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OECD Journal on Budgeting

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Foreword

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

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Budgeting and performance in the European Union: A review by the OECD in the context of EU budget focused on results

by

Ronnie Downes, Delphine Moretti and Scherie Nicol*

The European Union has a unique system of institutions and relationships between different levels of government resulting in a close attention to the performance aspects of budgeting. The EU system of budgeting for performance and results is advanced and highly specified, scoring higher than any OECD country in the standard index of performance budgeting frameworks. Aimed at improving the effectiveness of the EU budget in contributing to the achievement of EU objectives for growth, the EU Budget Focused on Results initiative is one that is gaining more focus and importance since it was launched in 2015.

This report is the OECD's independent assessment of how the EU model of budgeting for performance and results compares with good practice around the world, in line with the long-established practice of OECD Budget Reviews; and offers suggestions for how the current reform agenda might be advanced.

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Foreword

Budgeting is a key pillar of policy development and accountability in any country or region. In the context of the European Union, with its unique system of institutions and relationships between different levels of government, there has traditionally been a close attention to the performance aspects of budgeting: i.e. demonstrating to stakeholders that EU resources being used effectively to achieve results, and that these results are of benefit to citizens.

One important current initiative is the EU Budget Focused on Results, launched in 2015 by then Commission Vice-President Kristalina Georgieva as a multi-pronged initiative to improve the effectiveness of the EU budget in contributing to the achievement of EU objectives for growth, jobs and stability. A number of reforms and innovations have already been introduced under the aegis of this initiative.

Within this overall context, the EU has asked the OECD to undertake an independent assessment of how the EU model of budgeting for performance and results compares with good practice around the world, in line with the long-established practice of EU Budget Reviews. In carrying out this task, the OECD team has benefited from extensive consultations and interviews with officials and politicians within the various EU institutions, and with civil society interests and independent think-tanks. This report presents the findings of the OECD assessment and offers suggestions for how the current reform agenda might be advanced.

This report was written by Mr Ronnie Downes, Ms Delphine Moretti and Ms Scherie Nicol, all of the OECD's Budgeting and Public Expenditures Division, Directorate for Public Governance and Territorial Development, with contributions from Mr Trevor Shaw, Ms Anne-Claire Léon, Mr Paulo Areosa Feio and Mr Jon Blondal.¹

Executive summary

The EU system of budgeting for performance and results is advanced and highly specified, scoring more highly than any OECD country in the standard index of performance budgeting frameworks. The EU system is *sui generis*, reflecting various aspects of the standard OECD categorisation of presentational, performance-informed and direct performance budgeting, and including strengths and weaknesses that are also seen at national levels. EU budgetary practices include many effective and innovative aspects, which may hold lessons for national governments in reflecting on their own agendas of performance-focused budgetary reform.

The EU's strategic and operational goals are set out in multiple, complementary frameworks – Europe 2020, the Juncker 10 Priorities, the Strategic Agenda of the European Council – which raises potential challenges for coherence and communication. In general, the EU system manages these challenges in a pragmatic and sensible manner: In particular the Europe 2020 agenda of smart, sustainable and inclusive growth has become a *de facto* reference whose influence is transmitted throughout the performance framework of the various Programmes. There is scope for communicating more clearly, in the budget context,

how these strategic aspects underpin performance and results: A new *ex ante* “Statement of Goals for the EU Budget” is suggested, using the structural template of the existing EU Budget Headings and specifying a limited number of headline targets in each area. Such an approach would help circumvent the risk of “information overload” which is inherent to many national performance budgeting frameworks, and is also a particular risk in the EU context.

More generally, the Commission has undertaken extensive streamlining of its reporting in recent years, yielding clearer insights on performance and results including via the new Annual Management and Performance Report (AMPR), which subsumes the former “Synthesis Report” on management achievements and “Article 318” report on results achieved from the EU budget. It is suggested that the AMPR evolve further to mirror the structure of the proposed *ex ante* Statement of Goals, providing a more systematic *ex post* account of performance against headline targets.

The European Parliament and Council of the European Union together comprise the Budgetary Authority. Parliamentary stakeholders are broadly happy with the level and nature of performance information provided with the budget, although there are recognised challenges in marshalling and using this extensive corpus of material for effective scrutiny and accountability. It is advisable to adopt a more structured, joined-up approach that engages the various Parliamentary committees, including the two budget-related committees and the sectoral Standing Committees, to make the best use of performance information across the budgetary and broader policy-making cycles. In the future, such an approach might also be supported through establishing a European Parliamentary Budget Office, to add extra status, focus and co-ordinating capacity to this core parliamentary function.

The development of clear, concise *ex ante* and *ex post* strategic budget reports, as suggested above, coupled with enhanced institutional co-ordination throughout the budgetary cycle, would facilitate both the Parliament and Council in engaging more fully with the policy substance of the EU budget, helping to shift the focus from (potentially more contentious) proxy issues such as error rates and absorption.

The European Court of Audit (ECA) takes an independent perspective in assessing the qualitative aspects of budgeting, including the performance dimension, as a normal part of its annual reporting and through special reports. The ECA’s focus upon performance aspects of budget accountability ranks highly in terms of international good practice. However, the ECA’s findings on EU performance budgeting are not yet comprehensive or systematic – reflecting the under-developed nature of this dimension of auditing at international level. There are nevertheless advancements that can be considered, drawing on international good practice, including developing a more integrated annual scrutiny of performance information, which might entail clearer specification of basic quality criteria for performance data and for measurement of impacts. The suggested development of standardised *ex ante* and *ex post* strategic budget reports, with a limited number of headline indicators, would also facilitate the ECA’s work in this regard.

As the EU budget is primarily an investment budget with annual ceilings laid down in the 7-year Multiannual Financial Framework (MFF), opportunities are limited for performance signals (positive and negative) to influence the debate on the annual budget. It is suggested that new flexibility mechanisms, building upon the model of the “performance reserve” that applies for European Structural and Investment (ESI) Funds, be adopted as the norm for all future EU programmes.

In addition to the main findings outlined above, other key points and suggestions arising from the OECD assessment are as follows:

- as a further aid to budget responsiveness and flexibility, the EU should consider introducing Spending Review to critically assess the baseline of public expenditures in light of performance and evaluative findings; in principle, a Spending Review process could be linked to a mid-term review of each MFF; and in turn the mid-term review should be standardised as a “window of flexibility” in the EU budget
- stronger linkages should be encouraged between national and EU systems of performance budgeting, to pool good practices and promote synergies and harmonisation between the various approaches; linkages at the level of parliaments and audit institutions would also be beneficial in this regard
- the EU’s multi-year budgeting and strategic policy timeframes (currently 7 and 10 years respectively) should be brought into alignment; the expiry of the current MFF and Europe 2020 in the same year, for the first time, offers an opportunity to introduce such an alignment
- the multi-year, investment character of EU programmes should, in principle, facilitate the effective use of a) programme monitoring b) regular strategic performance reporting and c) longer-term evaluation, in contributing to a meaningful performance assessment of policy interventions over the short and longer term. How these evaluative tools will be applied across the policy continuum could usefully be articulated more explicitly
- closer alignment of EU Budget Focused on Results with the EU Better Regulation initiative would promote an integrated approach to modern, evidence-based EU policy-making.

1. The EU model of results-based budgeting in international perspective

1.1. Introduction

The budget of the European Union (EU) in 2017 amounts to EUR158 billion, representing about 1% of EU-wide GDP and 2% of overall public expenditure in the region. While the EU budget is small in proportionate terms, the processes for scrutinising and approving the budget – in parliamentary, political and audit terms – are intensive and highly developed. This report outlines the functioning and efficacy of the overall process, in particular as regards the relationship between spending and results, based upon the range of viewpoints expressed by the stakeholders in the EU budget process, as well as by reference to international practice.

Annex A provides a detailed account of the EU budget process. However, a number of characteristics should be noted from the outset, as they are relevant for an understanding of how the EU model compares with other international models:

- The EU budget is primarily an investment-focused budget, with an emphasis on allocating resources towards specific EU-wide goals, rather than duplicating national budget allocations.
- Investment programmes are, by their nature, best considered from a multi-annual rather than an annual perspective, and it is notable that the EU budget has a strong multi-annual character, to a degree unmatched in any EU member state or OECD country. The EU’s Multiannual Financial Framework (MFF) lays down the maximum annual amounts (“ceilings”) which the EU may spend in different policy fields (“headings”) over the multi-year period: the current MFF covers the period 2014-20. The annual EU budget is, in effect, a specification of the pre-defined MFF ceiling in the given year and the scope for variation is limited.

- While in many national systems, performance information is seen as an adjunct to the financial allocations, the EU budget system is suffused with performance information and reporting structures. This elaborate framework has developed over the years to assure that the EU acts within its mandate and to help justify the spending in terms of results and impacts. As a result, the performance aspects of EU budgeting are in some respects more advanced than is typically seen at national levels.
- EU budgeting is legally required to abide by the principle of “sound financial management” – which includes the principles of economy, effectiveness and efficiency, and encompasses the need to set “SMART” objectives – and in turn Member states are legally required to co-operate with the Commission in ensuring that these principles are upheld.
- The concern for performance and results in the EU budget system permeates the different institutions and budget processes: From the internal workings of the European Commission (hereafter the “Commission”) itself, to the design of all major EU-funded programmes, and to the processes of scrutiny and accountability involving the European Parliament (the “Parliament”) and the European Court of Audit (ECA).

In 2015, the European Commission launched the “EU Budget Focused on Results” initiative, aimed at strengthening the systematic focus upon performance and results, while making it easier for citizens and stakeholders to understand the objectives and impacts of the EU budget (see Annex B). This OECD review is intended to complement, and contribute to, this overall initiative. International country experiences of dealing with similar challenges in performance budgeting, as outlined in this report, may yield useful insights for the ongoing EU agenda of reform.

1.2. International approaches to performance budgeting

1.2.1. Performance budgeting – What is it, and what is it for?

Performance budgeting is the systematic use of information about the outputs, results and/or impacts of public policies in order to inform, influence and/or determine the level of public funds allocated towards those policies in the budgetary context. The international experience illustrates that performance budgeting can serve a number of purposes:

- **Transparency:** The OECD *Recommendation on Budgetary Governance* (2015) notes that the systematic use of performance information helps parliament and citizens “to understand not just what is being spent, but also what is being bought on behalf of citizens – i.e. what public services are actually being delivered, to what standards of quality and with what levels of efficiency”. Transparency is, in turn, an important underpinning of public trust and assurance regarding how public funds are used.
- **Accountability:** Making explicit the performance objectives and targets helps the public, parliamentarians and senior managers to hold the public administration to account for the proper use of public funds and for the achievement of goals.
- **Efficiency:** Consistent, comparable indicators of outputs and impact in different areas, alongside the corresponding financial allocations, can facilitate an assessment of efficiency by reference to benchmarking of unit costs, and to improvements over time.
- **Evidence-based policy-making:** A clear linking of budgets with results and impacts, drawing on findings from different sectors and from comparable countries and regions, helps to lay the basis for an evidence-based approach to policy-making.

- **Promoting “culture shift”:** The practice of specifying objectives, designing indicators and tracking progress is an important element in moving the system of public administration and management from a traditional input-based model, towards a governance model that prioritises performance and results.
- **Budgetary decision-making:** Properly designed, and in light of all of the factors outlined above, a performance budgeting system provides relevant information that facilitates the task of annual and multi-annual budgeting, including the core budgeting task of deciding on where limited resources are best allocated (or re-allocated). The OECD *Recommendation on Budgetary Governance* (2015) specifies that performance information should be presented “in a way which informs, and provides useful context for, the financial allocations in the budget report”.

1.2.2. *The different models of performance budgeting*

Different models and approaches to performance budgeting are observed across the OECD. Even when countries have adopted similar models, they have taken diverse approaches to implementing these and they have adapted them to national capacities, cultures and priorities. In this context, the OECD has identified three broad categories of performance budgeting systems:

1. **Presentational performance budgeting**, which involves the provision of performance information in parallel with the annual budget, e.g. as a transparency exercise or for the background information of policy-makers, with no necessary expectation that the information will be taken into account in deciding upon the budget allocations;
2. **Performance-informed budgeting**, which presents performance information in a systematic manner alongside the financial allocations, in order to facilitate policy-makers in taking account of this information, to the extent that they may deem appropriate, when deciding upon with the budget allocations;
3. **Direct performance budgeting (or performance-based budgeting)**, where performance information is provided with the financial information, and where there is the expectation that performance, relative to previously stated objectives, will have direct consequences for the budget allocations.

More recently the OECD has identified a fourth broad category:

4. **Managerial performance budgeting**, in which performance information is generated and used for internal managerial purposes and for organisational/managerial accountability, with a lesser focus upon the linkages with budget allocations.

Across OECD countries more generally, performance budgeting practices tend to fall into the first and second categories, with only a few in the third category (direct performance budgeting) for select types of expenditures (e.g. funding of higher education or hospitals).

