performance. In this regard

the external audit function is critical. International experience suggests that this function is most effective when the supreme audit institution has: genuine independence from the Executive, with timely access to comprehensive budget-execution data; reports to the legislature, but is able to pursue a systematic, independently determined program of audit, with separate budgetary provision for any *ad hoc* investigations required by the legislature; and confines its role principally to *ex post* audit, without compromise from any parallel engagement in the activities of budget formulation and execution.

In Russia, the Chamber of Accounts has been hindered in carrying out this role due to three main factors: i) inadequate expenditure reporting and accounts preparation by the Executive; ii) diversion from a systematic work program by the intervention of *ad hoc* investigations requested by the legislature; and iii) dilution of its core responsibilities for *ex post* audit by other tasks such as advice on budget formulation, intervention in budget execution and an enforcement role with respect to implementation of audit findings and penalties. A strategy to relieve these weaknesses could include:

- improved timeliness and comprehensiveness in reporting budget execution by the Executive (dependent on reforms in coverage and operation of the FT described above);
- legislative amendment to clarify the role of the Chamber, defining its responsibilities principally in terms of *ex post* audit; and
- with this refocused mandate, technically reinforce the Chamber of Accounts with more suitably qualified personnel, computerisation, and a training program.

8. The next stage of reform

It is evident that in pursuit of compliance and stabilisation objectives, the Russian budget system presently features a high degree of centralisation and a complex set of budgetary restrictions. These taken together have diminished the allocative and operational efficiency of budget execution with budget managers operating with little responsibility or incentive to deliver results. The next stage of budget system reform will involve a fundamental reorientation of the budget system – as has already been evidenced in OECD member countries – to provide greater inducement for managers to focus on possible improvements in allocative and operational efficiency in service delivery. This reorientation will require substantial capacity building in skills, which are currently in short supply. The present highly centralised budget system discourages the development of financial and allocative skills in spending agencies. To encourage such skills will require a more decentralised budget management system and one, which allows managers greater freedom

to manage. The risk with such increased flexibility is that spending agencies might undermine aggregate fiscal stabilisation objectives when revenue conditions deteriorate.

At this stage in the budget system development it would be unwise to move precipitously to this stage of budget system reform. Until the budget system can ensure fiscal discipline, and compliance with the law, and can provide a higher level of certainty in the spending agencies' operating environment, such a move could prove counter productive. Full application of the budget code, and the suggestions for its strengthening, will certainly do much to improve the budget system's ability to ensure compliance and stabilisation objectives. Perhaps more important, however, seriously addressing the reform agenda previously outlined will allow the budget system to move to the next stage of its development.

Notes

1. See discussion in Chapter 2, *Managing Public Expenditure – A Reference Book for Transition Countries*, (eds).
2. For a general review of this development see, W. Allan, "Toward a Framework for a Budget Law for Economies in Transition," *IMF Working Paper* 94/149.
3. In early FY 2001, the MOF carried out a survey which indicated the following breakdown of budget recipients: Unitary companies and SOEs, 639; joint stock companies, 322, non-profit organisations, 105. In addition to these 15 713 institutions, there were 205 others.
4. Namely, 110721, heating and technological necessities; 110722, consumption of natural gas; 110723 consumption of fuel for boilers; 110730 electric power; and, 110740 water supplies to premises and facilities.
5. Article 21 specifies that revenues from off-budget activities must be fully registered with the FT (although allows them to be used for the SU's own activities); Article 111 states that the FT will not pay for unregistered contracts; and Article 114 states that off-budget funds must be deposited in the accounts opened with the FT for that purpose.
6. A full explanation of this approach, and the experience of developing such systems in BRO countries, is contained in *IMF Occasional Paper* No. 198.

Annexe 1. **Russia: The Budget Formulation Process, FY 2000**

Step	Action	Time
1	Ministry of Finance submits to the RF government revenue and expenditure targets by the functional classifications for federal budget 2000.	Within two weeks of the date of approval by the RF government of the contingency scenario for the economy in the next fiscal year proposed by the MOE.
2	Macroeconomic Policy Department submits to Budget Department key macroeconomic targets for 2000 and for period until 2002.	By 31 May 1999.
3	Budget Department advises other Ministry of Finance Departments. The cap on budget 2000 revenue and deficit (broad detail).	No later than three days after the date of approval of the financial plan by RF government.
4	Tax Policy Department and International Co-operation Department advise Budget Department of changes proposed in tax legislation.	By 5 April 1999.
5	Domestic Public Debt Department, External Sovereign Debt Department, and IFIs Department submit to Budget Department estimates of domestic and external sources of funds and costs of debt servicing during 1999-2002.	By 7 April 1999.
6	External Sovereign Department, IFIs Department and International Co-operation Department advise Budget Department of estimated cost of international activities in 1999-2002.	By 7 April 1999.
7	Deputy Minister in charge of State Committee on Precious Metals advises Budget Policy of estimated proceeds from sales of precious metals and gems and amount required to replenish precious metals/gem stocks.	By 7 April 1999.
8	Treasury submits to Budget Department data on tax breaks provided and their expiration dates, budget loans and repayment dates.	By 7 April 1999.
9	Ministry of Finance Departments submit to Budget Department revenue and expenditure forecasts for 1999-2002.	8 April 1999.
10	Budget Department, Tax Policy Department, Domestic Public Debt Department and External Sovereign Debt Department submit proposals to macroeconomic Policy Department on the financial plan for 2000-2002.	12 April 1999.
11	Treasury informs Budget Department on execution on 1998 federal and consolidated budgets and submits to Budget Department preliminary report on execution of 1998 federal and consolidated budgets and I Qtr 1999 federal budget.	By 25 April 1999 and 1 July 1999, respectively.

Annexe 1. **Russia: The Budget Formulation Process, FY 2000** (cont.)

Step	Action	Time
12	Budget Department informs Ministry of Finance Departments of cap on federal budget 2000 outlays by the functional classifications; departments propose a breakdown of allocations for line ministries by groups and subgroups of the functional classification.	No later than three days after the date of approval of the financial plan by RF government (BPD) 28/04/99 (MOF departments).
13	Budget Department consolidates proposals of Ministry of Finance Departments on federal budget 2000 allocations for line ministries by groups and subgroups of the functional classification.	29 April 1999.
14	Budget Department advises line ministries of the cap on federal budget 2000 outlays by groups and subgroups of the functional classification accounts, works out the schedule of work of the Interagency Commission.	1 May 1999.
15	Line ministries submit to Budget Department breakdown of federal budget 2000 allocations by earmarked accounts, types of expenditure and the economic classification.	15 May 1999.
16	Department of External Debt Management. IFIs Department provide to central bank info on foreign borrowings and costs of foreign debts servicing.	By 1 May 1999 (preliminary), 1 November 1999 (final).
17	Budget Department prepares the draft federal budget 2000; a list of disputes regarding proposed allocations to be reviewed at the Interagency Commission.	3 June 1999.
18	The Interagency Commission reviews and reconciles federal budget 2000 proposals.	7-15 June 1999.
19	Budget Department submits to Ministry of Finance Board the draft federal budget 2000.	9 July 1999.

1. Following the MOF Order No. 68 of 31 March 1999.

Annexe 2. **Russia: The budget execution process, FY 2000**

Step	Department ministry agency	Action	Authority	Time
1	Budget Policy Department	Advises line ministries of their annual appropriations and quarterly apportionment by the functional classification.	Ministry of Finance Order No. 37n of 17 May 1999.	
2	Line ministry	Line ministry advises its SUs of quarterly apportionment of budget funds, consolidates returnable limits on expenditures, and submits to Ministry of Finance quarterly apportionment of its budget by the functional and economic classifications.	Article 217.2 of the Budget Code.	Within 10 days of the date of approval of the budget.
3	Budget Policy Department	Prepares a consolidated quarterly apportionment of budget funds by the departmental, functional and economic classifications and submits it to the Treasury (for execution), the Assembly and the Chamber of Accounts.	Articles 217.3 and 217.4 of the Budget Code.	Within 15 days of the date of approval of the budget.
4	Treasury	Treasury head office advises line ministries of their annual appropriations (the advice <i>per se</i> does not allow a line ministry to incur expenditures.	Article 220 of the Budget Code.	Within 10 days of the date of approval of the consolidated quarterly apportionment.
5	Line ministry	Spending unit finalises the revenue and expenditure budget and has it approved by administrator of budget funds/line ministry.	Article 221 of the Budget Code.	Within 15 days of the date of advice on annual appropriations.
6	Bank of Russia	Tax and other receipts are credited to Treasury accounts in BOR branches.		On a rolling basis.
7	Treasury	Treasury regional/local office receives an account statement from BOR branch; splits shared taxes between sub-national and national (federal) budgets; advises Ministry of Taxes regional/local office of tax payments received.		On a rolling basis.

Annexe 2. **Russia: The budget execution process, FY 2000**

Step	Department ministry agency	Action	Authority	Time
8	Bank of Russia	Advises treasury head office of balance in all treasury receipt accounts with the bank.		On a five-day basis.
9	Budget Policy Department	Determines and advises line ministries of monthly limit on commitment of budget funds by functional and economic classifications.	Article 223 of the Budget Code.	At least five days before the beginning of the month.
10	Line ministry	Prepares and submits to the treasury head office a requisition for allotment of budget funds.		On a rolling basis.
11	Treasury	Treasury head office processes requisitions from line ministries for allotment and advises Treasury regional offices that in their turn advise administrators/SUs of the availability of funds.		On a rolling basis.
12	Treasury	Regional/local Treasury office records commitments of SUs.	MOF Order No. 55n of 13 August 1999.	
13	Line ministry	Spending unit submits a request for payment (payment order) to the Treasury regional or local office where it has a nominal account.		On a rolling basis.
14	Treasury	Treasury regional or local office processes payment orders of SUs and submits them to the regional/local branch of the BOR for execution.		On a rolling basis.
15	Bank of Russia	Makes payment and issues an account statement to regional or local Treasury office.		On a rolling basis.
16	Treasury, line ministries	Prepare accounting reports.		Monthly, quarterly.

Government Procurement: A Synthesis Report

by
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Executive summary

Governments are significant purchasers of goods and services and these markets represent huge opportunities for international trade. Measuring government procurement for a large number of countries, in a consistent manner, is not a trivial task and careful attention must be paid to ensure that national data is gathered on the basis of harmonised procedures in all countries covered. Quantifying the size of government procurement markets becomes even more complicated when attempts are made at distinguishing procurement between government levels (central *versus* sub-central), or by types of expenditure (consumption *versus* investment), or at measuring the share of procurement that is potentially opened up to international trade (contestable). The latter indicator is meant to capture tradable purchases and excludes two categories of government purchases that are assumed to be non-tradable, i.e. the compensation of government employees and defence-related expenditure.

The absence of detailed and consistent measurements of government procurement markets for a large number of countries, broken down by government levels, by types of expenditure and contestable shares, represented an information gap. Informed knowledge about the size of government procurement markets and in particular the shares of national markets that are potentially opened up to international competition is relevant for the business community, governments and trade negotiators.

The challenge was addressed by the OECD Trade Committee, which undertook quantitative work that covers over 130 countries and proposes a series of detailed estimates. This report offers a synthesis of the analytical studies of the quantification of the size of government procurement markets and highlights the recent OECD quantitative work.

Based on this OECD work, the main estimates of the size of government procurement markets, expressed as percentage of 1998 GDP data or in billions of US dollars, are:

- For OECD member countries as a whole, the ratio of total procurement (consumption and investment expenditure) for all levels of government is estimated at 19.96% or USD 4 733 billion and for non-member countries the ratio is estimated at 14.48% or USD 816 billion.