1.2. *Characterisation of the EU model of performance budgeting*

1.2.1. *The EU Performance Budgeting model is highly developed by international standards*

As outlined in Annex A, issues of performance and results feature strongly in the overall legal basis for budgeting in the EU and this legal basis is carried through both in the design of EU programmes and in the specific reporting requirements upon the Commission and upon those implementing EU-funded programmes. Taken as a whole, the EU budget

system takes a sophisticated, systematic approach to developing and using performance information. Some of the key features that underlie this assessment are as follows:

- The **Programme Statements** that accompany the draft budget each year include a performance structure that is very well-designed, by the standards that apply in OECD countries, in providing all of the key information that is necessary for careful programme scrutiny: Including 7-year financial commitments; programme performance baselines (starting points for policy action); end-goals (to be achieved at the end of the multi-annual programming period); and intermediate milestones, expressed by reference to SMART criteria.
- **EU programmes** likewise include both financial and results-based information with structures in place to oversee delivery (see Annex C for an illustration of how these structures and systems apply in the case of EU Structural and Investment Funds).
- The **Commission's institutional performance reporting** is now well-developed along an annual and multi-annual cycle within the Directorates-Generals (DGs), and from the DGs to the College of Commissioners. Communication from the Commission has been streamlined and the mechanisms of policy co-ordination among the EU institutions have been enhanced (see Section 3.1).
- The **ECA** takes a systematic and thorough approach to assessing the qualitative aspects of budgeting, including the performance dimension, as a normal part of its annual reporting and through special reports. The ECA's focus upon performance aspects of budget accountability ranks highly in terms of international good practice (see Section 4).

In principle, all of these elements place the budget authority – which is composed of the Parliament and the Council of the European Union (the “Council”) – in a strong position to take performance into account as a significant factor in scrutinising the annual budget. In practice, for reasons outlined in subsequent chapters, making the fullest use of this rich performance information for budget purposes generally proves demanding for policy stakeholders, and some approaches to reforming the system are outlined in order to meet these challenges.

1.2.2. Which model of performance budgeting best describes the EU budget system?

The system of performance budgeting applied in the EU is *sui generis*, reflecting the unique political and administrative construct of the EU itself, and thus cannot be easily assigned to any of the standard categories outlined above. As this report illustrates, a distinctive feature of EU budgeting is the high degree of budget transparency and generation of extensive performance information, on the one hand; coupled with strong constraints on the ability of the budget authority (Parliament and Council) to adjust financial allocations in response to this performance information, on the other hand. Arising from this, the EU model may be characterised as sharing in several of the features of each category of performance budgeting:

- The EU model may be described as “**presentational**” in the sense that performance information is set out in the annual budget with no expectation that it will be used in annual budgetary decision-making, due to the limits on flexibility and responsiveness set out above.
- The EU approach is “**performance-informed**” in the sense that performance information is routinely integrated with the annual budget documentation in a way that is designed to highlight the correspondences between resources and results, and this correspondence is designed to be helpful in informing an “accountability dialogue” with the budget

authority. A limitation of the characterisation, however, is that the performance information is somewhat “sterile” in the sense that it is not typically used in a way that is relevant for annual resource allocation in the EU budget.

- The EU model involves aspects of “**direct**” performance budgeting in the sense that there are performance conditionalities built into some aspects of EU budgeting (e.g. in the Operational Programmes), and there are some performance-linked flexibility mechanisms (especially the performance reserve applicable to the European Structural and Investment Funds (ESIF)). These mechanisms go beyond the features seen in most OECD countries and have the potential to introduce stronger incentives for effective performance. However, it should be noted that the conditionalities serve as “emergency brakes” rather than graduated-response mechanisms and that the performance reserve is very limited in scope, and remains to be tested regarding the rigour of its performance-linkage.
- Finally in this regard, the EU system is “**managerial**” in the sense that performance information is transmitted in a structured manner both in the context of Programme monitoring, and in the context of Commission internal processes, in a way that is designed to highlight effectiveness and achievement of results, even if the linkages to broader resource allocation policy are weak and indirect by comparison with national budgeting models. Stakeholders report that the focus upon performance (particularly by reference to the Juncker 10 criteria) has become more systematic and intensive within the Commission since 2015, and that these performance factors have new weight in the processes of internal prioritisation. A limitation in this regard is the Commission’s very limited latitude to introduce entirely new programmes each year and thus to re-direct resources at the level of the overall EU budget (as distinct from resource re-allocation within the institution itself).

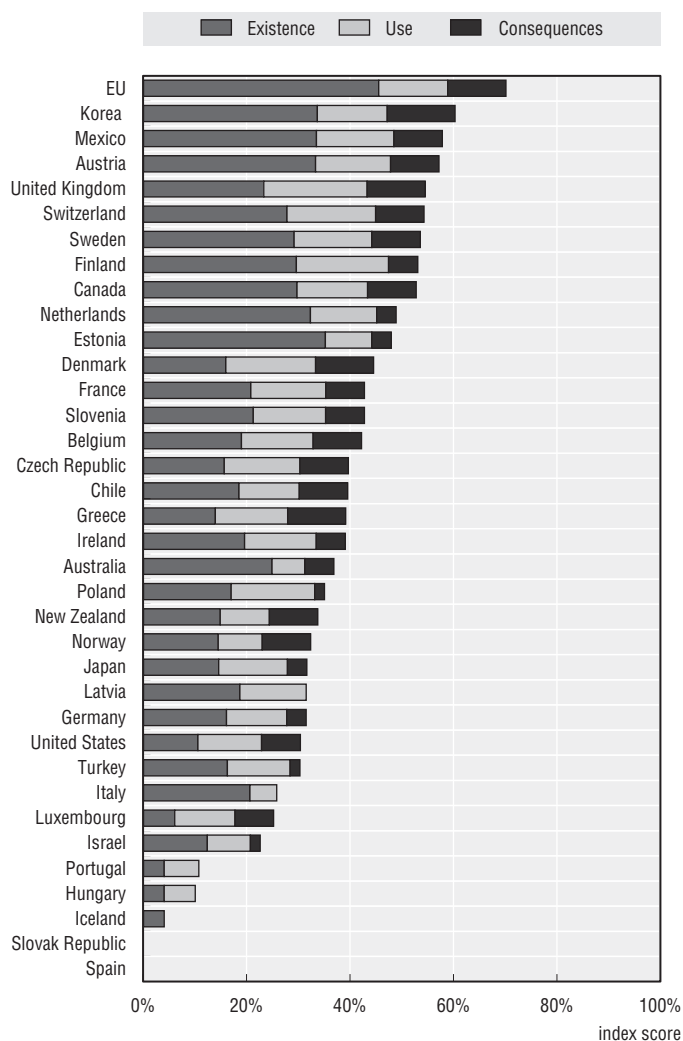
1.2.3. Analysing and assessing international performance budgeting frameworks: How the EU model compares

As a way of capturing the extent to which performance budgeting is implemented across OECD countries, the OECD has developed a composite performance budgeting index. It contains 11 variables that cover information on the availability and type of performance information developed, processes for monitoring and reporting on results and whether (and how) performance information is used on budget negotiations and decision making by the central budget authorities, line ministries and politicians. The index highlights three different aspects of the performance budgeting system:

1. **Frameworks:** The existence of a performance budgeting system;
2. **Use:** The use of performance information; and
3. **Consequences:** Consequences if the performance is not in line with targets.

Countries that receive a high overall score have typically created a comprehensive, government-wide framework for developing performance information (evaluations and performance measures), integrating performance information into budget and accountability processes, using it in decision making and monitoring and reporting on results. The index scores for the EU performance budgeting system relative to other OECD countries are shown in Figure 1.1.

It should be noted that this index does not measure how successfully any given system operates in practice. Success is better evaluated by examining whether policy execution is achieving the stated objectives. This dimension cannot be captured in this index. Box 1.1 below provides an explanation of how the index is compiled.

Figure 1.1. **OECD Performance Budgeting Index 2016**

Source: 2016 OECD Performance Budgeting Survey.

Box 1.1. **The OECD's composite performance budgeting index**

The 2016 Performance Budgeting Index presented in Figure 1.1 is a composite index built up using information on 10 variables. These variables cover information on the availability and type of performance information developed, processes for monitoring and reporting on results and whether (and how) performance information is used in the context of budget negotiations. Note that the score for the EU reflects the overall framework for the EU budget as it applies at both EU Institution and Member State levels.

Subject to this caveat, it is notable that the **EU performance budgeting system scores considerably higher than all countries in the OECD composite index**. This is driven by a high score for the “frameworks” component of the index, reflecting the highly specified nature of the EU performance budgeting system. The processes for monitoring and reporting on results in the EU are more elaborate than those in OECD countries. In particular the EU performance budgeting system is characterised with general guidelines and definitions;

standard templates for reporting performance information; a standard set of performance indicators and targets; and a standard ICT tool for entering/reporting performance information. Given the scale and complexity of the EU budget, the highly specified nature of the system generates large volumes of performance information.

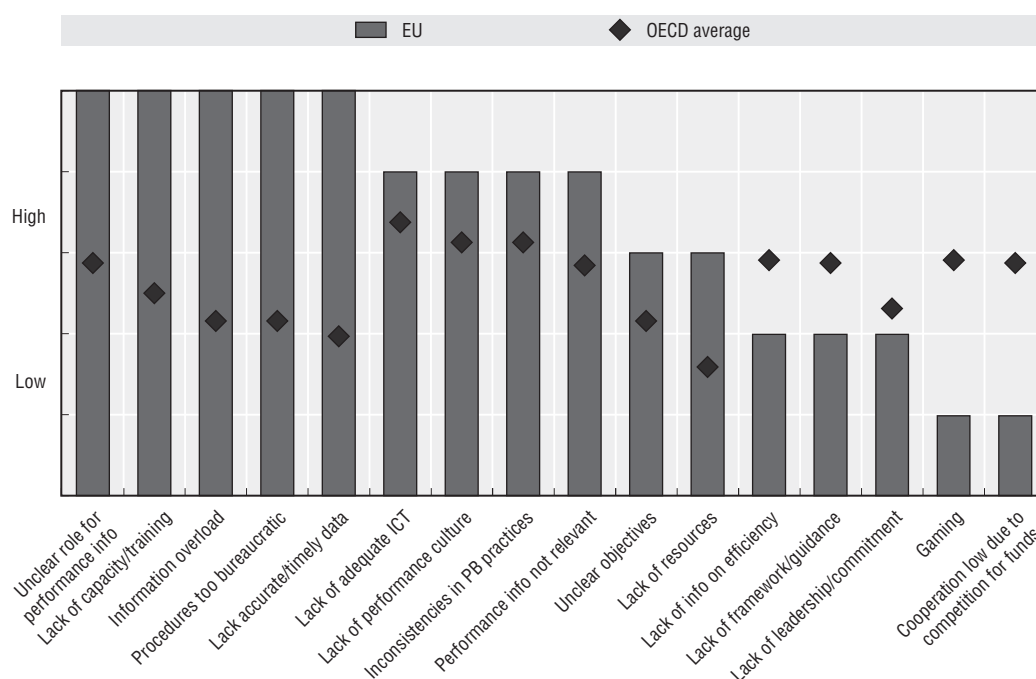
Despite the highly developed nature of the performance budgeting framework in the EU, it is striking that the scores for “use” and “consequences” are relatively similar to OECD countries. This measures the extent to which performance information is used as a decision tool to inform the budget.

In the EU and across the OECD, countries report that poor performance triggers a variety of consequences. Management responses are most common, such as publicising poor performance or more intense monitoring in the future. Budget consequences are more likely in the EU performance budgeting system than in OECD countries. However, in practice the budgetary responses under the EU model tend to be limited in scope.

1.2.4. Key challenges

The 2016 OECD Performance Budgeting Survey also highlights the greatest challenges to effectively implementing performance budgeting. Across the OECD these are: A lack of performance culture, a lack of resources, a lack of capacity/training, a lack of accurate/timely data and a lack of information on efficiency. While these are also reported as challenges at the EU level, a number of other challenges have higher prominence. These include: Information overload, an unclear role for performance information and overly bureaucratic procedures, as illustrated in Figure 1.2. These challenges may well be symptomatic of a system which is highly specified and has a strong presentational focus. Note that as is the case for Figure 1.1, the rating for the EU reflects the overall framework for the EU budget as it applies at both EU Institution and Member State levels.

Figure 1.2. **Challenges to effectively implementing performance budgeting**



Source: 2016 OECD Performance Budgeting Survey.

1.2.5. A superabundance of performance indicators

Alongside its budgetary documents in July 2016, the Commission presented an analysis of budget-related performance indicators showing that the Programme Statements contain in excess of 700 performance indicators, of variable quality. The Commission acknowledged in this context that “in terms of indicator usefulness, experience shows that it might be more important to have good quality information on a fairly small number of simple and key measures rather than a long list of indicators with limited information and relevance”.

The indicators arise from negotiations among the EU’s institutions and are set in the legal basis of the various programmes. Streamlining this information, so that it is brought within the cognitive capacities of policy-makers and can feed usefully into the processes of budget formulation and scrutiny, is an important challenge for the EU Budget Focused on Results initiative. The OECD suggestions (set out in Section 2) for rationalising and systematising the budget reports, both *ex ante* and *ex post*, are intended to assist in this regard.

1.3. Summary: A distinctive, highly-specified EU system of performance budgeting

Although the EU model of performance budgeting has characteristics in common with a number of different performance budgeting approaches observed across the OECD, it is unique in an international context. The most notable difference between the EU model and that seen across OECD countries is the level of system specification. In particular, the EU performance budgeting system is much more highly specified, complete with guidelines, standard templates, sets of indicators/targets, reporting requirements and a high level of engagement from different institutions.

Against this background, in assessing the effectiveness of the EU performance budgeting system and the most fruitful avenues for continuing reform, some of challenges arise.

First: The primary issue for the EU system is not to adapt to more closely resemble one or other of the national models of performance budgeting, but to start from a recognition of the distinctive characteristics – including strengths and weaknesses – inherent in the EU model and to map a reform strategy around these elements.

Second: It is undoubtedly the case that in several areas, the experience of national performance budgeting systems may hold useful analogies and insights for EU reforms. However given the advanced nature of EU budgeting systems in several respects, further advancement will require a reflection upon the internal logic of the system and upon its future potential and in mapping out a medium-term vision that allows for this potential to be realised more fully; international comparators will become more sparse.

Accordingly the remainder of this report provides analysis and qualitative considerations on the various dimensions of EU performance budgeting, with a view to informing such a medium-term vision of continuing reform.

2. Coherence and co-ordination of performance goals within the EU

2.1. The EU’s over-arching goals

2.1.1. Benefits of a strategic framework of high-level goals

The OECD Recommendation on Budgetary Governance (2015) lays down ten internationally-accepted principles of modern budgeting, including the principles that “performance, evaluation and value for money are integral to the budget process”; and that budgets should be “closely aligned with medium-term strategic priorities”, including

through “organising and structuring the budget allocations in a way that corresponds readily with national objectives” and “showing the correspondence with expenditure objectives and deliverables from strategic plans”.

In light of these normative principles, an important starting point in assessing a performance budgeting framework is the degree of clarity that exists regarding performance goals; the existence of an over-arching framework for ensuring the coherence between higher-level strategic goals and more intermediate, operational objectives; and an accountability framework to make clear what is being achieved, to what standards of quality and with what levels of efficiency.

2.1.2. *The EU’s strategic goals are set out in multiple, complementary frameworks*

In principle the above considerations should lend themselves well to the EU budgeting framework, since EU action is predicated upon a clear rationale for intervention that serves to advance EU objectives, and upon the concept of “value-added” – i.e. achieving more through acting collectively than by the member countries acting alone. In practice, the importance of setting down a clear guiding strategy is recognised at EU level and is given effect through a number of complementary frameworks.

2.1.2.1. Europe 2020. The Europe 2020 framework was established in 2010 as a 10-year “jobs and growth strategy” for the EU, succeeding the “Lisbon Agenda” of the previous decade. It aims to be an organising framework for EU policy making, focused upon 3 pillar objectives – *smart, sustainable and inclusive growth*. The framework includes specific, high level targets for the EU, to be achieved by the year 2020, under five headings (see Box 2.1).

Box 2.1. Europe 2020 – 3 pillars, 7 flagship initiatives, 5 headline targets

Flagship policy initiatives:	
Pillar 1 – Smart growth	● Digital agenda for Europe ● Innovation union ● Youth on the move
Pillar 2 – Sustainable growth	● Resource-efficient Europe ● An industrial policy for the globalisation era
Pillar 3 – Inclusive growth	● An agenda for new skills and jobs ● European platform against poverty
Headline targets	To be attained by 2020:
1: Employment	● 75% of people aged 20-64 years to be employed
2: Research & Development	● 3% of the EU’s GDP to be invested in R&D
3: Climate change and energy sustainability	● greenhouse gas emissions 20% (or even 30%, if the conditions are right) lower than 1990 ● 20% of energy from renewables ● 20% increase in energy efficiency
4: Education	● Reducing the rates of early school leaving to below 10% ● at least 40% of 30-34-year-olds completing third level education
5: Fighting poverty and social exclusion	● 20 million fewer people in or at risk of poverty and social exclusion

The Europe 2020 strategy is also underpinned by a number of “flagship initiatives” in the various policy domains, and these in turn are supported by sector-specific frameworks. For example, under the pillar of Smart Growth, one flagship initiative is the “Innovation Union”, which is supported by the **Horizon 2020** framework programme for the research and

development programme which is one of the Europe 2020's flagships, directing EUR 80 billion of funding during the period 2014-20. Europe 2020 is intended as a co-ordinating framework to guide policy action at EU and national levels: Each of the headline targets has a corresponding national target. Monitoring of progress in implementing Europe 2020 is handled as part of the integrated economic surveillance arrangements in the "EU Semester", which also encompasses fiscal and economic policy co-ordination. Moreover, Eurostat (the EU's official statistics agency) has developed a web portal to allow each of the Europe 2020 indicators to be tracked, both at EU and at national levels.²

In budget terms, the need for alignment with the EU 2020 strategy of "smart, sustainable and inclusive growth" is ubiquitous in various policy instruments, and monitoring of performance against these headings has become a *leitmotif* of the Commission's activities over recent years.

2.1.2.2. Juncker 10 Priorities. The "Juncker 10" priorities (see Box 2.2) were set out by the Commission President Jean-Claude Juncker in 2014, as political priorities for action by the Commission. The first four of the ten priorities correlate directly with the Europe 2020 strategy for jobs and growth, the other priorities reflecting the EU's broader international and policy remit. Stakeholders report that the Juncker 10 priorities command a high visibility, both externally in communicating and reporting upon the Commission's activities in various spheres; and indeed internally, when assessing the priority areas for resource allocation and re-prioritisation among the Commission Directorates-General.

**Box 2.2. The "Juncker 10" Priority Areas for Action
by the European Commission**

- | | |
|--|---|
| 1. A New Boost for Jobs, Growth and Investment | 6. A Reasonable and Balanced Free Trade Agreement with the U.S. |
| 2. A Connected Digital Single Market Based on Mutual Trust | 7. An Area of Justice and Fundamental Rights |
| 3. A Resilient Energy Union with a Forward-Looking Climate Change Policy | 8. Towards a New Policy on Migration |
| 4. A Deeper and Fairer Internal Market with a Strengthened Industrial Base | 9. A Stronger Global Actor |
| 5. A Deeper and Fairer Economic and Monetary Union | 10. A Union of Democratic Change |

2.1.2.3. Strategic agenda of the European Council. Article 15 TEU states that the European Council (the institution composed principally of EU national heads of state and government) "shall provide the Union with the necessary impetus for its development and shall define the general political directions and priorities thereof." In exercising this function, a "Strategic Agenda for the EU in times of Change" was adopted by the European Council conclusions of 26/27 June 2014. The European Council sets its strategic agenda in context in the following terms:

"The May 2014 European elections open a new legislative cycle. This moment of political renewal comes precisely as our countries emerge from years of economic crisis and as public disenchantment with politics has grown. It is the right time to set out what we want the Union to focus on and how we want it to function".

The five overarching priorities agreed by the European Council are set out in Box 2.3 below. Two of these priorities (1 and 3) directly relate to the Europe 2020 agenda.

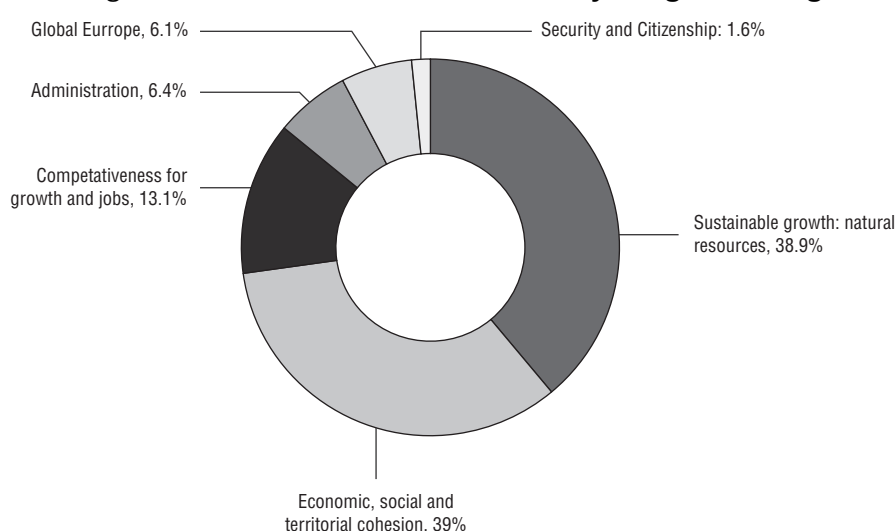
Box 2.3. The European Council “Strategic Agenda for the EU in times of Change”: Five Over-arching Priorities

1. Stronger economies with more jobs
2. Societies enabled to empower and protect
3. A secure energy and climate future
4. A trusted area of fundamental freedoms
5. Effective joint action in the world

2.1.2.4. The Budget Headings of the multi-annual financial framework. The Multi-annual Financial Framework (MFF) 2014-20 provides that EU expenditure is grouped under five main headings, and these headings form the primary basis for preparing and presenting the annual budget. As illustrated in Figure 2.1, the headings are:

Heading	MFF allocation 2014-20 (Million Euros)
1. Smart and Inclusive Growth	513 563
1a. Competitiveness for growth and jobs (including the Connecting Europe Facility)	142 130
1b. Economic, social and territorial cohesion	371 433
2. Sustainable growth: natural resources	420 034
3. Security and citizenship	17 725
4. Global Europe	66 262
5. Administration	69 585
Compensations	29
TOTAL	1 087 197

Figure 2.1. Allocation of EU resources by Budget Heading



The budget headings subsume the Europe 2020 goals (smart, sustainable and inclusive growth) which together account for most of the EU budget, while also reflecting the EU's wider policy agenda.

2.1.3. *How well do these strategic frameworks support EU performance budgeting?*

Where multiple strategic frameworks are in place, it is of fundamental importance that they are well-co-ordinated and that their operational effects are mutually supportive. In general, the EU system manages these challenges in a pragmatic and sensible manner. The Europe 2020 agenda of smart, sustainable and inclusive growth has become a *de facto* reference whose influence is transmitted throughout the performance framework of the various Programmes; Europe 2020 encompasses the bulk although not the totality of EU competencies and thus of EU expenditure. The Juncker 10 priorities are primarily a tool for organising the Commission's activities in response to political priorities (including those of the Europe 2020 framework). The Budget Headings encompass the Europe 2020 framework alongside all other EU competencies and associated expenditure, but are not widely referenced or used outside of the budgeting context.

A shortcoming of this multiplicity of overlapping strategic frameworks is that they can impede clarity and transparency, making it more difficult for stakeholders to apprehend the high-level goals which the budget is intended to advance. Lack of clarity in communication is not a cosmetic matter; it can potentially undermine an important pillar of a successful, well-understood system of budgeting for results.

On the question of communication, there would appear to be scope for a clearer approach in future. It is not obvious, for example, where one would direct a non-specialist, curious citizen who may ask the basic questions: "What is the EU budget as a whole trying to accomplish? And how well is it succeeding?" There is certainly a wealth of detailed information, transparently available on the various internet pages of the EU institutions, regarding the various EU programmes and projects; as well as user-friendly summary guides. However, summary guides and "citizen's budgets" are of limited value compared with official instruments of strategic communication and accountability. At least for the purposes of budgeting, the OECD's view is that there are benefits to be achieved from having a single, strategic frame of reference for how EU resources are deployed, which can command public understanding as well as political authority.

2.1.4. *How might strategic clarity and communication be enhanced?*

2.1.4.1. A new "statement of goals for the EU budget". During the phase of considering the draft budget, the Budgetary Authority is supplied with a volume of Programme Statements which, while impressive as regards the transparency and comprehensiveness of budgetary information, is nevertheless too large for any one person to come to terms with.

For the purposes of the EU budget process, it would be helpful to present a unified account of the goals and objectives that the EU budget is intended to advance. One possible approach would be to develop a new, clear "Statement of Goals for the EU Budget" to be structured by reference to the existing EU budget headings, drawing together the various goals and objectives that are already articulated in various other policy domains such as Europe 2020 and specifying, in each policy area, a limited number of "headline targets" to be pursued during the course of the budget year. The Statement of Goals could thus serve as a primary focal point, and frame of reference, for objective-setting, evaluation and indeed for *ex post* performance reporting (as discussed in more detail under Section 2.3) in relation to EU budget programmes and policies.

In this context, there would be advantages in abolishing the "**Administration**" Budget Heading (along with the residual "Compensations" line item) and apportioning these amounts

appropriately among the substantive policy headings; allowing the Statement of Aims to apply seamlessly across budgetary approval and reporting. This approach would not preclude the monitoring of administrative efficiency via parallel specific reporting (to the extent necessary); but would enhance the transparency of administrative expenditures, by integrating them alongside their associated policy goals and improved performance indicators.

Box 2.4. Country case: Apportionment of administration costs among Expenditure Programmes in Ireland

In Ireland's system of performance budgeting, the spending allocations for each ministry/agency (the Vote or Estimate) are framed by reference to the body's Mission Statement (from its Statement of Strategy); the spending allocations are grouped into Programmes (which correspond with high-level objectives from the Statement of Strategy); and a limited number of output objectives are set for each Programme. The administration costs of the body are not handled in a separate Programme or series of subheads: Since 2011, the administration costs – both pay and non-pay – are apportioned across each Programme so that the relative administration efficiency of each Programme can be seen. In determining the accounting basis for the apportionment of costs, standard guidelines were drawn up by the Department of Public Expenditure & Reform (the central budget authority) following consultation with the Office of the Comptroller & Auditor General (the national audit institution).