- The world total procurement estimate is roughly equivalent to 82.3% of the world merchandise and commercial services exports in 1998. Country specific procurement estimates are detailed in Table 5 for 28 OECD member countries and Table 6 for 106 non-member countries.
- The ratios of government procurement markets, which is potentially opened up to international trade (contestable), are estimated at 7.57% or USD 1 795 billion for OECD member countries and 5.10% or USD 287 billion for non-member countries.
- The world value of the contestable government procurement market is estimated at USD 2 083 billion, which is equivalent to 7.1% of the world GDP or 30.1% of the world merchandise and commercial services exports in 1998.
- Procurement by sub-central governments is larger than procurement by central governments by an estimated margin of two to three times depending on the ratios being measured. These aggregated estimates for the OECD as a whole however mask some distinctive country variations.

The European Commission has carried out a number of studies on the quantification of the EU size of procurement markets and estimated its ratio of government procurement, which is potentially opened up to international trade, at 8.7% of GDP (Table 4). Based on the OECD work, a lower estimate of the EU contestable market was estimated at 8.03% (Table 5) and the difference in the estimates is mainly explained by the use of different data and assumptions regarding defence-related expenditure. The EC has had access to detailed defence-related data for its member states that distinguished between hardcore and non-hardcore defence expenditure. In the EC study, hardcore defence expenditure was considered as non-tradable whereas the OECD study has considered all defence-related expenditure as non-tradable. These results suggest that the OECD procurement estimates slightly underestimate the size of procurement markets that is potentially opened up to international competition.

In early 2000, the EC has also published a number of preliminary indicators of public procurement to measure market trends for the period 1993-1998 and the impact of public procurement policies. The EU public procurement was estimated within a range between 13.9% to 14.6%. The definition of public procurement includes procurement by public utilities (publicly or privately owned enterprises), such as water, energy, transport and telecommunications sectors. These estimates are considerably above earlier public procurement estimates made by the EC for 1994 (11.2% and 11.8%) and illustrate the careful attention that needs to be paid to the definitions used for measuring procurement markets. These results also show the relative

importance of procurement by public utilities and the potentially huge opportunities that they represent for international trade.

Measuring procurement ratios broken down by government levels is helpful for appreciating the expanded reach of the WTO Government Procurement Agreement (GPA) to sub-central government entities. Based on the OECD estimates that the sub-central governments account for about 65% of total government procurement, it is extrapolated that the reach of the WTO GPA, due to its expanded coverage to sub-central entities, is about three times larger than under the GATT Code, the predecessor of the WTO GPA.

Up until recently, the 1968 version of the System of National Accounts (SNA) was universally applied in the compilation of national economic activities in both OECD and non-member countries, albeit with considerable differences in the availability of detailed national data by countries. The 1968 SNA thus offered the potential for measuring government procurement markets for a large number of countries in a consistent manner. The 1968 SNA is now outdated and, since 1999, most OECD member countries have switched to the 1993 version of the SNA, as a basis for compiling their national accounts. Once the switch over is fully implemented by a large number of countries, it will then be possible to quantify the size of procurement markets in a consistent manner for more recent periods. In the meantime, it is doubtful that additional insights could be obtained through further uses of the 1968 SNA-based data.

The so-called “bottom-up” approach refers to the process of gathering national data on procurement expenditure directly from national entities responsible for procurement decisions. The reliability of results obtained from bottom-up approaches stem, to a large extent, from the homogeneity and consistency of the compilation and reporting processes throughout the countries subject to the notification requirements. Establishing such processes require considerable resources at least in the initial stage. The information and data obtained on the basis of surveys of notification requirements usefully complements SNA-based data and is also useful for analysing the reach of some agreements and for making country comparisons.

1. Introduction

Governments at central and sub-central levels and state-owned enterprises are significant purchasers of goods and services, and these markets represent huge opportunities for international trade. While the largest opportunities, in value terms, arise in the industrial countries, emerging economies, too, offer markets with considerable potential. There are few studies on the quantification of the size of government procurement markets but their results are not necessarily comparable as different

definitions of procurement are used. Furthermore, these studies usually focus on a very limited number of countries, the period covered is fairly outdated, and detailed estimates of procurement by sub-central governments are either not carried out or are simply ignored.

Measuring the size of government procurement markets for a large number of countries, in a consistent manner, is not a trivial task and careful attention must be paid to ensure that national data is gathered on the basis of harmonised procedures in all countries covered. The absence of consistent measurements of the share of government procurement markets that is potentially opened up to international trade (hereby referred to as the contestable share) for a large number of countries, broken down by government levels, represents an information gap that needed to be addressed.

Government procurement traditionally tends to favour local suppliers; by limiting import competition, it has effects similar to other protectionist measures, introducing distortions that limit choices, increase prices and discourage economic efficiency. In recognition of these costs it imposes on national economies, efforts at bringing government procurement under multilateral trade disciplines began after the Second World War. However, governments faced virtually no restraints in favouring national suppliers over foreign competitors until 1981, when the Tokyo Round Agreement on Government Procurement entered into force for a limited number of GATT contracting parties. Since then, progress was achieved in expanding the scope and coverage of the Tokyo Round Agreement when the Agreement on Government Procurement (GPA) entered into force in 1996 under the World Trade Organisation (WTO) auspices.

In parallel, several regional trade agreements, such as the European Union (EU) and the North America Free Trade Agreement (NAFTA), have brought government procurement under specific disciplines for their member countries. By committing governments to observe some basic principles, such as transparency and non-discrimination, the negotiated disciplines of these regional and multilateral agreements have sought to do away with some of the preferential and discriminatory practices in government procurement activities. Improved import competition conditions in government procurement play a crucial role in keeping downward cost pressures on goods and services purchases, giving taxpayers value for money, improving the quality of government services and permitting improved allocation of resources.

The primary objective of this report is to present a synthesis of the analytical studies on the quantification of the size of government procurement and markets. To provide some background information to readers about the relationships between international trade and government

procurement, two brief introductory sections are presented as reference to the main theme of the report. Section 2 presents a brief historical review of how the GATT and WTO multilateral disciplines in respect of government procurement have evolved. The consensus building and analytical role that the OECD played during this process is stressed. Section 3 offers a brief survey of the academic research on the impact of discriminatory procurement practices. Section 4 compares the methodological approaches and results drawn from publicly available studies and highlights the recent work carried out by the OECD Trade Committee. Various indicators of the size of government procurement markets are presented for both OECD and non-member countries, including ratios detailed by government levels and by types of expenditure (consumption *versus* investment) and indicators of the contestable shares of procurement markets that exclude either or both the compensation of government employees and defence-related expenditures. Section 5 offers some concluding remarks.

This document responds to the mandate of the OECD Trade Committee to deepen understanding of the important of the government procurement sector in international trade. This work supports the efforts of governments preparing for discussions on government procurement in the WTO. This document also aims at building better understanding and appreciation in the general public for the benefits that arise from improved multilateral disciplines in government procurement matters. This project has involved a collaboration effort from many representatives of national statistical offices in OECD member countries and the assistance of the OECD and United Nations Statistics Departments.

2. Evolving multilateral trade disciplines

During the negotiating process for the establishment of the International Trade Organisation (ITO) in 1946-47, proposals to subject government contracts to the fundamental trade principles of “Most-Favoured-Nations” (MFN) and “National Treatment” clashed with prevailing practices that favoured national suppliers. The ITO itself never came into being. Instead, the General Agreement on Tariffs and Trade (GATT) entered into force in 1948 with a specific exemption for government procurement from the application of the national treatment principle, under Article III, but incorporated an obligation of “fair and equitable treatment” for procurement by state trading enterprises, under Article XVII.2. Blank and Marceau (1997) qualify this procurement obligation on state trading enterprises as “very modest best-endeavour language”.¹

Until the Tokyo Round Agreement on Government Procurement (GATT Code) entered into force on 1 January 1981, governments faced virtually no

restraints when making purchases that favoured national suppliers over foreign competitors. The GATT Code extended the MFN and national treatment principles to the procurement of goods above a certain threshold by central government entities of the countries that specifically agreed to apply the code. It also laid down some operational provisions, including transparency requirement at each stage of the procurement process, multilateral dispute settlement procedures and special and differential treatment for developing countries. The national treatment means that the products of other parties to the code should not be subject to a treatment less favourable than for products of domestic origins. The MFN provision prohibits discriminatory treatment between products of other parties to the code.

The GATT Code was very much influenced by the analytical work and consensus-building efforts carried out by the OECD that started in 1963 and cumulated in 1976 with the OECD Draft Instrument on Government Purchasing Policies, Procedures and Practices. Following a request made by the GATT in November 1976 to the OECD, the Draft Instrument was transmitted to the GATT. It was sent with the disclaimer that “this draft is the result of work carried out at the level of experts, on an explanatory basis, and that it does not imply any commitment by governments on the proposed solution in general or on any of its particular aspects.”²

The WTO Agreement on Government Procurement (GPA) that entered into force in 1996 expands the size of the global arena open to foreign competition. Whereas the GATT Code set forth rules for open and transparent bidding with regard to the purchase of goods by central government entities, the GPA expanded the disciplines to services and construction work and covers procuring entities at sub-central governments, as well as certain public and regulated private companies. A large part of the general rules and obligations concern tendering procedures that guarantee the transparency of the procedures and insure non-discrimination between domestic and foreign firms.³ The GPA also contains the schedules of national entities in each participating member country whose procurement is subject to the agreement. The GPA is a “Plurilateral Agreement” in the WTO and, contrary to the main WTO agreements that bind all member countries, the GPA only applies to the country members that have specifically adopted it. In early 2001, there were some 27 WTO member countries participating in the GPA and several countries with observer status in the WTO Committee on Government Procurement.⁴

In the context of the 1996 WTO Ministerial Conference in Singapore, a Working Group on Transparency in Government Procurement Practices was set up. The group’s work was to study transparency in government procurement practices, taking into account national policies and to develop elements for inclusion in a multilateral agreement. In the WTO, government

procurement is also discussed in the context of the GATS negotiations. Although the initial GATS Agreement contains an explicit exemption for the procurement by governmental agencies of services purchased for its own uses, it provides for multilateral negotiations on government procurement in services under the GATS within two years from the date of entry into force of the WTO Agreement. These negotiations are being pursued in the context of the overall GATS negotiations currently underway, under the so-called “Built-in Agenda”, which also provides for a review of the GPA.⁵

3. Economic literature on the effects of procurement practice

This synthesis of academic research on the impact of government procurement on international specialisation and trade is presented as background information to the main theme of this document, which primarily focuses on the quantification of government procurement markets. As an introduction, the main forms of discriminatory or preferential procurement practices are summarised.

Discriminatory or preferential procurement practices can take several explicit forms, including “outright exclusion” in which foreign bidders are excluded from the tendering process (for example, defence contracts are often, but not always, reserved for domestic suppliers). Under “preferential price margin”, purchasing entities accept the bids of domestic suppliers over foreign suppliers as long as the additional price is not above a specific margin of preference. A third type of discrimination is the use of a “domestic content requirement” in public purchasing in which the government purchases from foreign sources only if the latter commit to purchase some components from domestic firms. The above three forms of discriminatory practices are the most explicit and the most amenable for conceptualisation in modelling exercises.

The most insidious and pervasive forms of discriminatory practices relate to opaque tendering and bidding procedures, lacking in terms of transparency and non-discrimination provisions, which offer fertile ground for favouring domestic suppliers. Because of their implicit nature, the latter are the most difficult to conceptualise in modelling exercises. As a result, the economic costs and inefficiencies arising from non-transparent and discriminatory tendering and bidding procedures tend to be systematically underestimated.

Academic research on the impact of government procurement on international specialisation and trade flows started in the 1970s. Well-known work by Robert Baldwin (1970, 1984) and Baldwin and Richardson (1971) argued that discriminatory procurement policy affects neither domestic supply nor trade flows – the shift in government demand towards domestic products

leads to an equal but opposite shift in the private demand for imports. This somewhat counterintuitive result stood for some time as the main pillar of theoretical investigation. Nevertheless, Baldwin (1984) emphasised that his earlier results on the inconsequential impact of discriminatory practices may be attenuated under imperfect market conditions.

Several authors, including Lowinger (1976) and Deardorff and Stern (1979), have carried out empirical analysis of the trade impact of discriminatory procurement by comparing the actual import profile of government purchases with that of the private sector for the 1970s period. They supported the view that huge welfare gains would be derived from non-preferential procurement policies. Lowinger (1976) has estimated that imports by the US Government would increase by a factor of six or seven than their actual level in the mid-1960s. Deardorff and Stern (1979) argued that the welfare gains from the liberalising government procurement under the Tokyo Round would be greater than the gains from tariff liberalisation for industrial countries. These results did not validate the prevailing Baldwin's assumption that discriminatory procurement is inconsequential.

In Francois *et al.* (1996), the authors have assessed the impact of the Tokyo Round Agreement of Government Procurement on the procurement practices in the United States, based on data broken down by sectors and purchasing entities. They found that the US Government typically accounts for less than 5% of total domestic demand and argued that the potential impact of preferential practices on overall market access to be relatively limited. However, for certain key sectors, such as construction, maintenance and repair services, they argued that government preferences could and most likely affect market access.

Deltas and Evenett (1997) have examined the distribution effect of discriminatory procurement. They argued that preferential price policies in procurement bring in marginal welfare gains as the benefits from shifting profits to domestic firms are ultimately offset by increasing procurement costs. Mattoo (1997) has reviewed the main contributions of the economic literature on the impact of discriminatory procurement and argued that *"attempts to estimate the cost of procurement preferences without taking into account their effects on bidding behaviour may produce biased estimates."* This serves as a useful reminder of the inherent difficulties of conceptualising some of the key aspects of procurement, such as the complexity of bidders' behaviour under conditions of imperfect competition and informational asymmetries between concerned parties.

This brief survey of academic research on the impact of government procurement on international specialisation and trade highlights the inherently complex task of conceptualising multiple and intertwined factors

into a theoretical modelling exercise, particularly in conceptualising implicit forms of discriminatory practices. Greater understanding of several related aspects, such as transparency and non-discriminatory provisions, bidders' behaviour, informational asymmetries, distribution effects and the dynamic effects of procurement preferences, could usefully provide additional policy underpinning and insights.

4. The size of government procurement markets

Table 1 shows the coverage and results of several studies on the quantification of the size of government procurement markets. It includes the recent work initiated by the OECD Trade Committee and other publicly available studies in the economic literature. The list may not exhaustive but it is illustrative of the relative scarcity of studies on this topic. The methodological approaches used and results obtained from these studies are reviewed below.

4.1. Data sources

One key consideration in quantifying government procurement markets relates to the selection of the source of data, which ultimately enables reliable

Table 1. **Various estimates of the size of government procurement markets**

Various studies				General government			Sub-central levels
Authors	Sources	Countries	Period	Total expenditure % of GDP	Exclude non-tradable		
					Compensation of employees	Compensation of employees and defence	
SNA-based							
EC (1988)	SNA-OECD	EU-12	1987			11.7%	Yes
EC (1997)	SNA-OECD	EU-15	1994			11.2-11.8%	Yes
Francois <i>et al.</i>	SNA-OECD	USA	92-93	18.3%			Yes
Trionfetti	SNA-UN	9 OECD	83-90		7-9%		
Trionfetti	IMF data	8 OECD	84-90		10-18%		
OECD	SNA-OECD	28 OECD	90-97	19.96% w.a.	9.17% w.a.	7.57% w.a.	Table A1
OECD	SNA-OECD	13 OECD	90-97		9.02% w.a.	7.79% w.a.	Table A3
OECD	SNA-UN	106 non-OECD	90-94	14.48% w.a.	6.89% w.a.	5.10% w.a.	Table A2
Bottom-up							
Hoekman	WTO	20	83-92	0.42%			
EC (2000)	<i>Official Journal</i>	EU-15	93-98			13.9-14.6%	

Note: Weighted average percentages are noted by the indication w.a.

In the EC studies, the ratios are measuring public procurement.

Source: EC (1997 and 2000), Francois *et al.* (1996), Trionfetti (2000) and Hoekman (1997).

country comparison. The logical choice falls on the System of National Accounts (SNA) that is universally applied in the compilation of national economic activities, albeit with considerable differences in the availability of detailed national data among countries. Given the long experience of countries in using the SNA, the risk of inconsistent application or misinterpretation of some of its statistical definitions is considered low. All studies reported in Table 1 have used or partly used one of the three SNA-based data sources, with the exception of the study by Hoekman (1997), which is based on WTO notifications, and the EC (2000) study, which is based on periodic surveys of notifications requirements in the EU Official Journal. The latter data sources are classified under the so-called “bottom-up” approach and are discussed in Section 4.4.

The three SNA-based data sources are: the Government Finance Statistics by the International Monetary Fund (IMF); the National Accounts Statistics: Main Aggregates and Detailed Tables, by the United Nations (UN); and the National Accounts: Detailed Tables, by the OECD. Statistics published by the OECD and the UN are perfectly compatible. In the Government Finance Statistics by the IMF, the recording of transactions is slightly different, which gives somewhat different results for similar accounting categories of expenditure.⁶

4.2. The System of National Accounts

The SNA contains statistical definitions on a wide-range of economic activities, including government activities. Annex 2 provides a glossary of the main terms used in this review. The SNA enables to calculate the size of government procurement markets on the basis of data series on government accounts. The most important series for the measurement of government current procurement are “Final Consumption Expenditure” (FCE) and “Intermediate Consumption” (IC). IC of governments refers to the current acquisitions of governments whereas FCE contains all net costs of service production by governments, that is including compensation of employees (CE), consumption of fixed capital (depreciation) and indirect taxes. Income of sales is also subtracted from FCE. Annex 3 provides more technical information about how the FCE and IC data series are reconciled.

To obtain a complete picture of total acquisition by governments, it is necessary to add the investment expenditure realised by governments to the current acquisitions. Government investment is defined as the “Gross Fixed Capital Formation” (GFCF). Total government acquisitions (hereby referred to as total expenditure less compensation) can thus be measured by adding GFCF to either IC or FCE (less CE) data series or both depending on the availability of national data.

Whereas the availability of detailed IC series by government levels is weak and uneven for OECD member countries and virtually non-existent for non-member countries, detailed FCE series are abundant for the overwhelming majority of OECD member countries. Data on FCE series and GFCF are available for most OECD member countries by sub-levels of government, for: i) central government; ii) state governments (if they exist); iii) local governments (for most countries state and local governments data are combined); and iv) Social Security funds. For purpose of clarity, the term “general government” encompasses all government levels and “sub-central governments” refers to government levels other than the central government, i.e. state and local governments and social security funds. For non-member countries, it is primarily the main aggregates of the national accounts at the general government level that are compiled and available in the UN publication. Detailed FCE series for sub-central governments are virtually non-existent and GFCF data are unevenly available for non-member countries.

The SNA also contains a statistical definition for public enterprises, which are defined as those organisations, that are entirely or mainly, owned and/or controlled by public authorities. Unfortunately, national data on public enterprises is not widely available for OECD member countries and virtually non-existent for non-member countries. More importantly, the presence of huge differences in the reported national data raises doubts about their reliability. It appears that due to uneven compilation practices among countries, national data on public enterprises are sometimes improperly classified under public non-financial corporations, which overstates public non-financial corporations data and understate public enterprises’ procurement. This illustrates the key consideration of the consistency in the compilation procedures of national data among countries. Without harmonised compilation procedures among all countries, the basis for country comparison will be distorted.

The OECD-UN SNA data used in the studies reported in Table 1 are based on the 1968 version of the SNA (Series F. No. 2, Rev3). The 1968 version is now outdated and, since 1999, most OECD member countries have switched to the 1993 version of the SNA, as a basis for compiling their national accounts. The SNA 1993 was jointly prepared by the OECD, the EC, the IMF, the UN and the World Bank. For the first time, the OECD published in 2000 the national accounts data on the basis of the new SNA 1993, i.e. *National Accounts of OECD Countries, Detailed Tables, Volume II 1988-1998*. The switch over represents a large undertaking for national statistical agencies. At this juncture, some countries are producing very short time series on the new basis and the data compiled are less detailed than those previously available. Once these problems are solved, it would then be possible to use the SNA 1993 for measuring the size of government procurement markets in a consistent

manner for a large number of countries and for more recent periods. Since the SNA 1993 differs somewhat from the 1968 version, the methods applied in the estimation of government procurement will have to be modified accordingly.

4.3. SNA-based estimates of government procurement markets

4.3.1. Recent OECD work

With the set objective of quantifying the shares of government procurement markets in OECD and non-member countries that are potentially internationally contestable, various procurement ratios were measured. Tables 2 and 3 provide a synthesis of the average ratios calculated for the two groups of countries (the OECD member countries as a whole and the non-member countries as a whole), whereas Tables 5 and 6 provide the detailed ratios calculated for individual OECD member and non-member countries respectively. The initial OECD project intended to cover procurement by governments as well as public enterprises. Unfortunately, the project was scaled back to measuring government procurement markets only as the availability and reliability of national data on public enterprises did not permit reliable country comparison.⁷

The measurement of the 10 ratios of the size of government procurement markets, as shown in Table 5, has required data for 30 standardised SNA statistical items for each country (as detailed in Table 8). To deal with the problem of missing data in specific OECD member countries, the missing data were estimated and the methods and assumptions used for estimating them are explained in Annex 4.

Table 5 shows a total of 10 estimates of government procurement markets including six ratios that are designed to capture the tradable shares of government expenditure. The first four ratios measure the sum of government consumption and investment expenditure, i.e. Total Expenditure (TE), detailed by levels: general government; central government; local governments (state and local together); and Social Security fund. All ratios are expressed as a share of GDP of the country concerned. The next four ratios measure the respective total expenditure excluding the compensation of employees for each level of government. Finally, the last two ratios propose a measurement of the theoretical tradable procurement markets that exclude both defence-related expenditure and compensation of employees. These two categories of expenditure are assumed to be non-tradable. The latter ratios are measured respectively at the general and central government levels reflecting the exclusive responsibility of central governments in defence matters.

Each ratio shown in Table 5 is the average of the annual ratios calculated for the period starting in 1990 and up to 1997, depending on the availability of annual data by country. The advantage of averaging is that it takes into

account of the annual fluctuations over the period and therefore avoids the problem of picking up one single year, which may not be a representative year. One consequential disadvantage is that the ratio for the general government for anyone country shown in Table 5 does not added up to the sum of the reported ratios for the three levels of governments (central, local and Social Security fund).⁸

The bottom section of Table 5 also shows the average percentage for the OECD as a whole for each of the 10 ratios based on a simple average and a GDP-weighted average. The weighted average ratios take into account the relative size of each country and thus are better indicators of the average size of government procurement markets for the OECD as a whole. The weighted average ratios are all smaller than the ratios measured on a simple average basis.

Table 6 shows seven ratios covering government procurement at the general government level for 106 non-member countries. Disaggregated data for sub-central government levels was available for four countries only, i.e. Colombia, Ecuador, Peru and Venezuela, and was not considered as a sufficiently representative basis for extrapolating results on all non-member countries. Each ratio is the average of the annual ratios calculated for the period starting in 1990 and up to 1994, depending on the availability of annual data by country (the most recent period available in the UN publication). The average ratios calculated both on a simple average and a GDP-weighted basis for the group of non-member countries as a whole are shown in Tables 2 and 3.