2.2. Institutional accountability: reporting on performance and results by the European Commission

2.2.1. The Commission has complex reporting obligations relating to Budgeting and performance

As the EU institution that bears central responsibility for the implementation of EU programmes in furtherance of EU objectives, the European Commission must also ensure that its own processes and activities are fully in alignment with these higher-level goals. In keeping with its over-arching responsibility, the Commission has in place a number of reporting mechanisms which form the basis of institutional accountability. These mechanisms have been developed progressively since the far-reaching governance reforms set out in the 2000 White Paper (Prodi) reform, and involve Strategic Planning & Programming (SPP) and Activity-Based Management (ABM) via a sequence of reports on various aspects of institutional planning and performance.

The overall reporting framework is designed to balance financial and non-financial (performance) reporting at key stages of the annual and multi-annual policy cycle:

Forward-looking/planning phase (before the budget year)

- The **draft budget** and accompanying documents, which include extensive information and Commission commentary on objectives and results, are submitted in June.
- The Commission President makes a **State of the Union address** before Parliament in September, presenting a political assessment and an agenda for action over the year ahead. The address is not primarily a budget-related event, but it is important in articulating high-priority EU objectives (and associated resources) for which the Commission will be accountable.
- In autumn, after the State of the Union address, the **Commission Work Programme** for the coming year is presented to the Parliament, Council and other institutions. Again,

this document is not primarily a budget-focused publication but it expresses the Commission's key objectives.

- In January, each Commission Directorate-General produces a **Management Plan** which shows the actions and outputs for the year ahead, reflecting the priorities set in the State of the Union address and in the Work Programme. The Management Plan in turn will form a basis of reporting in the subsequent Annual Activity Reports (see below).

Backward-looking/accountability phase

- In spring, following the completion of the budget year, each Directorate-General prepares an internal management report known as an **Annual Activity Report (AAR)**, as required under the Financial Regulation. The AAR outlines how the Directorate-General has achieved its corporate outputs/ objectives, as previously stated in the Management Reports. The AARs also include a “statement of assurance” from each Director-General regarding the correctness of all financial transaction in his/her area of responsibility.
- The key elements of all of the AARs are brought together in a **Synthesis Report**, again in compliance with the Financial Regulation requirements. This synthesis report is submitted by the Commission (the College of Commissioners) to the Parliament and Council.
- Article 318 of the Treaty requires the Commission to produce an annual “evaluation report on the Union’s finances based on the results achieved”. This **Article 318** report has been the primary vehicle for systematic annual reporting of performance and results, on an overall basis, from the Commission to the budgetary authority.

2.2.2. The reporting cycle is becoming more streamlined and performance-focused

The package of reports from the Commission, as described above, already represents a degree of harmonisation and consolidation of information from disparate sources. In particular, the Synthesis Report on management achievements brings together the key results from the Annual Activity Reports of the various DGs, whereas the Article 318 Report attempts to summarise key messages from the various reporting streams across all of the EU's programmes.

In June 2016 the Commission put forward an “**Integrated Financial Reporting Package**” in respect of the financial year 2015, with a view to providing a more concise and coherent account of its activities to the Budgetary Authority. The Package included the following four reports:

- a new Annual Management and Performance Report (AMPR) which amalgamates the Synthesis Report and the Article 318 Report (see below)
- the EU Annual Accounts
- the Financial Report, and
- the Communication on the Protection of the EU Budget.

The **Annual Management and Performance Report (AMPR)** represents a further, significant stage in the streamlining of performance reporting. It includes separate sections on *performance and results* and on *management achievements*. The section on *performance and results* provides a summary account of progress by reference to the Europe 2020 headline indicators, and proceeds to give an account of results achieved under each of the budget headings, with extensive cross-referencing to Europe 2020 and Juncker 10 priorities. This section of the AMPR is effectively a digest of key performance-related

information from the various strands of monitoring and evaluation, and from the Programme Statements; and it spotlights notable outputs in the various areas as well as “Examples of EU added value”. The section on *management achievements* is more focused upon issues of probity in financial management including internal control and anti-fraud activities.

In recent years, the Juncker Priorities have also been used as an organising theme for the actions and outputs in the **Management Plans** mentioned above. More fundamentally, since 2016 the focus of the Management Plans has been adjusted in favour of new, multi-annual **Strategic Plans**. These plans make explicit how the Directorate-General will contribute to the Juncker Priorities over the medium term, supported with impact indicators. Alongside these Commission-wide “general objectives” are “specific objectives” for the Directorate-General, including an apparatus of results indicators, milestones and targets – analogous (but not identical) to the performance information provided in the budget-related Programme Statements.

2.2.3. *Inter-institutional co-ordination on performance is being strengthened*

Various mechanisms to enhance co-operation and co-ordination among the various EU institutions involved in performance monitoring, reporting and accountability have been developed in recent years.

Since 2015 **expert meetings on Performance-based Budgeting** have been organised under the EU Budget Focused on Results initiative, so that the broad range of issues relevant to performance and results can be discussed at technical level, with a view to working towards shared understandings on how the commonly-recognised challenges in this area might be addressed (see also Annex B).

At more formal levels, Article 295 TFEU provides that “the European Parliament, the Council and the Commission shall consult each other and by common agreement make arrangements for their co-operation. To that end, they may, in compliance with the Treaties, conclude interinstitutional agreements which may be of a binding nature.” Such interinstitutional agreements (IIAs) allow the three bodies to put co-operative arrangements on a fixed, legal footing, without a requirement for Treaty revisions or the full EU legislative procedure.

The 2013 **IIA on “budgetary discipline, on co-operation in budgetary matters and on sound financial management”**³ lays down arrangements for a number of matters including budget transparency; handling of the flexibility tools not included in the MFF; and implementation of the principle of “sound financial management of Union funds”, including issues relating to the Article 318 Report and the cross-referencing of budgetary and legislative programming.

In 2016, a revised **IIA on Better Law-Making**⁴ was introduced to advance a number of important elements of the EU’s Better Regulation agenda (see below). Arising from the provisions of this IIA, the **Commission Work Programme** assumes a new importance as a focal point for policy planning and prioritisation over the coming year. The Work Programme is now the subject of *ex ante* consultation with the Parliament and Council. Taking account of the consultation process and as envisaged in the IIA, the Presidents of the Parliament, Council and Commission signed their first **“Joint Declaration on the EU’s Legislative Priorities”** for the year ahead in December 2016. The Joint Declaration also referenced the European Council’s Strategic Guidelines and the Juncker Priorities.

In addition, the EU's long-standing agenda of Better Regulation aims to ensure that the body of EU laws and procedures agenda are effective in achieving objectives, efficient in doing so, and proportionate as regards "administrative burden". In its 2015 Communication on **"Better Regulation for Better Results"**,⁵ the Commission outlined an enhanced, integrated approach to quality in policy-making, grounded in evidence, and with clear professional reporting on the expected and actual impacts of policies (see Annex A).

Finally in this context, the EU's economic governance arrangements have been more closely co-ordinated over recent years via the **EU Budget Semester**, which in principle allows aspects of conditionality arising from the ESI Funds to feed through to fiscal governance (also explained in more detail in Annex 1). However, there is not yet any mechanism in place for analogous EU-wide co-ordination on issues of performance and results.

2.2.4. *Are the reforms to budget reporting complete?*

The above account illustrates that much progress has been made in rationalising the various performance-related reporting streams and bringing key messages into closer alignment. Specifically in the budgetary context, the new Annual Management and Performance Report (AMPR) from the Commission, which integrates the previous Article 318 report and Synthesis Report on management achievements, is an important streamlining initiative, and is a useful aid to policy-makers and stakeholders in forming a strategic overview of the EU budget.

However the treatment of performance information in the AMPR falls some way short of being structured and systematic, in such a way as to allow policy-makers to get a clear sense of what programmes are working well and not working well in achieving their stated objectives and in contributing to EU goals. The information on performance and achievements spotlighted in the 2015 AMPR (July 2016) may be useful in providing some insights into how money is being spent; but it is not obvious whether or how any of these outputs correspond to objectives and milestones. This issue is linked, in the OECD's assessment, to the desirability of achieving a more fully-integrated strategic framework of EU budgetary goals.

2.2.5. *What direction should be considered for future reforms in budget reporting?*

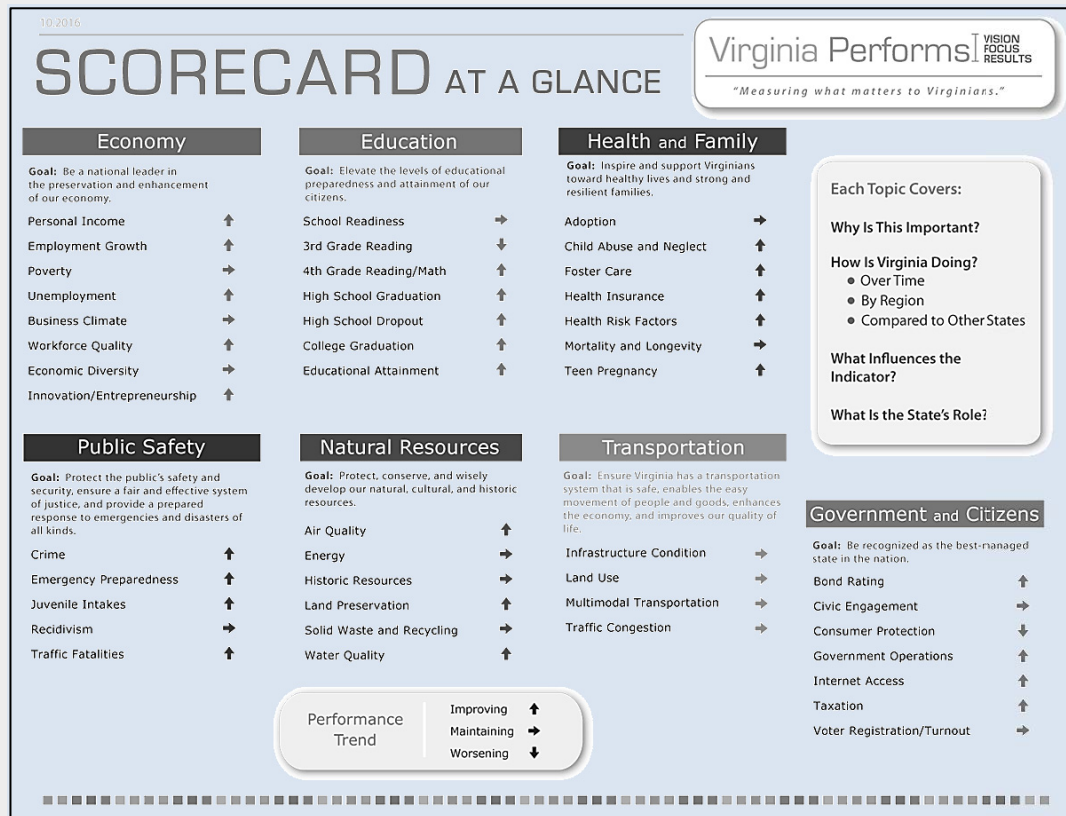
In the previous section, a new *ex ante* "Statement of Goals of the EU Budget" was proposed for consideration, elaborating upon the familiar template of the existing EU Budget Headings. An advantage of this approach is that, by carrying the same structured approach through to the *ex post* accountability phase, this would allow for a more systematic and coherent approach to performance-related budgetary reporting across the cycle.

In practice, this would require the Commission's Annual Management and Performance Report (AMPR) to evolve further, i.e. to be re-configured in line with the Statement of Goals. Rather than provide a sampling of the detailed performance-related information – as is currently the case – the evolved AMPR would report upon performance by reference to the budgetary Goals and Headline Targets. To aid accessibility and clarity of the information, a standardised concise reporting system should be used – e.g. a performance "dashboard" or "traffic light" system – to signal to policy-makers the degree to which Targets have been achieved or not achieved (an example of good practice from Virginia in the United States is provided in Box 2.5).

In principle, all of the information in this report should be subject to audit by the ECA. As a standardised, summary document, the AMPR would also be a better basis for citizen-

Box 2.5. Country case: Performance scorecards from Virginia Performs, United States

Virginia Performs is a signature initiative of the Council on Virginia's Future. It is a performance leadership and accountability system within state government. An online "Scorecard at a Glance" offers the public a snapshot of how Virginia as a state is performing against each indicator. Scorecards are also available for Virginia's regions, showing how well they are doing on the same indicators tracked at the state level.



faced reporting on EU impacts, and it should usefully be re-branded accordingly – e.g. *Annual Report of EU Achievements*.

A key challenge in this overall context is to agree upon a limited number of headline Targets, which are properly representative of the diversity of EU budget activity and policy priorities. Some country examples from around the OECD may provide useful examples on this point (see Box 2.6).

2.3. Relationship between national and EU performance budgeting systems

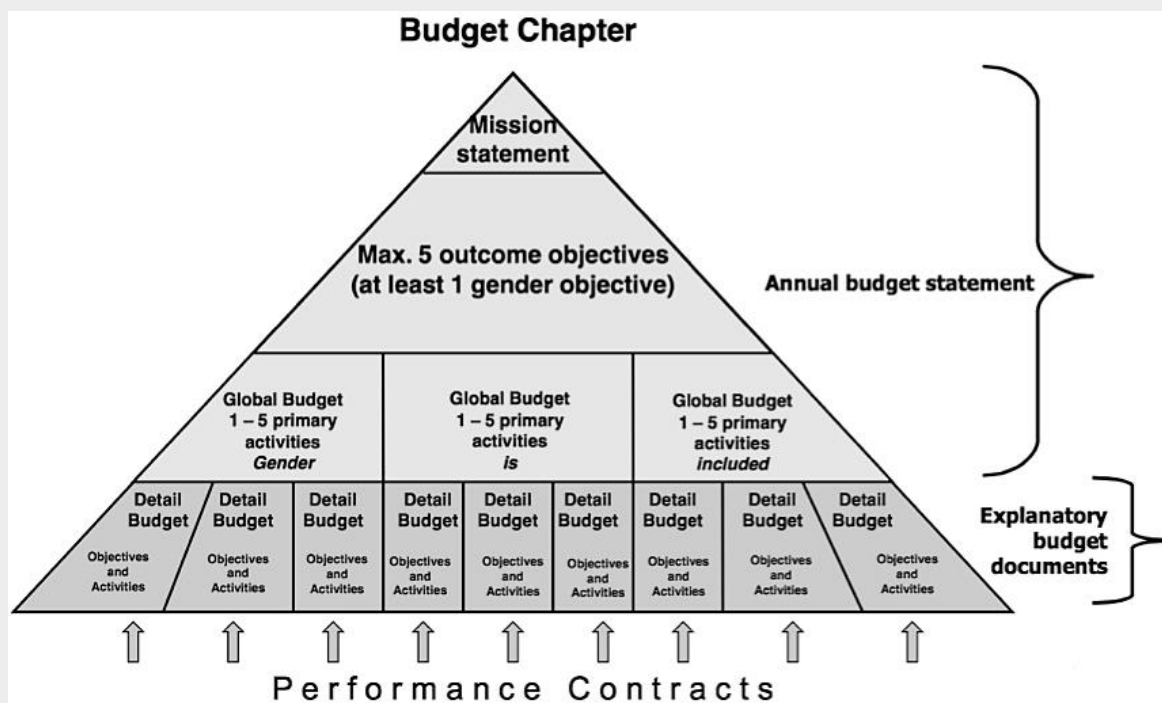
2.3.1. How well co-ordinated are EU and national performance budgeting systems?

Most (59%) EU countries responding to the 2016 OECD Performance Budgeting Survey reported that they have a standardised performance budgeting framework in place for EU funds. Half of these countries observe that the performance framework for EU-funded programmes is more rigorous than the performance framework for nationally-funded programmes (see Figure 2.2).

Box 2.6. Country cases: Selection of headline performance targets

Austria

Austria undertook major reforms of its budget law reform in 2009 and 2013 with the objective of improving budgetary decision-making and design of the federal budget as a comprehensive steering instrument for resources, outputs and outcomes. A crucial element of the Austrian reform was performance budgeting. Each ministry now has to define a strictly limited number of intended policy outcomes, outputs, and performance indicators which require the approval of parliament. For each of the 32 budget chapters, a maximum of five outcome/impact objectives (and related performance indicators) have to be defined by the ministries, out of which one objective must be related to improving gender equality. The performance information now published for each budget chapter is shown in the diagram below:

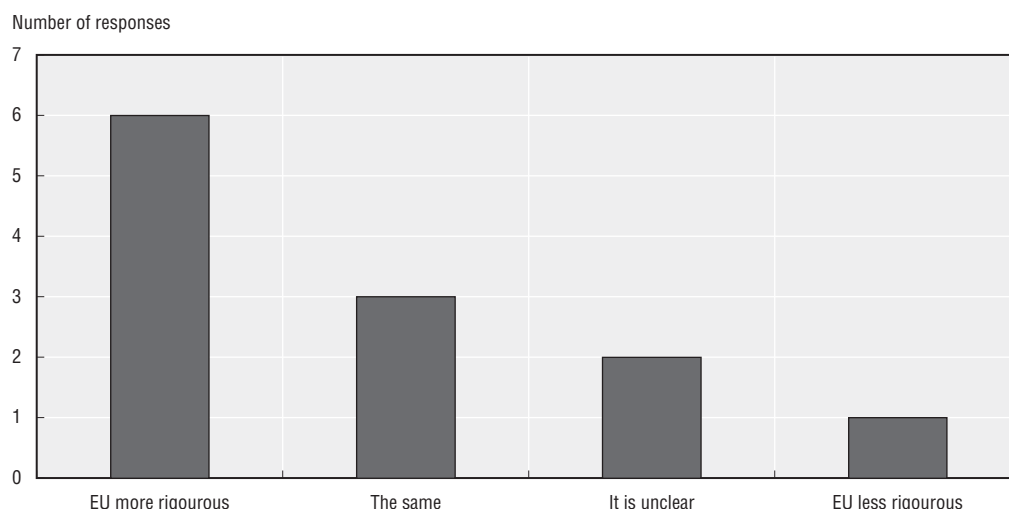


United States

The US Government Performance and Results Modernization Act 2010 created a more defined performance framework by defining a governance structure and by better connecting plans, programmes, and performance information. The law included specific requirements for performance reporting by Federal Agencies. Specifically, it requires the head of each agency to identify a small number of “Agency Priority Goals” from among the agency’s performance goals. The Director of OMB has the authority to determine the total number of agency priority goals across the federal government, as well as the number of priority goals to be developed by each agency. A limited number of Cross-Agency Priority Goals are also adopted to improve cross-agency co-ordination and best practice sharing. For the fiscal year 2012-13 there were 103 Agency Priority Goals in total for twenty-four agencies, along with 14 Cross-Agency Priority Goals. Agencies outline long-term goals and objectives in their strategic plans and annual performance goals in annual performance plans. All of this information is available through performance.gov.

Source: US Government Office of Management and Budget.

Figure 2.2. Is the performance framework for EU-funded programmes the same as the performance framework for nationally-funded programmes?



Source: 2016 OECD Performance Budgeting Survey, Question 71.

In particular, performance frameworks for EU-funded programmes are much more likely to feature a standard set of performance indicators and/or targets, standard templates for reporting performance information and a standard ICT tool for entering/reporting performance information (see Table 2.1).

Table 2.1. Frequency of key elements of performance budgeting frameworks

Performance framework element	General performance budgeting frameworks across the OECD, %	Performance budgeting frameworks for EU-funded programmes, %
General guidelines and definitions	92	85
Standard set of performance indicators and/or targets	73	85
Standard ICT tool for entering/reporting performance information	42	62
Standard templates for reporting performance information	27	62

Source: 2016 OECD Performance Budgeting Survey, Questions 9 and 69.

Although some countries have applied performance practices required at the EU level to national programmes, in general terms, the OECD has heard from stakeholders that the interplay is relatively limited. The extensive performance budgeting practices that apply in the various EU-funded programmes are only partially applied in the equivalent national performance budgeting systems. This tends to create, in effect, a sharp disjunction between national and EU systems, hindering the transfer of knowledge and insights between the two policy realms, and thus the development of capacity and expertise in performance budgeting. It is notable, for example, that the Common Provisions Regulation governing the ESI Funds (see Annex C) calls *inter alia* for the “co-ordination and synergies between ESI Funds and other Union policies and instruments”, noting that such approaches can avoid duplication of effort and add impact; but there is no corresponding call for co-ordination and synergies with national systems.

In addition, the EU’s budgetary legislation involves an obligation on the part of member states to assist the Commission in ensuring that the principles of sound financial management are obtained, including economy, efficiency and effectiveness.

As the 2016 OECD Performance Budgeting Survey makes clear, almost all EU countries have some performance budgeting and evaluative frameworks in place, and some of these are quite well-established. It would seem implausible to suppose that the development of parallel systems of performance budgeting, servicing both national and EU-level programmes but with limited linkages and synergies is an optimally-efficient administrative arrangement.

2.3.2. How might co-ordination between national and EU levels be enhanced?

The OECD would suggest that the Commission and the member states should work to promote co-ordination of national approaches to performance-based budgeting as a common, qualitative element of public financial frameworks in the EU; consistent with the obligation on member states to co-operate with the Commission in promoting sound financial management. This voluntary co-ordination would be in keeping with the trend among most OECD countries to develop and refine their national systems of performance budgeting.

For the future, in those areas where EU programmes are dependent for their effectiveness on significant national co-financing, in principle it would be reasonable that the *ex ante* conditionalities attached to the programme could also include references to the quality of the national performance budgeting framework and its alignment with accepted standards of good practice.

Sections 3 and 4, which refer respectively to EU-national co-ordination on issues of parliamentary engagement and national auditing, and (in the case of Section 4) to issues of quality and standardisation in performance budgeting frameworks, are also relevant in this regard.

3. Engagement and accountability with the budgetary authority: Institutional and broader strategic considerations

3.1. The EU's Budgetary Authority

In OECD countries, the legislature is the institution invested with the task of formally authorising and approving the annual budget, and is the body to which accountability is exercised. The legislature may be either unicameral or bicameral; in the latter case, the different chambers may have parity of budget authority, or may have distinct roles, in line with national constitutional requirements.

In the EU, the Parliament is not a legislature in its own right but acts as co-legislator, jointly with the Council. Accordingly the two institutions are sometimes referred to collectively as the “legislative authority” or, specifically in the budget context, the “budgetary authority” even though the two institutions are legally distinct and are not referred to in the Treaties as constituent parts of an overall legislative body. In practice, however, the two institutions function in a manner loosely analogous to the two chambers of a bicameral legislature. The budgetary approval procedure (see Section 1) provides for co-ordination and conciliation among the institutions, including also the Commission which has the executive-type role of budget proposer. In practice, the degree of engagement of the Parliament and Council differs significantly, during the various phases of the budget cycle, and in particular with regard to the focus upon performance and results.

There are a number of other distinct differences which affect their budgetary role in practice. For example, the Parliament is not a revenue-raising body and it has tended to

advocate increases in EU spending in various areas; by contrast, budget revenue policy is determined by the Council which in recent years has advocated a more constrained approach to EU spending. Since EU spending and revenues must balance, in effect the Council has operational primacy in setting the overall ceilings for the multiannual (and thus the annual) budget. Given the level of detail contained in the EU budget in many distinct policy areas, the Parliament tends to have operational primacy in the exercise of the accountability function.

3.2. The budgetary role of the European Parliament

The European Parliament comprises 751 Members of the European Parliament (MEPs) who are directly elected on a proportional basis by the citizens of the EU. Whereas the Council represents the member states, the Parliament directly represents the interests of EU citizens (i.e. all nationals of EU member states), and it exercises functions of political control and consultation as laid down in the Treaties. As outlined above, the Parliament exercises legislative and budgetary functions jointly with the Council, and so the two institutions together comprise the “budgetary authority”. Accountability for the effective and efficient use of budgeted resources is a fundamental role of parliaments in all OECD countries and this is equally the case in the EU.

3.2.1. Parliamentary committees facilitate in-depth policy and budget scrutiny

The work of the Parliament is handled by 23 committees, the structure of which largely mirrors the DG system at Commission level. The Parliament’s committees meet once or twice a month as a rule. The role of various committees in the budget process is outlined below:

- **Committee on Budgetary Control (CONT):** This Committee has 30 members and has roles and responsibilities similar to the audit committee of a national parliament. In particular, it has special responsibilities in relation to the EU budget’s discharge procedure. During this procedure it scrutinises the implementation of the budget by all actors involved and prepares individual discharge reports for consideration by the plenary. The plenary considers these reports and decides either to grant or postpone discharge.
- **Committee on Budgets (BUDG):** This Committee has 41 members and has roles and responsibilities similar to the budget/finance committee of a typical national parliament. In particular, it discusses, amends and adopts the EU’s Multiannual Financial Framework and the annual budget together with the Council. It is also responsible for setting out a Parliament position before the Commission proposal has been submitted, and it undertakes this task by arranging hearings involving expert witnesses.
- **Other Standing Committees:** The Parliament has 18 other standing committees, as well as important sub-committees and other specialised committees. Each standing committee consists of between 25 and 73 members. Responsibilities are diverse, but in general each standing committee oversees matters relating to the establishment, implementation and monitoring of policy measures in their domain, e.g. Employment and Social Affairs (EMPL) or Transport and Tourism (TRAN).

An interesting feature of the committee system at the European Parliament is the rapporteur model. This helps to distribute the work of the committee and enables committee members to develop expertise in relation to particular topics (see Box 3.1).

Box 3.1. The rapporteur model at the European Parliament

Rapporteurs in the European Parliament are members of committees that are chosen to report on a particular topic, for example, budget oversight. The rapporteur's key task is to analyse the project, consult with specialists in the particular field and with those who could be affected, discuss with other members within the committee and recommend the political "line" to be followed. All of these considerations flow into a draft report to be presented to colleagues who are also members of the parliamentary committee. Together, the members consider the draft report and may propose amendments before adopting it by vote. The reports are informally known by the personal names of the MEPs who draft and present them (e.g. the "Spinelli report").

The rapporteur receives practical help from the committee's staff and for very technical matters may also get support from external experts and experts from other EU institutions.