The measurement of the seven ratios of the size of the general government procurement markets in non-member countries has required data for nine standardised SNA statistical items for each country, which are the same first nine standardised items used for OECD member countries (see Table 8). Gaps in the availability of data for non-member countries have somehow undermined the reliability and robustness of the estimates of certain ratios of procurement markets. Few estimates of the missing data for non-member countries were made.⁹ More particularly, although the consumption segment of general government expenditure is available for 106 countries, the investment segment (gross fixed capital formation) is available for 29 countries only. Table 2 shows four ratios of the size of procurement markets for the consumption segment of general government expenditure and three ratios of total expenditure taking into account both consumption and investment expenditure.

The last two columns of Table 2 show respectively the number of non-member countries taken into account in the calculation of each ratio and, for each ratio, the GDP percentage of those countries relative to total GDP of all

Table 2. **Government procurement ratios in OECD member and non-member countries**

	Weighted average		Simple average		Non-OECD	
	OECD (%)	Non-OECD (%)	OECD (%)	Non-OECD (%)	No. of countries	GDP covered (%)
General government						
Consumption expenditure	17.09	14.12	19.04	16.96	106	89.5
Less compensation	6.31	4.82	7.13	5.35	30	41.1
Less defence	14.17	9.54	17.03	12.05	22	22.6
Less compensation and defence	4.73	2.09	6.03	3.50	13	14.6
Total expenditure	19.96	14.48	22.22	19.46	29	26.6
Less compensation	9.17	6.89	10.32	8.80	20	21.2
Less compensation and defence	7.57	5.10	9.25	6.92	10	10.8

Source: United Nations (1997) and OECD (1998).

non-member countries. This last percentage amounts to 89.5% for the ratio of consumption expenditure, falling to 10.8% for the ratio of total expenditure excluding defence-related expenditure and compensation of employees. These percentages are indicative of the robustness of the estimated ratios of the size of government procurement markets for non-member countries. As it can be seen the robustness diminishes as additional elements are built into the ratios.

Table 3 shows all the estimates of the size of government procurement markets calculated on a weighted average basis for the two groups of countries. The ratios are expressed as a percentage of the total GDP for the respective group of countries and also in billions of US dollars based on 1998 GDP data. The main results are:

- The ratios of total expenditure, at the general government level, are estimated at 19.96% or USD 4 733 billion for OECD member countries and 14.48% or USD 816 billion for non-member countries. This world total procurement estimate is roughly equivalent to 82.3% of the world merchandise and commercial services exports in 1998.
- About 35% of the OECD total expenditure is accounted for by central governments with the remaining 65% accounted for by local government and social security funds taken together. When the OECD total contestable expenditure is measured, the relative share of the central government is 23.1% and the share of the sub-central governments is 76.9%. These aggregate percentages for the OECD as a whole mask some important country variations in the relative shares of total expenditure between central and sub-central governments (see Section 4.3.4).

Table 3. The value and ratios of government procurement markets

Government procurement	OECD		Non-OECD		World
	% GDP	Value	% GDP	Value	Value
GDP 1998 (USD billions) and (% of GDP w.a.)		23 716.3		5 641.4	29 357.7
Consumption expenditure					
General government	17.09%	4 053.1	14.12%	796.6	4 849.7
Less compensation	6.31%	1 496.5	4.82%	271.9	1 768.4
Less defence	14.17%	3 360.6	9.54%	538.2	3 898.8
Less compensation and defence	4.73%	1 121.8	2.09%	117.9	1 239.7
Total expenditure (TE)					
General government	19.96%	4 733.8	14.48%	816.9	5 550.6
Central government	7.13%	1 691.0			
Local government	12.12%	2 874.4			
Social security funds	1.22%	289.3			
TE less compensation					
General government	9.17%	2 174.8	6.89%	388.7	2 563.5
Central government	3.39%	804.0			
Local government	5.44%	1 290.2			
Social security funds	0.51%	121.0			
TE less compensation and defence					
General government	7.57%	1 795.3	5.10%	287.7	2 083.0
Central government	1.75%	415.0			

Source: United Nations (1997) and OECD (1998).

- The ratios of contestable total expenditure, at the general government level, (excluding defence-related expenditure and the compensation of employees) are estimated at 7.57% or USD 1 795 billion for OECD member countries and 5.10% or USD 287 billion for non-member countries.
- The world value of the contestable government procurement is estimated at USD 2 083 billion in 1998, which is equivalent to 7.1% of the world GDP or 30.1% of the world merchandise and commercial services exports in 1998. OECD member countries account for 86.1% of this world contestable procurement market, which is slightly above its relative share of the world GDP (80.2%).

Due to the use of a somehow restrictive assumption whereby all defence-related expenditure is treated as non-tradable, the above estimates of the contestable procurement ratios underestimate the actual competitive conditions in procurement since several OECD member countries have opened up their non-hardcore defence procurement under regional trade arrangements or unilaterally. This underestimation is further confirmed by

the similar quantitative work carried by the European Commission (EC) that has treated non-hardcore defence expenditure as tradable (see Section 4.3.2).

Comparison of the ratios obtained for OECD and non-member countries reveals some differences in terms of the size and the composition of expenditure between the two groups of countries. All ratios measured for OECD member countries as a whole are systematically higher than the equivalent ratios measured for the group of non-member countries. Concerning the composition of expenditure, defence-related consumption expenditure is on a relatively larger scale in non-member countries than in OECD member countries (4.58% versus 2.92%).¹⁰ Similarly, the share of investment expenditure is higher in non-member countries than in OECD member countries, after defence-related expenditure and the compensation of employees are deducted (3.01% versus 2.84%).¹¹ These comparative shares in the composition of government expenditure should be interpreted with caution given the small sample of non-OECD member countries taken into account in these estimates.

The above OECD estimates present a number of distinctive characteristics for measuring in a consistent manner the shares of government procurement markets for a large number of countries. The country coverage is considerably wider and more detailed than any other studies on the quantification of government procurement markets, as reported in Table 1. In total, 14 different ratios of government procurement markets are measured for OECD member countries with detailed ratios by countries broken down by government levels and tradable shares. For non-member countries, 106 countries at the general government level are covered and seven detailed ratios are measured broken down between consumption versus investment expenditure and tradable ratios. The periods covered, 1990-97 for OECD member countries and 1990-94 for non-member countries, also represent the most recent periods for which consistent SNA-based data (1968 version) are available. Unlike any other studies, the ratios are measured for the two groups of countries as a whole on a GDP-weighted basis, thereby taking into account the relative size of the countries considered.

4.3.2. *The EC estimates of government procurement markets*

The EC published in 1988 and 1997 two comprehensive reports regarding public procurement in the context of the Single European Market program. The first report entitled *The Cost of non-Europe in Public Procurement* (EC 1988), assessed the potential savings in public expenditure within the EU-12 from removing all barriers to trade in public purchasing including procurement carried out by publicly or privately owned enterprises, i.e. water, energy, transport and telecommunications sectors. It also assessed the size of public procurement markets for the 12 member states in 1987, based on SNA data

and other sources. The second report, *The Single Market Review, Subseries III: Dismantling of Barriers, Volume 2: Public Procurement* (EC 1997), estimated the size of public procurement for the 15 member states in 1994 on the basis of SNA data complemented with demand-side survey results (bottom-up analysis).

In these EC studies, one ratio of public procurement is consistently measured as a basis of comparison among the EU member states. The public procurement in question is composed of two parts. The first refers to government procurement at the general government level, including both consumption and investment expenditure, excluding the compensation of employees and “warlike” materials (Article 223 of the EC Treaty which are not covered in EC Directives on procurement). The measurement of “warlike” materials by the EC is derived from SNA-based statistics and estimates of the share of “warlike” materials in the study, *The Cost of non-Europe in Defence Procurement* (EC 1994). The second part refers to public utilities’ procurement, excluding the compensation of employees, and is measured on a combination of SNA data and demand-side survey results.¹²

Table 4 shows the estimated size of public procurement for individual EU member states calculated for 1987 and 1994, as reported in EC (1997). To ensure comparison between the 1987 and 1994 results, the market size

Table 4. EU public procurement in 1987 and 1994

European Union	Public procurement (includes government and public services)		Government procurement (government only)
	1987 (%)	1994 (%)	1994
Belgium/(Luxembourg 1994)	12.7	5.8-7.2	
Denmark	11.6	11.0-11.1	
France	11.5	10.2-10.7	
Germany	9.9	13.0-13.5	
Greece	15.7	6.5-8.2	
Ireland	11.5	8.7-9.8	
Italy	10.4	8.6-9.6	
Netherlands	11.6	8.5-9.0	
Portugal	14.5	11.4-12.0	
Spain	10.4	9.4-9.9	
United Kingdom	16.5	14.4-14.5	
EU-12	11.7	11.1-11.6	
Austria	11.7	11.6-12.0	
Finland	11.6	10.8-12.3	
Sweden	11.7	14.6-14.7	
EU-15 (ECU billions)	476.1	704.1-737.6	547.4
EU-15	11.7%	11.2-11.8%	8.7% est.

Source: EC (1997, Tables 4.1, 10.1 and 10.3).

statistics in the first report were adjusted to reflect the differences in coverage of public entities. EU public procurement is estimated at 11.7% in 1987 and at a range between 11.2% and 11.8% in 1994. Despite these adjustments, there are significant differences in the estimated ratios for 1987 and 1994. The 1994 ratios are lower than in 1987 for all EU-12 member states, except for Germany due to its unification. Among the explanatory factors for the decrease in the size of the public procurement, the report notes the general reduction in public expenditure as a result of policy to reduce budget deficits, the privatisation of public services and the contracting out of non-core services. Also noted in the report is the problem of relying on data for one year only due to annual variances in expenditure, particularly in the smaller countries, where large infrastructure projects can have a significant impact on government expenditure (EC 1997, pp. 110-112).

Based on a value of total EU government procurement of ECU 547.4 billion in 1994, the equivalent ratio of government procurement to GDP is estimated at 8.7%, as shown in the last column of Table 4. This estimated ratio of the size of the EU general government procurement market, excluding compensation of employees and warlike expenditure, is above the 8.03% EU weighted average ratio measured in the OECD work that excludes compensation of employees and all defence-related expenditure (see the last line of Table 5). These two ratios are nevertheless broadly consistent since the adjustment made in the OECD work for all defence expenditure is larger than the adjustment made in the EC studies for warlike materials. This comparison also highlights the restrictive assumption used in the OECD work, in which all defence expenditure is assumed as non-tradable. While the Commission has had access to break down data for hardcore and non-hardcore defence expenditure for its member states, such detailed data is available in neither the OECD-SNA publication nor the UN-SNA publication.

4.3.3. *Other estimates of government procurement markets*

In François *et al.* (1996), the authors have assessed the impact of the Tokyo Round Agreement of Government Procurement on the procurement practices in the United States. From SNA-based data for 1992-93, the average total expenditure of general government is estimated at about USD 1 100 billion, which is equivalent to an average of 18.3% of the US GDP for the period covered, and of which 40% is accounted for by the federal government. Trionfetti (2000) has estimated the size of government procurement markets on the basis of both the United Nations SNA and the International Monetary Fund data.¹³ The most recent year covered is 1990 and ratios of procurement markets are measured for a small number of OECD member countries.

4.3.4. Government procurement by sub-central governments

Although the broken down data by government levels is generally compiled by OECD member countries and available in the OECD-SNA publication, it is only in the OECD work (Table 5) and EC (1997, Table 10.2) that the respective shares of government procurement are consistently measured for individual countries. In EC (1997), the shares of total public procurement for the EU-15 as a whole in 1994 is estimated at 28.8% for the central government, 47.1% for sub-central governments, and 24.1% for public utilities. In François *et al.* (1996), the authors evaluate the share of total expenditure of the US federal government at 40% of total expenditure – by deduction, the 18.3% share of total expenditure is divided in 7.3% and 11.0% for the central and sub-central governments respectively.