3.2.2. The Parliament's ex ante role in performance budgeting is limited

In the early part of the year, in order to inform the deliberations of the Commission as it begins to formulate its budget proposal, the Parliament's Budget Committee (BUDG) prepares "general guidelines for the preparation of the budget". The guidelines, which are submitted to the Commission after ratification by Parliament in plenary session, convey the Parliament's priorities for supportive action in the budget while also expressing views about broader qualitative aspects of the budget process. For example, in its General Guidelines for the preparation of the 2017 EU budget, the Parliament made *inter alia* a number of points relevant to these qualitative aspects, including performance and results – see Box 3.2.

Box 3.2. Performance-related aspects of the Parliament's budget guidelines for the 2017 budget

The European Parliament,

5. Welcomes [...]the Commission's efforts to enhance the use of the European Structural and Investment Funds in support of key priorities highlighted in the country-specific recommendations; [...]

27. Recalls the importance of gender mainstreaming, which should underpin Union policies as a horizontal principle; calls on the Commission to put the principle of gender mainstreaming into practice when preparing the draft budget for 2017, as appropriate; [...]

29. Welcomes the Commission's efforts in developing the "EU Budget Focused on Results" strategy; calls on the Commission to demonstrate progress in the field of simplification of EU funding, especially with regard to reducing the burden of implementation and management of EU-funded projects; stresses that particular attention should be paid to the performance of financial instruments which can reach out to important target groups, such as SMEs, innovative enterprises and microenterprises under the Union funding programmes; believes, furthermore, that, apart from the Union institutions, considerable responsibility also lies with the Member States, given the fact that 80% of the budget is under "shared management"; calls on the Member States, therefore, to do their utmost to guarantee sound financial management and the reduction of errors, and to avoid any delays in the implementation of programmes under their responsibility; emphasises the need to focus more on developing suitable quantitative and qualitative output indicators in order to measure performance and evolve a concrete picture of the effect of EU spending in the real economy [...]

Source: T8-0080/2016 "European Parliament resolution of 9 March 2016 on general guidelines for the preparation of the 2017 budget, Section III – Commission".

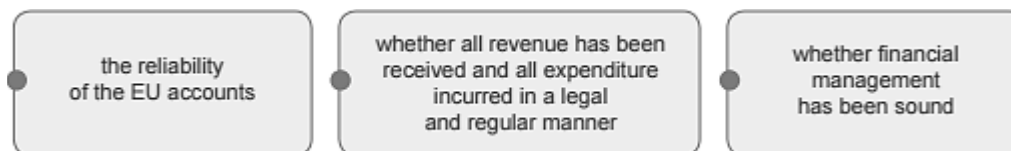
The Council also submits its own guidelines to the Commission (see below). Such a structured, formal opportunity for a legislature to submit its priorities, *ex ante* of the budget being formulated, is an advanced practice among OECD countries.

However, when the cycle moves on to the consideration and approval of the draft budget, the Parliament's role is relatively muted: It is during this phase of the budget that the Council comes to the fore (see below). Despite high level institutional commitment to the principle of performance budgeting, in general it is observed that there is very little practical consideration of performance information by Parliament throughout the budget approval process.

3.2.3. Parliament has a strong role in budget scrutiny and accountability

Once the EU budget is adopted, the Parliament, as the directly-elected institution representing the interests of EU citizens, exercises democratic oversight to make sure that the Commission and the other institutions make best use of EU resources. The principal way in which it exercises this power is by subjecting the annual accounts and other accountability reports from the Commission to scrutiny, and by deciding whether or not to grant the discharge, which marks the conclusion of the Commission's responsibilities with regard to budget implementation in that year. When granting the discharge, the Parliament has not only to verify the correctness of spending (compliance) but also has to ensure that there has been sound financial management and achievement of objectives (performance).

The Parliament's decision to grant, to postpone or to refuse the discharge is primarily, although not exclusively, based on reports from the Commission and the ECA which contain information on:



In the wake of the euro crisis, one particular issue in relation to the discharge procedure is that a number of new financial instruments and tools have been created to allow funding to be allocated in a more flexible way towards new priorities. However, these instruments sit outside the EU's standard budget procedure and as such are not subject to the discharge procedure; a consideration which gives rise to concern among some parliamentarians.

Traditionally, the focus of the discharge procedure has been on verifying compliance through consideration of metrics such as **error rates** (the amount of the adjustments – for example, resulting from errors in the preparation of the cost claims or from non-compliance with financial rules – on the amount audited). In addition, the concept of **absorption** – the degree to which available EU funds (“commitment appropriations”) have been successfully drawn down and expended – has been highly significant as an indicator of programme implementation and associated investment in countries and regions. While these concepts remain important, since the amendments introduced in the Treaty of Lisbon (effective since 2009), Article 318 TFEU provides for a new accountability instrument – an “evaluation report on the results achieved with the EU's finances” (the so-called “Article 318 Report”). Over recent years, this instrument has helped to sharpen the focus on monitoring the achievement of policy objectives. For example, in granting discharge in respect of the European Commission

budget allocation for the year 2014, the Parliament in its decision of 28 April 2016 included a number of specific observations regarding the performance aspects of the budget, as illustrated in Box 3.3.

Box 3.3. Selected performance-related aspects of the Parliament's discharge for the 2014 budget

The European Parliament,

Underlines that in the past, the discharge procedure primarily verified the legality and regularity of financial transactions; believes, in the context of the Commission initiative “An EU Budget Focused on Results”, that more emphasis should also be given in future, beyond the above verifications, to examining whether the results achieved by projects and programmes match the intended objectives;

Considers that a results-oriented budget requires strong, solid and commonly agreed indicators; notes, however, that these indicators still need to be agreed with the co-legislators, the Commission and through extensive consultation with Member States' authorities and other stakeholders. Welcomes in this sense the establishment of the inter-institutional working group on performance-based budgeting of results-oriented budget that has only recently started its work; encourages all parties involved to accelerate its work while ensuring that a high quality set of indicators is agreed;

Welcomes the fact that the structure and content of the [ECA's] 2014 annual report follows the headings of the MFF and places greater emphasis on performance and results; Is aware that the move to an increased level of performance auditing cannot be done in a single step, as it is only once the basic legal acts and the budget are drafted with the intention to align policy objectives with qualitative indicators or to produce measurable results that performance audits can move forward;

Points out that since the periods covered by the Union's ten-year strategy and its seven-year budgetary period are not aligned, the Commission's ability to monitor the contribution of the Union budget to the Europe 2020 Strategy is limited for the first half of the strategy period, albeit that all the data necessary for performing annual checks are available;

Points out that the objectives and the budget for results must be geared to the objectives laid down in the Treaties, the Europe 2020 Strategy and sectoral and cohesion policies and must be sufficiently flexible so that it can be adapted to emergency situations that may arise, such as the economic crisis and/or the refugee crisis;

Takes note that according to the Court, there are inherent weaknesses in the performance framework of the common provisions regulation on ESIF, as poor results do not lead to the loss of the performance reserve for Member States and as the financial sanctions available to the Commission are limited; however, considers that before asking for sanctions a better system for performance measurement should be in place and potential sanctions should be preceded by a process of assisting Member States to improve performance

Calls on the Commission to make fuller use of the scope afforded by existing legislation with regard to the performance reserve so as genuinely to create a financial incentive to improve financial management in practice; calls furthermore for greater use to be made of the performance reserve as an instrument to increase the element which is conditional on performance when the legislation is next revised;

Concludes that the discharge: a) priorities include a balanced approach between traditional methods and a strengthened focus on performance and results, taking account in every case of the obligations arising from the Treaties, the sectoral policies and the flexibility necessary to deal with unforeseen events; b) requires improvement in data availability and management to declare the performance and results; c) appreciates a strengthened linkage of the Union budget with key Union policy strategies and concepts (as the Europe 2020 Strategy) and their correlation with key sectoral policies.

Source: P8_TA-PROV(2016)0147: European Parliament decision of 28 April 2016 on discharge in respect of the implementation of the general budget of the European Union for the financial year 2014, Section III – Commission.

3.2.4. Parliamentary scrutiny across the budget cycle is not fully connected

As indicated above, the Parliament's Budget Committee has expressed its views regarding the need for enhanced performance information in the budget and the Budgetary Control Committee has provided extensive, considered commentary on various aspects of this subject. However, the current budgetary procedures provide only limited "windows of opportunity" for Parliament to engage in performance-related scrutiny with any degree of intensiveness or continuity. Some parliamentary stakeholders have expressed the view that while the reforms of recent years are welcome, further re-balancing is needed – for example through a greater degree of practical and operational discussion of performance metrics during the discharge procedure – so that the processes of Parliament scrutiny can have maximum relevance and impact.

As outlined above, the Parliament's various standing committees are the locus of expertise and policy specialism in the various areas of EU activity. Over recent years, the Committee on Budgetary Control has been seeking to encourage a more holistic, Parliament-wide approach to performance oversight, so that the concerns and insights of the Standing Committees are brought to bear in a more systematic way upon the budget process. For example, the Committee on Budgetary Control has made increasing use of the Performance Audits published by ECA (see Section 4). The Committee holds sessions with the ECA on their Special Reports and invites other Standing Committees to participate in these sessions where they are related to their policy domain; however, the level of involvement elicited from other committees to date has been limited. Moreover, some Standing Committees appear reluctant to engage fully with the shift towards performance and results; perhaps reflecting anxieties, which are not uncommon among parliaments in OECD countries, that tools such as performance budgeting may strengthen the hand of the executive, by reducing the scope for budgetary allocations that are not grounded in evidence.

Some MEPs sit on both the Committee on Budgetary Control and the Budget Committee of Parliament. In principle, such an overlap of membership can help in connecting the cycle of budget accountability, by enabling information and issues from the oversight of previous spend to be used to inform the incoming budgetary cycle. However, parliamentarians have pointed to challenges in adopting a fully "joined up" approach to considering performance information, and to using this information systematically as a basis for scrutiny and accountability, throughout the phases of the budgetary cycle and effectively drawing the information provided by the Commission and the ECA in the context of considering the Multiannual Financial Framework and the annual budget.

3.2.5. Enhancing cross-committee engagement in EU performance budgeting

It appears to be widely accepted among stakeholders that the development of a joined-up, Parliament-wide approach to using performance information will require a wider shift in the culture of Parliamentary oversight and cross-committee functioning – i.e. involving the sectoral Standing Committees as well as the budget-related committees.

Accordingly, the various committees of the European Parliament should seek to co-ordinate and connect their activities to make the best use of performance information across the budgetary and broader policy-making cycles. This should involve a structured form of co-operation and engagement among the Budgetary Control Committee, the Budget Committee and the Standing Committees, so that the policy messages arising at the various parliamentary forums can be input and transmitted in a seamless manner through the *ex ante* budgetary approval through to the *ex post* accountability stages.

In the first instance, such a development will require a stronger co-ordinating role for Budgetary Control Committee, which at present bears most responsibility for engaging with information on performance and results. However the availability of clear, strategic statements and reports, which maintain uniformity in structure and content across the budget cycle as recommended above – including also clear, thematic reporting that is relevant for Standing Committees – would facilitate an enhanced and re-balanced performance oversight role across the various parliamentary committees.

One technique that has been used in OECD countries to generate wider parliamentary engagement in performance oversight has been to enhance the consultative role of the legislature, including sectoral committees, in establishing performance indicators. Illustrations of how this type of exercise has been undertaken in both Sweden and the United States, involving parliament and government stakeholders, is provided in Box 3.4.

Box 3.4. Country cases: Enhancing the role of parliament in selecting performance information

Sweden

An informal working group of approximately ten civil servants from the Ministry of Finance and the Parliament's Finance Committee was set up in 2000 to improve performance information given to the Parliament. It met over a period of several years. When the group discussed specific budget areas, representatives from various line ministries and parliamentary sectoral committees also participated in the group, ensuring that there was broad engagement in the process. The group served as a catalyst, spreading good ideas to government and parliament and identifying the types of performance information most useful to parliament in its deliberations on the budget.

United States

The Government Performance and Results Modernization Act reforms enhanced the consultative role of Congress in establishing performance indicators. Previously, performance data was highly centred on consultation between the OMB and agencies. As delivery agents, agencies already possessed a large informational advantage and the perception among many Congress members was that performance data could be strategically presented by agencies to reflect intended performance narratives, rather than a comprehensive, performance-informed snapshot. The reforms established more specific requirements for agency and OMB interactions with Congress. This increased consultation, engaging Congress and legislative staff earlier in the process to facilitate better proposals, improving trust in the data presented within. Consultation is required to occur every two years.

3.2.6. More systematic research support on performance budgeting may be useful

The **European Parliamentary Research Service** offers tailored briefing and personalised research for individual MEPs as well as more detailed publications for Parliament as a whole. Each Committee Secretariat also provides some research support to Committees of the Parliament. In general, both services are highly regarded by MEPs. Moreover, as outlined elsewhere in Sections 2 and 4, the Parliament now has available to it a wealth of information and reports relating to performance and results – ranging from the Programme Statements in the draft budget, to the new integrated Annual Management and Performance Report and the ECA's Special Reports.

Parliamentary stakeholders have in general expressed satisfaction with the level and nature of performance-related information that is available, while also acknowledging the practical difficulties of remaining abreast of all of this information and of distilling key messages that are useful for the processes of budget approval and accountability. It appears that there is scope to provide enhanced technical analytical support in the area of budget and performance oversight, in line with developments in a number of OECD and EU member countries (see Box 3.5). Indeed, in the context of implementing a more joined-up approach within parliament to engaging across the budgetary cycle, consideration could be given in future to establishing a standalone European Parliament Budget Office to provide extra status, focus and co-ordinating capacity to this core parliamentary function.

Box 3.5. Country cases: Resources to support performance budgeting in national parliaments

The House of Commons Scrutiny Unit at the UK Parliament

The House of Commons Scrutiny Unit supports Select Committees in examining the expenditure and performance of government and the relationships between spending and delivery of outcomes. It does this by promoting the value of linking examination of spending with examination of outcomes, by helping committees analyse spending patterns alongside the performance and by pressing the government to improve the information available and promoting Parliament's interests of holding the executive to account. This includes contributing financial and performance material to committee inquiries, including briefings, questions, reports and analysis of impact assessments.

The Parliamentary Budget Office at the Austrian Parliament

The Austrian Parliamentary Budget Office has a mandate to support Parliament in the budgetary process, in consulting and enacting budget laws and exercising its oversight role. As part of this, it provides Parliament with information on the performance budgeting framework, maps all outcome objectives, advises how to read documents efficiently and provides analysis on each budget chapter, including performance goals/tasks/indicators. It also makes recommendations to the Government on how budget documents (including performance information) can be improved from a parliament user's perspective and pushes for better and earlier access to information.

3.2.7. Fostering Relationships with member state parliaments may be productive

Committees of the European Parliament have, on a number of occasions, held discussions with representatives of the equivalent committees in member state parliaments and national audit authorities. In general, parliamentary stakeholders have expressed support for better contacts with the national parliaments. While enhanced parliamentary contacts involve practical difficulties, the Committee on Budgetary Control has attempted to manage these challenges by systematically inviting a national parliament representative from the member state that holds the Council Presidency. The Committee is also planning to organise periodic meetings with small groups of national parliaments in relation to specific areas of EU spending. Such multi-lateral approaches could also prove helpful, in future, to encourage exchanges of good practice for parliamentary oversight of performance in the budgetary context.

3.3. The budgetary role of the Council of the European Union

The Council of the European Union is composed of representatives of the EU's 28 member states. Traditionally, budgetary concerns of the Council have focused on high political questions of revenue raising ("own resources") and aggregate expenditure management, with countries often characterised as falling into the broad categories of "net payers" (i.e. states whose overall contributions towards the EU budget exceed their benefits received), and "net contributors" (states whose benefits exceed their contributions). While such a characterisation is simplistic – not taking account, for example, of the benefits enjoyed by all member states as part of the single market, or the benefits from economic and democratic convergence in the countries and regions of Europe – stakeholders accept that the budgetary discussions in Council have a political character, involving a regard for state interests, that is distinct from the budgetary discussions in Parliament.

3.3.1. The Council is strongly engaged on financial aspects of budget approval

The Council's engagement with the budget process is handled via its Budget Committee of senior officials. The Budget Committee is chaired by the country holding the Council Presidency, a position which rotates every 6 months.

As is the case with Parliament, the Council submits *ex ante* guidelines to the Commission at an early stage of the cycle, to inform budget preparations. In its guidelines for the 2017 budget, the Council emphasised the need for "a realistic budget respecting the principle of sound financial management" involving strict compliance with expenditure ceilings. As a general principle, the Council puts a very high priority on the need for financial discipline in the preparation and implementation of the EU budget. However, in its guidelines the Council also encouraged the Commission "to further improve the content of its budgetary documents in order to make them more transparent, simple and concise", noting that "Programme statements should, in particular, focus on performance information and ways to improve it, including the results achieved, the justification for the level of appropriations requested, and on the added value of EU activities. This analysis should be clearly linked to the relevant budget lines in order to support the budgetary decision-making process."

Once the draft budget and its associated documentation is published by the Commission, in practice the bulk of discussions and negotiations are handled between the Commission and the Council (see Section 1.2), with the focus of discussions being on the financial rather than the performance aspects.

3.3.2. Better performance reporting would aid the Council's accountability role

While the Parliament is structured in a way that allows members to engage in the details of policy in each area, member state representatives on the Council are subject to more limitations on time and specialist capacity. Accordingly during the *ex post* stages of analysing annual accounts and budget implementation, it is the Parliament rather than the Council that tends to take the primary role in exercising detailed scrutiny.

However Council stakeholders also signal the lack of a single accountability document, of a strategic nature, that would facilitate them in exercising a stronger accountability function. Such a document would need to be concise; structured narrowly on the basis of performance and impact; while also corresponding to the financial allocations. In particular, Council stakeholders emphasise the need for simplicity and streamlining, cutting through

the perceived information overload and providing an “executive summary” to form a basis for budgetary decision-making.

The recent evolutions in the Commission’s budget-related reporting – notably the Annual Management and Performance Report (see previous Section) – represent a move in this direction. For future reform, the proposed approach of introducing a clear, strategic “Statement of Goals of the EU Budget” and a corresponding *ex post* document, should be considered as a means of facilitating the Council in its task, as a co-equal arm of the Budgetary Authority, of holding the Commission and its agencies to account for the performance aspects (and not merely the financial aspects) of the EU budget.

3.2.3. Budget responsiveness to results information is very limited in the EU model

A more fundamental question is whether such performance information, even if presented in an ideal manner, could realistically be used to influence the budget allocations. Stakeholders in both institutions – Council and Parliament – note that the political sensitivity attaching to the various Programmes precludes such flexibility: In practice, national stakeholders see the allocations, once settled in the MFF context, as “their” money that should not be adjusted except *in extremis*. This inflexible aspect of the MFF, while well-suited to medium-term strategic orientation and planning for resource availability, marks a distinct departure from the practices of national budgeting, where annual or periodic reallocation of resources in response to changing priorities – and indeed in response to evaluations of performance and results – is the norm.

In practice, the EU’s annual budget process is now largely an exercise in accountability and reporting, but without the possibility (and expectation) of resource reallocation that features in national systems. In such an environment, it is more challenging to promote engagement among budgetary decision-makers (in Parliament or Council) or the public with information on budgetary performance and results. Indeed, in the absence of opportunities for refining and re-prioritising among programmes to achieve better overall outcomes, there is a heightened risk that the annual budgetary dialogue focuses on issues of contention and fault-finding. The strong focus on the “error rates” of EU programmes, to an extent not typically seen in analogous budget scrutiny processes at national level, is perhaps a reflection of this. It should be acknowledged that in recent years, as outlined above, the Parliament’s budget discharge procedure has included more qualitative discussion on performance issues, signalling an appetite for greater engagement on this aspect on budgeting.

The “flexibility instruments” described in Annex A represent a pragmatic workaround for the lack of inherent flexibility in the budget; however these instruments in themselves are not a sustainable solution in the longer term, inasmuch as they are extraneous to the normal budget process and to its standard routines of accountability including Parliamentary scrutiny and discharge.

3.2.4. How could Budget Flexibility and responsiveness to performance-related signals be further enhanced?

Generally, institutional stakeholders appear to accept that innovations such as the performance reserve (see Annex C) could – if handled sensitively and in a way that commands confidence among all stakeholders – be expanded over time to introduce genuinely performance-responsive elements in EU budgeting.

On balance, the OECD would suggest that the principle of making budgetary allocations responsive to performance and results, as introduced with the **performance reserve**, should be applied as a general principle of EU programme design. The principle can be applied in a meaningful way, in terms of its impact of resource allocation, to the extent that it a) accounts for a more significant proportion of spending than the 6% level that currently applies for the ESI Funds; b) allows for greater latitude to move funds across different programmes and regions; even if, for reasons of political acceptability, the reallocated funds must remain within a national area; and c) the results of a performance review allow for a graduated (rather than pass-or-fail) response.

However, even such a model may not be fully effective in helping policy-makers to address a more fundamental question: Whether the current disposition of resources, as reflected in the multi-annual and annual budget envelopes, remains in line with political priorities; and if not, how resources should be reallocated towards these new priorities. The question becomes more relevant, depending on the length and fixity of the budget envelopes: Therefore in the case of EU budgeting, with 7-year budget envelopes and very little latitude for adjustment, the question is indeed highly relevant. Accordingly it may be appropriate to introduce a **Spending Review** model into the EU budget system, along the lines that have been introduced in a growing number of countries around the OECD and in EU member states.

Spending reviews offer policy-makers a range of benefits, from analysis of the baseline of expenditure as between fixed, flexible, legal and discretionary elements; review of efficiency and duplication of resources among various agencies; and an opportunity to re-calibrate their spending framework to reflect new priorities. Such an initiative would introduce a further opportunity to make use of longer-term, evaluation findings across the continuum of public policy in the EU. Indeed, it is worth considering, as outlined in the following section, institutionalising Spending Review as a standard procedure during mid-term review of future MFFs.

Box 3.6. Use of Spending Reviews in OECD countries

Spending review is becoming more commonplace as a budget management tool, with it now having been used in 23 OECD countries, compared to 16 in 2011. An additional 6 countries are considering this tool for future use (Austria, Estonia, Israel, Korea, Norway and Turkey). Over 70% of countries that report using spending reviews have now had multiple reviews indicating that spending reviews may be becoming embedded in budgeting processes in some “new adopter” countries rather than being used as an *ad hoc* response to fiscal pressures.

Two models of a spending review have been used historically: i) targeted annual reviews, most common to the Netherlands and Denmark and ii) cyclical comprehensive reviews, common to the UK. So far, comprehensive rather than narrow spending reviews appear to be favoured among “new adopters”.

Source: 2016 OECD Performance Budgeting Survey.

3.4. Broader strategic and medium-term considerations for enhancing coherence, co-ordination and flexibility in EU performance budgeting

In addition to considering the coherence and co-ordination of EU performance budgeting from the perspective of the current institutional arrangements, it may be useful to set out

some suggestions which may be more far-reaching in terms of their impact upon the political and administrative architecture of the EU budget system; but which may nevertheless be helpful in provoking creative deliberations on how the performance aspects of budgeting may be developed into the future.

3.4.1. Align the multi-year budgeting and strategic policy timeframes

It would be helpful to resolve the mismatch between the current 7-year horizon of the MFF and the 10-year strategic policy horizon (as currently set out in Europe 2020), so that the two frameworks are always in synchronisation and so that the correspondences between strategic goals and the budgetary framework can be maintained and reinforced. The expiry of the current MFF and Europe 2020 in the same year, for the first time, offers an opportunity to introduce such an alignment. This can be achieved either by reducing the strategic policy horizon from 10 to 7 years to match the MFF; or by reducing the MFF from 7 to 5 years, so that each strategic policy period encompasses two successive MFF periods. There are advantages and disadvantages to both approaches; on balance however, the latter option may be preferable for reasons set out under the next heading.

3.4.2. Align the MFF with the 5-year cycle of the Parliament and commission

Both the European Parliament and European Commission are elected/appointed for five-year terms. By analogy with good practice in national budgeting and in the interests of making the EU-wide discussion of performance and results more meaningful and politically relevant, there may be merit in aligning the EU's budget period with this 5-year cycle of political accountability and renewal.

3.4.3. Standardise the MFF mid-term review as a “window” for budget flexibility

The practice of conducting a mid-term review of the MFF is helpful, in introducing opportunities for reassessment of overall objectives and allocations in what is otherwise an extremely rigid budgetary framework. Whether the future MFF follows a 7-year or 5-year model, the practice of mid-term review should be maintained and its role should be explicitly enhanced to underpin the expectation that the results of performance and evaluations will be used to reassess budgetary allocations. The mid-term review would be an appropriate juncture to conduct an EU Spending Review, to explicitly counteract the “rigidity” in the baseline of expenditure and allow space for political reassessment, including in response to performance and evaluation data.

3.4.4. Making best use of performance and evaluation across the policy continuum

EU programmes are subject to regular monitoring, performance reporting and rigorous evaluation procedures (see e.g. Annex C), all of which are intended to support programme impact and efficiency at various stages of policy design and review. This analytical activity generates a wealth of performance-relevant information and a key challenge for policy-makers is how to make optimum use of this information throughout the policy cycle.

For example, high-quality programme evaluations typically take a long time – a year or more – to deliver findings and so it is difficult to take account of useful results in a timely way during the annual budget cycle. Programme monitoring may yield useful data on a more regular basis, albeit the data are not necessarily intended or designed to influence the annual budgetary discussions.

Box 3.7. **Country case: Multi-annual budgeting and periodic spending review in Ireland**

The design of the Irish budgetary framework – and of the spending review process within it – reflects international best practice. The Comprehensive Expenditure Report 2012-2014 (CER) of 5 December 2011 introduced a new model of multi-annual budgeting called a Medium Term Expenditure Framework (MTEF). Another of the key reforms to the budgetary architecture, announced in the CER, was the introduction of regular spending reviews. Since the beginning of the economic and financial crisis, comprehensive spending reviews have played an important role in Ireland's efforts to restore expenditure policy to a more sustainable footing.