Table 5 shows government procurement ratios broken down by government levels for each OECD member country and illustrates a contrasting pattern of expenditure among them. For 19 OECD member countries, the structure of government procurement shows a lower ratio of total expenditure for the central government than for local government and Social Security fund taken together. Two countries (France and Italy) have almost equal ratios for central *versus* sub-central governments. Finally, nine countries have a centralised structure with higher ratios in central government than in sub-central governments. For the OECD as a whole, central government expenditure accounts for about 35% of total general government expenditure *versus* 65% for sub-central governments. When the ratios of total expenditure excluding the compensation of employees are compared, only five countries (Greece, Poland, Portugal, Turkey and the United Kingdom) still have a centralised structure of procurement.

The last two columns of Table 5 show two ratios of contestable total expenditure, excluding compensation of employees and defence-related expenditure, for the general government level and the central governments. In these cases, central government expenditure account for slightly less than a quarter (23.1%) of the total contestable general government expenditure *versus* 76.9% for the sub-central governments taken as a whole. These ratios of the contestable total expenditure reveal an even higher weight of sub-central governments in total contestable expenditure than in the ratios of total expenditure (in which the compensation of employees and defence-related expenditure are included), 76.9% *versus* 65%. These aggregated estimates for the OECD as a whole however mask some distinctive country variations.

Measuring procurement ratios broken down by government levels is helpful for appreciating the expanded reach of the WTO GPA Agreement to sub-central government entities. With an estimated 35% share of total government procurement accounted by the central government and 65% for

the sub-central governments, it is extrapolated that the reach of the WTO GPA is about three times larger than under the GATT Code.¹⁴

From the EC study (1997), the quarter share of total public procurement accounted by the public utilities' procurement (24.1%) may also be used as a proxy for estimating the expanded WTO GPA coverage to certain public and regulated private companies. On the basis of the above rough extrapolations, the value of procurement falling under the purview of the GPA would become four times larger than under the GATT Code, i.e. one-quarter for the central government, two-quarters for the sub-central government and one-quarter for the public utilities. To evaluate more precisely the reach of the GPA after 1996, more detailed data would be required, including data broken down by entities, by contracts below and above specific threshold for each type of entities, and data for the period after 1996. Once OECD member and non-member countries will compile sufficiently detailed national data on the basis of the SNA 1993, estimating the reach of the GPA will be able on a more reliable basis.

4.4. The “bottom-up” approach

The so-called “bottom-up” approach refers to the process of gathering national data on procurement expenditure directly from national entities responsible for procurement decisions. The reliability of bottom-up approaches stem, to a large extent, from the homogeneity and consistency of the compilation and reporting processes throughout the countries subject to the notification requirements. Underreporting from one large country or several countries can seriously distort the quality of the overall database and, as a result, mislead any assessment drawn from it. Nevertheless, the information and data obtained on the basis of bottom-up approaches can be very useful for analysing the reach of some agreements and for making country comparisons. Two distinct notification requirements of procurement practices are discussed below.

4.4.1. WTO GPA notification requirement

The participating countries in the GPA Agreement, under Article XIX.5, are required to collect and to submit on an annual basis various statistics on their procurements covered by the GPA, including the estimated value of contracts awarded, both above and below specified threshold values broken down by entities. While the GPA entered recently into force in 1996 and there is a normal time lag before annual data can be accurately compiled, no comprehensive assessment of the notified GPA data have yet been published. This would be useful for appreciating the reach of the expanded coverage of the GPA over the Tokyo Round Agreement on Government Procurement (GATT

Code), i.e. sub-central entities and certain public and regulated private companies were added.

Based on the notification requirements of the GATT Code, Hoekman (1997) has analysed the notified data reported by 20 countries for the period 1983-1992. Mindful that the GATT Code only covered the procurement of goods by central governments, he estimated the total purchases to amount USD 62 billion in 1992 and to represent a ratio of 0.42% of the GDP for the countries concerned. This 0.42% ratio, based on the bottom-up approach, is suspiciously low in regard to the SNA-based procurement ratios shown in Table 1. The author also calculated that the share of contracts above thresholds subject to the GATT Code increased from an average of 38.8% to 49.5% of total contracts between the period 1983-85 and 1990-92. This is partially attributable to the 13% reduction in the threshold value that occurred in 1988 for contracts excluded from its application (falling from SDR 150 000 to 130 000).

4.4.2. Notice requirements under EC Directives

Public procurement within the EU is governed by the EC Government Procurement Framework, which is based on six substantive Directives.¹⁵ Among other things, the Directives require EU procurement entities to publish in the EC Official Journal (OJ) tender notices and a Contract Award Notice (CAN) for each contract awarded. In the EC (1997) study, several types of information about public procurement were gathered through surveys of the Tenders Electronic Daily (TED) and of notices published in the OJ. Useful information was obtained through periodic surveys of published notices, which otherwise would not be obtained from SNA-based data.¹⁶

More recently, the Commission has developed a number of preliminary indicators to measure markets trends and the impact of public procurement policy based on information gathered from notifications in the Official Journal [EC(2000) study]. These indicators provide annual estimates of total public procurement, the value of calls for tenders and the number of calls for competition advertised in the Official Journal, and the number of entities publishing in the Official Journal. These annual values are available on the Internet for the period 1993-1998.¹⁷ In particular, the estimated ratio of EU total public procurement to GDP declines slightly during this period from 14.6% to 13.9%. These ratios are considerably above the earlier estimates of EU total public procurement of 11.2% – 11.8% (Table 4), which is mainly due to a series of small changes in the expenditure accounted for public enterprises. One of these changes refers to fuel purchased by power generators, which was not taken into account in the EC (1997) study but added in the EC (2000) study.

The latest EC indicators of public procurement illustrate the careful attention that needs to be paid to the definitions used for measuring public

procurement. These results show the relative importance of procurement by public utilities and the potentially huge opportunities that they represent for international trade. They also illustrate the usefulness of bottom-up approaches based on periodic surveys of published information and data in the Official Journal, data that are not otherwise available from SNA-based studies.

5. Conclusions

Governments are significant purchasers of goods and services and these markets represent huge opportunities for international trade. Informed knowledge about the size of these huge markets and in particular their internationally contestable shares is relevant for the business community, governments and trade negotiators. There are few studies on the quantification of government procurement markets but their limited country coverage and uneven treatment of procurement at sub-central government levels leave interested parties with an overall incomplete and segmented analytical picture. The absence of detailed and consistent measurements of contestable shares of government procurement markets for a large number of countries represented an information gap that has needed to be addressed. This document presents a synthesis of the analytical studies on the quantification of the size of government procurement markets and highlights recent work carried out by the OECD Trade Committee that covers over 130 countries.

Based on the SNA 1968, the recent OECD work presents a number of distinctive characteristics for measuring in a consistent manner the shares of government procurement markets for a large number of countries. The country coverage is considerably wider and more detailed than any other studies. In total, 14 different ratios of government procurement markets are estimated for OECD member countries with detailed ratios by countries broken down by government levels and contestable shares. For non-OECD countries, 106 countries at the general government level are estimated and seven detailed ratios are measured broken down between consumption versus investment expenditure and contestable ratios. The country specific estimated procurement ratios are detailed in Table 5 for 28 OECD countries and Table 6 for 106 non-member countries.

The contestable shares of total government procurement were measured by adding the consumption and investment components of government acquisitions and subtracting the compensation of employees and all defence-related expenditure which are assumed to be non-tradable expenditure. On the basis of 1968 SNA data, the contestable shares of government procurement are estimated at 7.57% for OECD member countries and 5.10% for non-member countries. The world value of the contestable government procurement market is estimated at USD 2 083 billion in 1998, which is

equivalent to 7.1% of the world GDP or 30.9% of the world merchandise and commercial services exports in 1998. OECD member countries account for 86.1% of this world contestable procurement market, which is slightly above its world GDP weight (80.2%). The estimate for the world total government procurement market is USD 5 550 billion, which is roughly equivalent to 82.3% of the world merchandise and commercial services exports in 1998.

The EC has carried out a number of studies on the quantification of procurement markets and estimated the contestable procurement for the EU at 8.7% of its GDP. Based on OECD work, a lower estimate of the EU contestable market was estimated at 8.03% which is mainly explained by the use of different assumptions and data regarding defence-related expenditure. The EC has had access to detailed defence-related data for its member states that distinguished between hardcore and non-hardcore defence expenditure. In the EC study, hardcore defence expenditure was considered as non-tradable whereas the OECD study has considered all defence-related expenditure as non-tradable. These results suggest that the OECD procurement estimates slightly underestimate the size of procurement markets that are potentially opened up to international competition.

Central governments are estimated to account for 35% of total government procurement within the OECD taken as a whole, with the remaining 65% accounted for by local government and Social Security funds taken together. The central government share of the total contestable general government is slightly less than a quarter (23.1%), with the remaining share accounted for by the sub-central governments taken as a whole (76.9%). These aggregated percentages for the OECD as a whole mask some important country variations in the relative shares of total procurement between central and sub-central governments.

The so-called “bottom-up” approach refers to the process of gathering national data on procurement expenditure directly from national entities responsible for procurement decisions. The participating countries in the WTO Government Procurement Agreement (GPA) are required to submit on an annual basis various statistics on their procurement covered under the GPA. Under EU Procurement Directives, procurement entities are subject to various notification requirements in the EU Official Journal. The reliability of results obtained from bottom-up approaches stem, to a large extent, from the homogeneity and consistency of the compilation and reporting processes throughout the countries subject to the notification requirements. Establishing such processes require considerable resources at least in the initial stage. The information and data obtained on the basis of surveys of notification requirements usefully complements SNA-based data and is also useful for analysing the reach of some agreements and for making country comparisons.

Measuring procurement ratios broken down by government levels is helpful for appreciating the expanded reach of the WTO GPA Agreement to sub-central government entities since 1996. Based on OECD work, the shares of total government procurement accounted by the central government and the sub-central governments are 35% and 65% respectively. It is thus extrapolated that the reach of the WTO GPA, due to its expanded coverage to sub-central entities, is about three times larger than under the GATT Code. By extrapolating the estimated shares of total public procurement accounted by public utilities (EC work), the reach of the GPA gains an additional quarter – overall four times larger than under the GATT Code.

The SNA 1968 version is now outdated and, since 1999, most OECD member countries have switched to the 1993 version of the SNA, as a basis for compiling their national accounts. At this juncture, some OECD member countries are producing very short time series on the new basis and the data compiled are less detailed than those previously available. No data have yet been published for non-member countries on the basis of the SNA 1993. Once these problems are solved, it would then be possible to use the SNA 1993 to measure the size of government procurement markets in a consistent manner for a large number of countries and for more recent periods. Hopefully, the availability of national data for public utilities will improve and enable to measure public procurement encompassing both government and public utilities' procurement.

Notes

1. See Blank and Marceau (1997, p. 31). For a detailed description of the origins and evolution of the GATT/WTO disciplines in government procurement, readers should refer to the detailed article prepared by Mrs. Blank and Marceau "A History of Multilateral Negotiations on Procurement: From ITO to WTO."
2. The OECD Draft Instrument was not adopted as a formal OECD instrument and it contained a series of bracketed provisions as alternative formulations. It was forwarded to the GATT in December 1976.
3. The GPA also reinforces rules guaranteeing fair and non-discriminatory conditions of international competition. Participating governments are required to put in place domestic procedures by which aggrieved private bidders can challenge procurement decisions and obtain redress in the event such decisions were made inconsistently with the rules of the agreement. The GPA applies to contracts worth more than specified threshold values. For central government purchases of goods and services, the threshold is SDR 130 000 (some USD 178 100). For purchases of goods and services by sub-central government entities the threshold varies by country but is generally in the region of SDR 200 000. For utilities, thresholds for goods and services are generally in the area of SDR 400 000 and for construction contracts, in general the threshold value is SDR 5 000 000. The country specific thresholds are available on the WTO website www.wto.org.

4. The WTO member countries that are parties to the GPA are: Canada, the 15 member states of the European Union and the European Commission, Hong Kong China, Iceland, Israel, Japan, Korea, Liechtenstein, the Kingdom of Netherlands with respect to Aruba, Norway, Singapore, Switzerland, and the United States. The countries that have observer status are: Argentina, Australia, Bulgaria, Cameroon, Croatia, Chile, Colombia, Czech Republic, Estonia, Georgia, Jordan, the Kyrgyz Republic, Latvia, Lithuania, Malta, Moldova, Mongolia, Oman, Panama, Poland, Slovak Republic, Slovenia, Chinese Taipei and Turkey.
5. The WTO website www.wto.org provides materials in the three areas of work in the WTO on government procurement: i) Transparency: the Working Group on Transparency in Government Procurement; ii) Services: The Working Party on GATS Rules; and iii) the Plurilateral Agreement on Government Procurement.
6. There are numerous small differences between the SNA and Government Finance Statistics (GFS). For instance, the purchases of uniforms for the military are classified under purchases of goods and services in the GFS but under wages and salaries in kind in the SNA. There is also a major difference: the SNA subtracts from each purchase some of the fees and taxes collected by the government in connection to government contracts or to the purchase of goods used to offer a public service. Neither method is univocally better than the other for the purpose of measuring the size of government procurement markets. For instance, taxes and fees paid by firms in relation to government contracts should not be considered as part of the market size; here the SNA is better. However, the small fees paid in order to receive lunches for kids in primary schools should not be subtracted from the total purchases of food for that purpose; here the GFS system is better. This myriad of differences is such that it is not possible to establish which system is better for the purpose of measuring the size of the public procurement.
7. It took more or less 18 months of collaboration efforts between the Secretariat and national statistical departments for achieving sufficient confidence in the database and to compile this project.
8. The review of the trends in the annual ratios shows that annual fluctuations are rather small and the ratios are following a negative trend in 18 countries and a positive trend in 10 OECD member countries. The standard deviation was indeed measured for each single ratio calculated but it is not reproduced in the text.
9. The measurements of the size of government procurement markets for non-member countries have been made from data actually available and a limited number of estimates of missing data. Those estimates solely concern defence-related segment of the compensation of employees. They were made for 11 of the 13 countries for which it is stated in Table 4 that these data are available. For each country, the share of defence-related compensation of employees corresponds to the observed proportion of defence-related final consumption expenditure in final consumption expenditure relative to total expenditure on compensation of employees [$CE_{def} = (FCE_{def}/FCE)(CE)$]. These minor adjustments have served to increase significantly the number of countries for which it is possible to calculate the ratios of the size of procurement markets, excluding defence-related expenditure and the compensation of employees. Concerning the FCE, FCE data for OECD member countries was calculated on a net basis of consumption of fixed capital, indirect taxes and sales. For non-member countries, data on CFC, indirect taxes and sales were available for

only 14, seven and one countries respectively. No adjustments were made for the missing data.

10. The share of defence-related consumption expenditure for non-member countries is obtained by subtracting the ratio of defence-related expenditure from the ratio of consumption expenditure falls from $(14.12\% - 9.54\% = 4.58\%)$. For member countries, the defence-related share of consumption expenditure is equivalent to 2.92% of GDP $(17.09\% - 14.17\% = 2.92\%)$.
11. The investment share of general government for non-member countries is obtained by subtracting from the ratio of total expenditure, excluding defence-related expenditures and the compensation of employees (5.10%), the ratio of consumption expenditure less compensation of employees and defence-related expenditure (2.09%), i.e. $5.10\% - 2.09\% = 3.01\%$. In the same way, the investment share of general government for member countries is $7.57\% - 4.73\% = 2.84\%$.
12. The EC estimates of public procurement shown in Table 4 and the OECD estimates of the EU-15 ratios, shown in bottom part of Table 5, are not strictly comparable. The EC estimates cover public utilities procurement, which is not covered in the OECD estimates and only warlike materials are excluded in the EC estimates whereas all defence-related expenditure is excluded in the OECD estimates. Another distinction between the two studies relates to the source of data. The OECD estimates are solely based on SNA data whereas the EC studies are based on a combination of SNA-based data and data obtained on the basis of surveys.
13. Government procurement in these estimates refers the final consumption expenditure, plus gross fixed capital formation, less compensation of employees. No further details are available to evaluate whether the final consumption expenditure was adjusted for consumption of fixed capital, sales and indirect taxes.
14. This extrapolation is based on a rough rule-of-thumb. It should be kept in mind that the estimated ratios shown in Table 5 present averages of annual data for the period 1990 to 1997. It is possible that the relative weights of total expenditure between the central government and the sub-central government may have occurred for the period before and after 1996.
15. The six substantive Directives are: The Public Supplies Directive (93/36/EEC); the Public Works Directive (93/37/EEC); the Public Services Directive (92/50/EEC); the Public Remedies Directive (89/665/EEC); the Utilities Directive (93/38/EEC); and the Remedies Utilities Directive (92/13/EEC). In May 2000, the European Commission adopted a package of amendments to simplify and modernise the public procurement Directives. The new legal framework proposes, *inter alia*, to consolidate three existing Directives into one more coherent text, to relax some of the award procedures that are considered too inflexible to achieve the objective of best value for money and to encourage public authorities to make greater use of electronic means. It also provides for the exclusion of former regulated sectors, i.e. telecommunications, electricity and water, from the scope of the Directives as these sectors are effectively being liberalised and opened up to real competition. The European Commission recommends that member states implement the new legal framework by 2002.
16. For example, Tables 12.6, 12.8 and 12.10 in EC (1997) show the most used tendering procedures in 1994 by entities or Table 11.4 shows a comparison of contract award notices to total tenders published by Member States.

17. EC (2000), "Measuring the Impact of Public Procurement Policy, First Indicators", *Single Market News*, March. See www.europa.eu.int/comm/internal_markets/en/smn/smn20/s20mn18.htm

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Annex I
TABLES

Table 5. **Government procurement in OECD member countries, by government levels**

OECD	Total expenditure (consumption and investment)									
	Total expenditure				TE less compensation				TE less compensation and defence	
	General	Central	Local	Social	General	Central	Local	Social	General	Central
Canada	25.83	4.60	22.32	0.04	11.47	1.69	8.80	0.02	10.40	0.62
United States	19.49	6.94	12.57		8.80	3.71	5.11		6.18	1.09
Australia	20.02	5.72	14.78		8.85	2.07	5.81		7.64	0.86
Japan	16.77	3.53	12.99	0.22	9.35	1.85	7.59	0.08	8.98	1.29
Korea	16.24	6.84	8.97	0.20	9.13	3.94	5.10	0.09	7.20	1.94
New Zealand	18.13	13.52	4.79		7.28	3.66	3.80		6.67	3.05
Austria	24.68	7.67	12.63	4.38	12.16	2.75	5.70	3.70	11.71	2.31
Belgium	17.23	10.09	5.63	0.86	5.37	2.48	1.95	0.30	4.84	1.95
Czech Republic	24.94	9.30	8.40	5.28	17.03	4.45	6.53	5.18	15.74	2.71
Denmark	28.29	8.71	19.30	0.29	10.63	3.34	7.20	0.09	10.04	2.75
Finland	25.63	8.58	18.77	1.53	9.64	4.22	7.44	1.22	9.00	3.58
France	23.10	11.03	7.33	4.74	9.05	3.24	4.22	1.60	7.63	1.81
Germany	17.81	2.94	13.77	1.10	7.32	1.52	5.39	0.40	6.72	0.81
Greece	18.64	12.98	1.61	3.22	7.29	4.32	0.84	1.30	6.73	3.76
Hungary	29.77	13.47	13.76	2.22	18.31	8.56	7.38	2.05	16.78	7.03
Iceland	25.80	14.02	8.17	2.67	12.92	4.81	5.07	2.11	11.76	3.62
Ireland	20.81	8.73	11.70	0.28	10.08	2.73	7.11	0.12	9.93	2.59
Italy	20.03	9.99	9.69	0.70	7.99	2.72	4.90	0.43	7.38	2.12
Netherlands	18.74	7.67	10.16	0.91	8.96	3.68	4.90	0.37	7.98	2.71
Norway	25.44	9.61	16.05		11.44	5.61	6.06		9.65	3.82
Poland	22.57	14.40	7.41		10.69	6.55	4.31		9.72	5.57
Portugal	20.98	16.42	4.41	0.46	7.24	4.83	2.59	0.13	6.22	3.80
Slovak Republic	25.08	18.09	3.70	3.30	15.34	9.46	2.79	2.98	14.09	8.21
Spain	20.51	7.11	8.88	4.49	8.74	2.63	4.44	1.64	8.06	1.95
Sweden	33.15	10.66	23.14	0.04	14.60	6.25	9.00	0.04	13.01	4.67
Switzerland	19.58	3.43	15.68	0.30	8.60	2.08	6.24	0.12	8.02	1.50
Turkey	17.72	14.83	2.13		7.47	5.58	1.13		6.84	4.96
United Kingdom	25.17	14.57	9.71	0.20	13.08	9.00	3.29	0.10	9.97	5.88
OECD simple av.	22.22	9.84	11.02	1.70	10.32	4.20	5.17	1.09	9.25	3.11
OECD weighted av.	19.96	7.13	12.12	1.22	9.17	3.39	5.44	0.51	7.57	1.75
EU weighted av.	21.48	8.87	10.79	1.79	9.24	3.76	4.67	0.72	8.03	2.53

Source: These ratios were calculated on the basis of actual data submitted to the Secretariat by OECD member countries and estimations for missing national data. The methods and assumptions used for estimating the missing data are explained in Annex 4.

Table 6. **Government procurement ratios in non-member countries, by region**

Percentage of GDP and USD billions

Region	Consumption expenditure (%)				Total expenditure (TE) (%)			GDP 1998 (USD billions)
General government	FCE	Excl. comp.	Excl. def.	Excl. comp. and def.	TE	Excl. comp.	Excl. comp. and def.	
Africa								
Benin	12.59							2.32
Botswana	27.10							4.98
Burundi	17.36							0.98
Cameroon	10.22							8.70
Ivory Coast	16.76	4.32			20.39	7.96		11.10
Egypt	9.45							82.71
Ghana	11.88							7.17
Kenya	16.27	3.16	14.43	2.75	19.17	6.06	5.66	10.37
Lesotho	17.06							0.37
Madagascar	8.25							3.75
Malawi	15.31							1.69
Mali	14.91							2.65
Mauritius	11.73	3.23	11.37	3.07				4.20
Morocco	16.59							36.12
Mozambique	20.18							3.82
Namibia	29.33	9.89			35.78	16.34		3.00
Niger	17.24							2.01
Nigeria	3.89	1.23						36.14
Reunion	27.35							7.25
Rwanda	21.28							2.04
Senegal	13.26							4.86
Seychelles	28.75		24.98					0.56
Sierra Leone	7.56							0.65
South Africa	19.74				21.77			116.73
Swaziland	20.80							1.18
Uganda	9.10							6.06
Tanzania	8.29		6.74					8.09
Tunisia	16.29	3.55			21.60	8.86		20.02
Zambia	19.33							3.35
America								
Anguilla	13.83							0.09
Bahamas	14.06	3.42	13.47	3.27	14.62	3.98	3.83	4.12
Barbados	19.75							2.33
Belize	19.47		18.24					0.67
Bermuda	12.70		12.48					2.31
Bolivia	12.45	1.84						7.96
Brazil	16.46	7.21						776.94
Cayman Islands	14.67							0.93
Chile	9.54				11.51			74.32

Table 6. Government procurement ratios in non-member countries, by region (cont.)

Percentage of GDP and USD billions

Region	Consumption expenditure (%)				Total expenditure (TE) (%)			GDP 1998 (USD billions)
General government	FCE	Excl. comp.	Excl. def.	Excl. comp. and def.	TE	Excl. comp.	Excl. comp. and def.	
Colombia	10.27	1.55	9.06	1.02	13.48	4.75	4.19	90.41
Costa Rica	16.75				18.36			10.42
Dominica	20.16							0.25
Dominican Rep.	4.23							16.04
Ecuador	9.33	4.21	8.05	3.63	13.23	8.11	7.53	19.30
El Salvador	9.74				11.14			11.86
French Guyana	34.54				48.75			1.50
Grenada	19.73							0.31
Guadeloupe	30.35				39.25			3.50
Guatemala	6.34				8.37			19.01
Guyana	13.04							0.74
Honduras	11.12							5.34
Jamaica	7.56							7.06
Martinique	28.75				36.19			4.38
Panama	16.37	3.72						9.82
Paraguay	19.33							10.93
Peru	7.94				9.87			64.06
Puerto Rico	14.12							50.51
Suriname	26.27							0.82
Trinidad-Tobago	16.44	2.59						6.14
Uruguay	13.70							20.95
Venezuela	8.60	2.31			10.28	4.00		95.02
Asia								
Azerbaijan	19.86	4.24	11.73	2.11				4.10
Bahrain	26.07							5.35
Bangladesh	13.95		12.53					41.42
Bhutan	21.58							0.36
China	12.84							960.79
Cyprus	17.81		13.49					8.88
Fiji	17.44							2.33
Hong Kong, China	8.69	2.49			11.00	4.81		166.45
India	10.54	3.44	7.42	1.74	13.29	6.18	4.46	420.31
Indonesia	9.20							215.00
Iran	11.06	2.63	8.00	1.90				187.42
Iraq	30.82							4.60
Israel	25.95	10.01						91.32
Jordan	23.74							7.45
Kuwait	37.30							26.45
Kyrgyzstan	20.04	11.74			21.60	12.88		1.87
Malaysia	13.75		10.76					67.48

Table 6. **Government procurement ratios in non-member countries, by region (cont.)**

Percentage of GDP and USD billions

Region	Consumption expenditure (%)				Total expenditure (TE) (%)			GDP 1998 (USD billions)
General government	FCE	Excl. comp.	Excl. def.	Excl. comp. and def.	TE	Excl. comp.	Excl. comp. and def.	
Maldives	21.97							0.40
Nepal	8.72							4.48
New Caledonia	33.02							3.56
Oman	27.34							14.96
Pakistan	12.87	6.61			16.29	10.03		64.13
Papua New Guinea	23.24							3.71
Philippines	9.85	2.94			14.29	7.38		82.24
Qatar	34.44							11.70
Saudi Arabia	33.86							125.84
Singapore	9.35							84.38
Sri Lanka	13.17	5.57	10.03	4.24	17.42	9.82	8.48	15.70
Syrian Arab Rep.	14.34							64.93
Thailand	9.67	3.08			17.31	10.72		117.04
United Arab Emirates	17.01							47.23
Uzbekistan	22.71							14.19
Vanuatu	28.24	16.86						0.25
Vietnam	15.93							24.60
Yemen	27.42							5.33
Europe								
Albania	10.20							3.03
Belarus	19.15	10.54	10.54	5.62	21.27	12.65	7.74%	14.28
Bulgaria	8.08							12.06
Estonia	16.62	8.06	15.96	7.75	21.05	12.50	12.18%	5.11
Latvia	14.70	7.79			17.09	10.18		6.19
Lithuania	15.68							10.69
Malta	17.56	4.24	15.20	3.67	21.87	8.55	7.99%	3.99
Romania	13.77		8.49					41.70
Russia	17.39		12.70					283.82
Slovenia	19.62							19.99
Ukraine	15.77	7.95	9.33	4.72	18.15	10.33	7.10%	42.70

Table 7. **Government procurement markets under the intermediate consumption approach**

Percentage of GDP

OECD	Intermediate consumption					
	Excluding compensation of employees				Excluding compensation and defence	
	General	Central	Local	Social	General	Central
Austria	12.16	2.75	5.70	3.70	11.71	2.31
Belgium	4.40	2.56	1.57	0.27	3.87	2.03
Czech Republic	12.41				11.21	
Denmark	10.63				10.04	
France	9.05	3.24	4.22	1.60	7.63	1.81
Germany	7.33	1.52	5.40	0.40	6.62	0.81
Italy	7.72	2.54	4.89	0.35	7.11	1.94
Netherlands	9.09	3.69	5.03	0.37	8.11	2.71
New Zealand	8.95	6.56	2.39		8.34	5.94
Portugal	7.25	4.56	2.57	0.13	6.18	3.49
Spain	9.08	2.76	4.58	1.73	8.40	2.08
Switzerland	8.44	2.03	6.29	0.12	7.86	1.45
United Kingdom	12.89	9.21	3.58	0.10	9.77	6.09
Simple average	9.18	3.77	4.20	0.88	8.22	2.79
Weighted average	9.02	3.68	4.58	0.72	7.79	2.43

*Annex II***Glossary of Main Terms**

Compensation of Employees (CE) is composed of all payments by governments of wages and salaries to their employees, including Social Security schemes and similar schemes. In general, Compensation of Employees takes the largest share of Final Consumption Expenditure of government services.

Consumption of Fixed Capital (CFC) is the value, at current replacement cost, of the reproducible fixed assets – except the roads, dams and other forms of construction other than structures of the producers of government services – used up during a period of account as a result of normal wear and tear, foreseen obsolescence and the normal rate of accidental damage. Unforeseen obsolescence, major catastrophes and the depletion of natural resources are not taken into account.

Final Consumption Expenditure of government services (FCE) is the value of goods and services produced by governments for their own use on current account, that is the value of their gross output less the sum of the value of their commodity and non-commodity sales and the value of their own-account capital formation which is not segregated as an industry.

General government includes central government, state/provincial and local levels, as well as Social Security funds.

Government acquisitions refers to the definition of **Intermediate Consumption of producers of government services (IC)**. It is defined as: acquisitions (purchases and transfers in kind) of new goods and services (mainly commodities) on current account, less net sales of similar second-hand goods and scraps and wastes therefrom, including durable goods acquired primarily for military purposes.

Government procurement refers to goods and services bought by the government for consumption and investment but not for resale. It generally covers two main types of expenditure: consumption expenditure and expenditure on capital formation, that is investment expenditure. These two types of expenditure are usually classified by government function.

Total Expenditure (TE) is composed of Final Consumption Expenditure (FCE) less Consumption of Fixed Capital (CFC) less Indirect Taxes (IT) plus Government Sales (SALES) plus Gross Fixed Capital Formation (GFCF). It is expressed as $[(FCE - CFC - IT + SALES) + GFCF]$.

Total Expenditure less Compensation is the Total Expenditure (TE) less Compensation of Employees (CE). It is expressed as $[(FCE - CFC - IT + SALES) + GFCF - CE]$.

Total Expenditure less Compensation and Defence is the Total Expenditure (GE), excluding defence-related expenditure and investment, less Compensation of Employees (CE), excluding defence-related compensation of employees. It is expressed as $[(FCE - CFC - IT + SALES) - FCE_{def}] + (GFCF - GFCF_{def}) - (CE - CE_{def})]$.

*Annex III***Reconciliation Between “Final Consumption Expenditure” and “Intermediate Consumption” Data Series**

The System of National Accounts (SNA) contains statistical definitions on a wide-range of economic activities, including government activities. With respect to government activities, the SNA defines the term of “Intermediate Consumption” (IC) for government levels as government acquisitions of goods and services on the current account. IC is equal to “Final Consumption Expenditure” (FCE) less “Compensation of Employees” (CE), less “Consumption of Fixed Capital” (CFC) i.e. the allocation for depreciation, less “Indirect Taxes” (IT), plus “Government Sales” (SALES). These terms are defined in the SNA and national data referring to these terms may be directly available from the Table 6 series of the OECD publication “National Accounts Detailed Tables, Volume II”.

Government Current Acquisitions = FCE – CE – CFC – IT + SALES = IC

To obtain a more complete coverage of all goods and services brought by government, i.e. government procurement net of CE, it is necessary to add the investment expenditure realised by governments – investment is defined as the “Gross Fixed Capital Formation” (GFCF). Total government acquisitions (hereby referred to as Total Expenditure less Compensation) can thus be measured either through the IC or FCE approaches or both depending on the availability of national data.

Total Government Acquisitions = Total Expenditure less Compensation

$$\text{FCE} - \text{CE} - \text{CFC} - \text{IT} + \text{SALES} + \text{GFCF} = \text{IC} + \text{GFCF}$$

Total government procurement or Total Expenditure (TE) is obtained by bringing back in the equation the compensation of employees (CE).

Total Expenditure (TE) = FCE – CFC – IT + SALES + GFCF = IC + GFCF + CE

By placing the assumption that defence-related procurement is reserved for national firms, government procurement net of CE and defence-related expenditures (Total Expenditure less Compensation and Defence) is obtained by removing defence-related component from every term from Total Expenditure less Compensation.

Total Acquisitions less Defence = Total Expenditure less Compensation and Defence

$$(FCE - FCE_{def}) - (CFC - CFC_{def}) - (IT - IT_{def}) + (SALES - SALES_{def}) - (CE - CE_{def}) + (GFCF - GFCF_{def})$$

Under the SNA 1968, defence-related GCF is fairly small and as a result defence-related depreciation (CFC_{def}) is insignificant. It is therefore assumed to equal zero. Similarly, it is assumed that there are no defence-related SALES ($SALES_{def}$) and no defence-related Indirect Taxes (IT_{def}).

Total Acquisitions less Defence = Total Expenditure less Compensation and Defence

$$(FCE - FCE_{def}) - CFC - IT + SALES - (CE - CE_{def}) + (GFCF - GFCF_{def})$$

The equality between the FCE and IC Approaches is maintained by removing the defence-related elements from the IC equation of Total Expenditure less Compensation.

Total Acquisitions less Defence = Total Expenditure less Compensation and Defence

$$IC - (FCE_{def} - CE_{def}) + (GFCF - GFCF_{def})$$

*Annex IV***Assumptions Used for Estimating Missing National Data**

Quantifying the size of government procurement markets in OECD member countries has involved the gathering of national data for 30 standardised SNA-based statistical items but in several instances the required data was missing. To remedy the statistical gap, a series of estimates of missing data was undertaken. Table 8 indicates which data was available and estimated at individual country level. The available data is indicated with “1” and the missing data is indicated with a specific letter symbol, as indicated below. The most important data in terms of value, such as the final consumption expenditure, the compensation of employees and gross fixed capital formation, was widely available throughout the countries and offered a solid base for the study. Missing data was mainly concentrated in the items for government sales, indirect taxes and the defence-related expenditure. The assumptions used for estimating the missing national data are explained below. Given the reliance on estimated data to address the problem of missing national data, the reliability of the measured ratios of government procurement may be somehow undermined, particularly for the countries in which the number of missing data was large.

Defence-related expenditure

Missing data on defence-related expenditure for the general government category was estimated by calculating the proportions that these types of expenditure represented in countries for which data was available for the three components involved, i.e. “final consumption expenditure”, “compensation of employees” and “gross fixed capital formation”. Since the levels of defence-related expenditure were considerably higher in France, Korea, the United Kingdom and the United States than in other countries, the weighted average of the proportions reported in other countries, excluding these four countries, was used. The estimated proportions for the general government category, GDP-weighted, were: 9.3% for defence-related FCE; 7.4 % for defence-related CE, and 1.5% for defence-related GFCF. Corroborated by the data supplied by countries, the figures for defence-related expenditure in the

categories of general government and central government are identical. Accordingly, when defence-related expenditure was estimated at the general government level, the same figure has been shown in the central government category. The estimated data is indicated with the symbol “D” in Table 8.

Compensation of employees

Missing data for the compensation of employees (CE) in the four government levels was estimated for Canada and Australia by calculating the proportions that these types of expenditure represent relative to FCE in the countries for which CE data was available. The GDP-weighted average of the reported CE data in other countries was considered to be a representative indicator. On that basis, the estimated ratios for CE as a percentage of FCE for the government level in question were: 63.7 % at the general government; 55.2 % at the central government; 74.7% at the local government; and 45.6% at the Social Security fund level. The estimated data is indicated with the symbol “C” in Table 8. Specific adjustments were made for Denmark and Japan given the availability of CE data only at the general government level. The corresponding CE data for the sub-central levels was estimated by duplicating the observed proportion of FCE for each sub-central level in relation to FCE at the general government level. These estimated data are indicated with the symbol “C%” in Table 8.

Gross fixed capital formation

Specific adjustments were made for gross fixed capital formation (GFCF) in Hungary and New Zealand. In both cases, GFCF data was only available for the general government. GFCF for the remaining government levels were estimated by duplicating the observed proportions of FCE for each level in relation to FCE at the general government level in the country in question. These are indicated with the symbol “G%” in Table 8.

Consumption of fixed capital

Missing data on consumption of fixed capital (CFC) in the four government levels was estimated by calculating the proportions that these types of expenditure represent relative to final consumption expenditure in countries for which such data was available. A GDP-weighted average of the reported information was considered to be a representative indicator. On that basis, the estimated ratios for CFC as a percentage of FCE for the government category in question are: 5.8% at the general government; 3.2% at the central government; 8.8% at the local government; and 2.3% at the Social Security fund level. These estimated data are indicated with the symbol “CFC” in

Table 8. A specific adjustment was made for the Czech Republic since it reported CFC for the general government only. CFC for the remaining levels were estimated by duplicating the observed proportions of FCE for each level in relation to FCE at the general government level. It is indicated with the symbol “CFC%’ in Table 8.

Sales

Missing data on sales in the four government levels was estimated by calculating the proportions that these types of expenditure represent relative to FCE in countries for which such data was available. A GDP-weighted average of the reported information was considered to be a representative indicator. On that basis, the estimated ratios for sales as a percentage of FCE for the government category in question are: 13% at the general government; 3.1% at the central government; 21.4% at the local government; and 7.3% at the Social Security fund level. These estimated data are indicated with the symbol “S” in Table 8. Specific adjustments were made for Denmark, Japan and New Zealand, since they reported sales for the general government only. Sales for the remaining levels were estimated by duplicating the observed proportions of FCE for each level in relation to FCE at the general government levels in the country in question. These are indicated with the symbol “S%” in Table 8.

Indirect taxes

Missing data on indirect taxes in the four government levels was estimated by calculating the proportions that these types of expenditure represent relative to FCE in countries for which such data was available. A GDP-weighted average of the reported information was considered to be a representative indicator. On that basis, the estimated ratios for sales as a percentage of FCE for the government category in question are: 1.1% at the general government; 1.0% at the central government; 1.0% at the local government; and 2.1% at the Social Security fund level. These estimated data are indicated with the symbol “IT” in Table 8. Specific adjustments were made in several countries, since they reported indirect taxes at the general government only. Indirect taxes for the remaining levels were estimated by duplicating the observed proportions of FCE for each level in relation to FCE at the general government levels in the country in question. These are indicated with the symbol “IT%” in Table 8.

Table 8. Available and estimated data

National Accounts	Line number	Canada	USA	Australia	Japan	Korea	New Zealand	Austria	Belgium	Czech	Denmark	Finland	France	Germany	Greece
Missing annual data		97			97	95-97	97	90-92		96-97	all ex 93, 95		90, 97		
General government (Central Government + Local Government + Social Security Fund)															
Final Consumption Expenditure (FCE)	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Consumption of Fixed Capital (CFC)	2	1	1	1	1	1	CFC	1	1	1	1	1	1	1	CFC
Sales	3	S	1	S	1	1	1	1	S	S	1	S	1	1	S
Indirect Taxes (IT)	4	IT	1	IT	1	1	1	1	1	1	1	IT	1	1	IT
FCE defence-related	5	D	1	1	1	1	1	1	1	D	1	1	1	1	D
Compensation of employees (CE)	6	C	1	C	1	1	1	1	1	1	1	1	1	1	1
CE defence-related	7	D	1	D	1	1	1	1	1	1	D	D	1	1	D
Gross Fixed Capital Formation (GFCF)	8	1	1	1	1	1	1	1	1	1	1	1	1	1	1
GCF defence-related	9	D	1	1	D	1	1	D	D	1	1	1	1	1	D
Central government															
Final Consumption Expenditure (FCE)	10	1	1	1	1	1	FCE%	1	1	1	1	1	1	1	1
Consumption of Fixed Capital (CFC)	11	1	1	1	1	1	CFC	1	1	CFC%	1	1	1	1	CFC
Sales	12	S	1	S	S%	1	S%	1	S	S	S%	S	1	1	S
Indirect Taxes (IT)	13	IT	1	IT	IT%	1	1	1	IT%	IT%	IT%	IT	1	1	IT
FCE defence-related	14	D	1	1	1	1	1	1	1	D	1	1	1	1	D
Compensation of employees (CE)	15	C	1	C	C%	1	1	1	1	1	C%	1	1	1	1
CE defence-related	16	D	1	D	1	1	1	1	1	1	D	D	1	1	D
Gross Fixed Capital Formation (GFCF)	17	1	1	1	1	1	G%	1	1	1	1	1	1	1	1
GCF defence-related	18	D	1	1	D	1	1	D	D	1	1	1	1	1	D
Local government (including State and Provincial Government)															
Final Consumption Expenditure (FCE)	19	1	1	1	1	1	FCE%	1	1	1	1	1	1	1	1

Table 8. **Available and estimated data** (cont.)

National Accounts	Line number	Canada	USA	Australia	Japan	Korea	New Zealand	Austria	Belgium	Czech	Denmark	Finland	France	Germany	Greece
Missing annual data		97				97	95-97	97		90-92	96-97		all ex 93, 95	90, 97	
Consumption of Fixed Capital (CFC)	20	1	1	1	1	1	CFC	1	1	CFC%	1	1	1	1	CFC
Sales	21	S	1	S	S%	1	S%	1	S	S	S%	S	1	1	S
Indirect Taxes (IT)	22	IT	1	IT	IT%	1	1	1	IT%	IT%	IT%	IT	1	1	IT
Compensation of employees (CE)	23	C	1	C	C%	1	1	1	1	1	C%	1	1	1	1
Gross Fixed Capital Formation (GFCF)	24	1	1	1	1	1	G%	1	1	1	1	1	1	1	1
Social Security Fund															
Final Consumption Expenditure (FCE)	25	1			1	1		1	1	1	1	1	1	1	1
Consumption of Fixed Capital (CFC)	26	CFC			1	1		1	1	CFC%	1	1	1	1	CFC
Sales	27	S			S%	1		1	S	S	S%	S	1	1	S
Indirect Taxes (IT)	28	IT			IT%	1		1	IT%	IT%	IT%	IT	1	1	IT
Compensation of employees (CE)	29	C			C%	1		1	1	1	C%	1	1	1	1
Gross Fixed Capital Formation (GFCF)	30	1			1	1		1	1	1	1	1	1	1	1

Table 8. **Available and Estimated Data** (cont.)

National Accounts	Line number	Hungary	Iceland	Ireland	Italy	Nether-lands	Norway	Poland	Portugal	Spain	Sweden	Switzer-land	Turkey	UK	Slovak		
Missing annual data		96-97				97	90-94, 97			96-97	96-97	90-92	97	95-97		90-94	
General government (Central Government + Local Government + Social Security Fund)																	
Final Consumption Expenditure (FCE)	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
Consumption of Fixed Capital (CFC)	2	CFC	1	1	1	1	1	CFC	CFC	1	1	1	CFC	1	1		
Sales	3	S	S	S	1	1	S	S	1	1	S	1	S	S	1		
Indirect Taxes (IT)	4	IT	IT	IT	1	1	IT	IT	1	IT	IT	1	IT	1	1		
FCE defence-related	5	D	D	1	1	1	1	D	1	1	1	D	D	1	D		
Compensation of employees (CE)	6	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
CE defence-related	7	D	D	1	1	1	1	D	D	D	1	D	D	D	D		
Gross Fixed Capital Formation (GFCF)	8	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
GCF defence-related	9	D	D	1	1	1	1	D	D	D	1	D	D	1	D		
Central government																	
Final Consumption Expenditure (FCE)	10	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
Consumption of Fixed Capital (CFC)	11	CFC	1	1	1	1	1	CFC	CFC	1	1	1	CFC	1	1		
Sales	12	S	S	S	1	1	S	S	1	1	S	1	S	S	1		
Indirect Taxes (IT)	13	IT	IT	IT	IT%	1	IT	IT	IT%	IT	IT	IT%	IT	1	1		
FCE defence-related	14	D	D	1	1	1	1	D	1	1	1	D	D	1	D		
Compensation of employees (CE)	15	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
CE defence-related	16	D	D	1	1	1	1	D	D	D	1	D	D	D	D		
Gross Fixed Capital Formation (GFCF)	17	G%	1	1	1	1	1	1	1	1	1	1	1	1	1		
GCF defence-related	18	D	D	1	1	1	1	D	D	D	1	D	D	1	D		
Local government (including State and Provincial Government)																	
Final Consumption Expenditure (FCE)	19	1	1	1	1	1	1	1	1	1	1	1	1	1	1		
Consumption of Fixed Capital (CFC)	20	CFC	1	1	1	1	1	CFC	CFC	1	1	1	CFC	1	1		
Sales	21	S	S	S	1	1	S	S	1	1	S	1	S	S	1		

Table 8. **Available and Estimated Data** (cont.)

National Accounts	Line number	Hungary	Iceland	Ireland	Italy	Nether-lands	Norway	Poland	Portugal	Spain	Sweden	Switzer-land	Turkey	UK	Slovak
Missing annual data		96-97		97		90-94, 97		96-97	96-97	96-97	90-92	97	95-97		90-94
Indirect Taxes (IT)	22	IT	IT	IT	IT%	1	IT	IT	IT%	IT	IT	IT%	IT	1	1
Compensation of employees (CE)	23	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Gross Fixed Capital Formation (GFCF)	24	G%	1	1	1	1	1	1	1	1	1	1	1	1	1
Social Security Fund															
Final Consumption Expenditure (FCE)	25	1	1	1	1	1			1	1	1	1	1		1
Consumption of Fixed Capital (CFC)	26	CFC	1	1	1	1			CFC	1	1	1	1		1
Sales	27	S	S	S	1	1			1	1	S	1	1		1
Indirect Taxes (IT)	28	IT	IT	IT	IT%	1			IT%	IT	IT	IT%	1		1
Compensation of employees (CE)	29	1	1	1	1	1	1		1	1	1	1	1		1
Gross Fixed Capital Formation (GFCF)	30	G%	1	1	1	1	1		1	1	1	1	1		1

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