The comprehensive spending reviews were integrated in the reformed expenditure framework and are planned to take place on a periodic basis. As such, they are designed to be part of normal budgetary and expenditure management practice and to support the MTEF by allowing for the examination of baseline expenditure alongside new policy proposals to generate better policy choices taking into account emerging political priorities.

The 2014 comprehensive spending review was the first Irish spending review to ask spending departments to identify a certain volume of savings – 5% of the expenditure ceilings for 2015 as set out in the Expenditure Report 2014. The original aim of setting the ceiling was to ensure that the process provided a sufficient and wide range of options to Government that would allow it to achieve its immediate fiscal objectives and potentially allow it to make room for new expenditure proposals.

Source: Kennedy and Howlin, 2017 (<http://dx.doi.org/10.1787/budget-16-5jg30cchf0g0>).

In responding to these challenges, two broad approaches are suggested. First, many EU programmes have a multi-year investment character; and the policy issues which they address may have an ongoing relevance, spanning more than one MFF, albeit the details of the programme may evolve from one iteration to another. This longer-term policy continuum provides opportunities for the full spectrum of evaluation and performance reports to “feed forward” to policy design and re-prioritisation, alongside other programme-specific tools and reporting requirements – see e.g. Box 3.8. Mobilising the full range of evaluative and analytical tools is important to counter “policy inertia”, whereby established programmes are retained even where their continuing relevance to EU strategic goals may be unclear.

Second, the roles and intended uses of the various performance reporting and evaluative instruments across the policy continuum could be more explicitly catalogued, explained and applied in the EU context. A clearer understanding of the sources and nature of performance-relevant information would promote a more holistic use of this information by policy-makers, in their task of designing, implementing, testing and re-designing programmes. In particular, policy-makers should be in a position to test each element of the programme-logic model in place: Whether the allocated resources are delivering their specified activities and outputs and whether these outputs are indeed well-designed to support higher-level programme outcomes and strategic policy goals. A more integrated approach to drawing upon a) programme monitoring b) regular strategic performance reporting and c) longer-term evaluation, should contribute to a meaningful performance assessment of policy interventions over the short and longer term.

Box 3.8. Country case: Use of evaluations in the longer-term policy continuum in Canada

Canada has long used evaluation to support evidence-based policy development. In 2006, the Financial Administration Act introduced the requirement that all ongoing grants and contribution programmes be reviewed every five years. Then in 2009, the Evaluation Policy sought to support better policy and programme improvement, expenditure management, Cabinet decision making and public reporting. Each department has designated a head of evaluation with unencumbered access to the head of the organisation, and most have formed departmental evaluation committees. Sub-directives under the Policy strengthened requirements for programme managers to collect ongoing performance information to support periodic formal evaluation of their effectiveness. Evaluations are increasingly seen as tools that can be used by departments and the centre of government to better integrate performance information into decision-making and the budget. During 2011-12, 80% of relevant evaluations were considered in Treasury Board submissions and 60% of relevant evaluations were considered in Memoranda to Cabinet, the two key financial decision stages for cabinet. In internal reviews of evaluation, two-thirds of programme managers reported that evaluations were useful or somewhat useful for spending reviews.

Source: Government of Canada Treasury Board Secretariat.

3.4.5. Closer alignment of budgeting for results with the “Better Regulation” initiative

As outlined in Section 2, the EU has in recent years taken initiatives to improve the quality of its overall law- and policy-making processes, including through stronger inter-institutional co-ordination. It remains the case, however, that the two flagship initiatives in the area of quality policy-making – the Better Regulation initiative and the EU Budget Focused on Results – are targeted at different policy-making communities and are not completely aligned. Given the large areas of commonality between the two policy domains, not least in the areas of quality evaluation and evidence-based decision-making, it would seem appropriate to bring these areas into closer alignment in future. This would reflect the fact that budgeting and regulation/law-making are key pillars of an overall, integrated approach to modern, evidence-based policy-making in the EU. Such closer co-ordination might require a re-casting and broadening of some elements of Better Regulation and indeed a more holistic re-branding.

4. External scrutiny and quality assurance: The role of the European Court of Auditors

4.1. Functions of the European Court of Auditors

The *European Court of Auditors* (ECA) is the independent external auditor of the European Union (EU) and as such plays a role of fundamental importance as “guardian” of the EU finances. In addition to carrying out the tasks of financial audit that are common to “supreme audit institutions” (SAIs) in the normal course, the ECA has developed a particular role in assessing and reporting on the qualitative aspects of financial management and in particular on its performance dimension.

The ECA annually conducts two types of audits based on international audit standards:

- *Statement of assurance audits*, which are financial and compliance audits on the reliability of financial statements of the EU as a whole⁶ and EU agencies individually, as well as the

legality and regularity of the transactions from the EU budget and European Development Fund; and

- *Performance audits*, which consider the economy, effectiveness and efficiency (or *sound financial management*) of EU spending.

These audit practices are similar to those implemented in OECD countries (see Box 4.1 below).

Box 4.1. **Financial, Compliance and Performance Audits**

In most OECD countries, external audit bodies or “supreme audit institutions” (SAIs) have three primary areas of responsibility: financial audit, compliance audit and performance audit.

In an annual **financial audit**, SAIs usually evaluate whether the financial statements of government entities are presenting a true and fair view of their operations.

In an annual **regularity audit** (also called **compliance audit**), SAIs assess whether the budget execution is in accordance with the approved budget, and whether the leadership of the authorities being audited are following current ordinances, rules and regulations regarding the legality and regularity of public spending.

Financial and regularity audits may be combined.

In **performance audit** (also called “**value for money audit**”), SAIs evaluate the government entities’ efficiency, effectiveness, and economy in getting good results for their efforts. These audits usually examine whether the audited entity is achieving its goals and the appropriateness of the organisation, operations, process, or function for the purpose. Areas for performance audit are usually selected independently by the SAI based on a set of indicators, risk and materiality evaluations.

All three types of audit are usually conducted based on the international audit standards and guidance of the International Standards of Supreme Audit Institutions (ISSAI), which are laid down by the International Organisation of Supreme Audit Institutions (INTOSAI).

The importance of these activities of SAIs are also recognised in the OECD Recommendation on Budgetary Governance (2015), in particular budget principle no. 10 which states that governments should “promote the integrity and quality of budgetary forecasts, fiscal plans and budgetary implementation through rigorous quality assurance including independent audit”, including through “promoting the role of both the internal and external control systems in auditing the cost-effectiveness of individual programmes and in assessing the quality of performance accountability and governance frameworks more generally”.

The ECA’s reports are public documents, communicated to the European Commission, European Parliament, and member states. These reports cover a range of different topics:

- The implementation of the EU budget and European Development Fund is discussed in the **Annual Report**, published in November each year;
- **Specific annual reports** present the results of the annual audits of EU agencies, joint undertakings and other decentralised bodies;
- Policies and management issues selected independently by the ECA for audit are discussed in **Special Reports**. The ECA tries to cover different budgetary and management areas, each year and undertakes verifications in different member states. In 2014 and 2015, the ECA published 24 and 22 special reports respectively.

4.1.1. Financial and compliance audits

Financial and compliance audits have historically been the core activity of the ECA. The results of these audits indeed play a crucial role in the European Parliament's decision whether to grant discharge to the Commission for its implementation of the EU budget.

The main component of the ECA's Annual reports is therefore the *Statement of Assurance* on the reliability of the EU's accounts and the legality and regularity of the transactions underlying them.

Since 2007, the ECA gives a clear opinion on the reliability of the EU accounts, with, however, an adverse opinion in respects of the legality and regularity of EU payments, which are affected by errors over the materiality level of 2%.

Although the European Parliament has granted discharge to the European Commission for its implementation of the EU budget since 1998, the adverse opinion on EU payments has tended to attract most attention over the years both from the Commission and member states. A number of corrective measures, improvements in control systems, and simplification of the administrative rules have been introduced in an attempt to reduce this error rate.

Auditing for Performance and Results

The OECD recommendation on Budgetary Governance provides, at principle no. 10, that internal and external control systems have a role to play “in auditing the cost-effectiveness of individual programmes and in assessing the quality of performance accountability and governance frameworks more generally”. The assessment of performance and value for money achieved from EU budget has assumed a heightened prominence in the ECA's work over recent years, in keeping with the Commission's stronger focus upon achieving – and reporting upon – results from the EU budget. The ECA assessment of the performance of EU spending is discussed in two sets of reports. Firstly, the *special reports*: While these are not dedicated to discussing specifically performance, the ECA has placed a stronger focus on results in assessing the principles of sound financial management in these audits over time. Secondly, in the *Annual reports*, Chapter III (previously Chapter X) discusses the quality of the EU performance framework, from a different angle each year and summarises some of the main performance issues arising from the ECA's *special reports* (see Box 4.2).

Box 4.2. ECA Annual Reporting on Results from the EU Budget

In the Annual Report concerning the financial year 2013, Chapter X Getting results from the EU budget is comprised of three sections.

1. *Part 1 Focus on Performance* mainly discusses the mechanics of the EU budget, in particular its focus on the absorption of member states' yearly allocation and compliance of spending.
2. *Part 2 The Commission's reporting on performance* discusses the Commission's performance information and identifies a number of gaps and inconsistencies in this area.
3. *Part 3 Results of the Court's audit on performance* summarises the findings of special reports and includes a follow-up of previous recommendations by the ECA.

In the Annual report concerning the financial year 2014, Chapter III *Getting results from the EU budget* is developed further and comprised of four sections.

Box 4.2. ECA Annual Reporting on Results from the EU Budget (cont.)

1. *Part 1 The Europe 2020 strategy and monitoring and reporting by the Commission* discusses the “priorities” set by the Commission, their disconnection from the budgetary cycle and limited operational impact, both at the EU and national levels, as well as the difficulties for reporting on achievements against these targets.
2. *Part 2 How Europe 2020 objectives are reflected in member states’ partnership agreements and programmes* discusses the disconnection between the Europe 2020’s objectives and those set out in partnerships agreements and programmes, the positive introduction of “common indicators” for each fund, and other weaknesses in the design of the performance framework, including the need for focus on result in the partnerships agreements.
3. *Part 3 The Commission’s reporting on Performance* discusses the guidance to DGs with regard to performance reporting and possible improvements to the reports established by the DGs.
4. *Part 4 Results of our audit on performance* summarises the findings of special reports and realises a follow-up of previous recommendations by the ECA.

In an annual financial audit, SAIs usually evaluate whether the financial statements of government entities are presenting a true and fair view of their operations.

Source: ECA website ([www.eca.europa.eu/en/Pages/AuditReportsOpinions.aspx?ty=Annual Report&tab=tab2](http://www.eca.europa.eu/en/Pages/AuditReportsOpinions.aspx?ty=Annual%20Report&tab=tab2)).

Because of the specific features of the EU budget system (including the seven-year MFF, mid-term and final reviews), the planning and duration of performance audits may substantially compromise their relevance, their interest to stakeholders and, as a result, their usefulness and impact. In this context, the ECA has made sustained efforts over recent years to reduce the duration of its performance audits (“13 months rule”). A number of performance audits have been scheduled for completion before the mid-term review of the MFF in order to maximise their impact.

4.2.1. How well is ECA performance auditing integrated within the EU system of performance budgeting?

The rigorous attention of the ECA to the performance dimensions of the EU budget represents one of the features of the EU budget system that is comparatively advanced and sophisticated, in international terms. Despite this increased focus on performance audit over recent years, the ECA’s performance audits are not yet at a stage where they can be regarded as fully integrated within the EU framework of budgeting for results. Firstly, the ECA is not yet in a position to furnish an opinion on the performance framework as a whole (the *Annual reports’* Chapter III discusses different areas of the performance framework each year). Secondly, the ECA’s assessments of the performance of EU spending and management are distributed among various special reports, which are prepared on a stand-alone basis. Lastly, the ECA does not scrutinise the full set of performance data produced by the European Commission each year. Only a sample of DGs’ *Annual Activity Reports* is reviewed annually and performance figures included in the European Commission’s Article 318 Report (now the *Annual Management and Performance Report, AMPR*) are not commented upon.

This situation is not unique to the ECA, and reflects the comparatively under-developed nature of performance auditing, relative to traditional financial auditing, internationally; reflected also in the fact that practices with regard to auditing of governments’ performance measurement systems are not regulated by international audit standards (see Box 4.4 below).

As highlighted by a recent survey, in OECD countries, the most common practices for external auditors involve the conduct of performance or value-for-money audits of their own design. Just over half of the countries surveyed reported that the external auditors always “assess or critique” the quality of the performance information used in the budget, and even fewer audit the achievement of performance objectives and targets in the year-end reporting (see Box 4.3).

Box 4.3. Role of external auditors in performance budgeting systems

	Audit financial information of public bodies	Conduct “performance audits” or “VFM audits”	Audit the achievement of performance objectives	Assess the quality of performance information	Assess the quality of the “programme logic models” being used	Assess the performance budgeting system and may recommend reforms
Australia	●	●	▲	►	►	▲
Austria	●	●	+	+	+	+
Belgium	▲	▲	▲	+	+	■
Czech Republic	+	■	■	■	■	■
Chile	●	■	■	■	■	■
Estonia	▲	+	+	+	●	●
Finland	●	+	●	+	+	+
France	●	+	■	●	▲	▲
Hungary	●	+	■	+	■	▲
Iceland	+	▲	■	■	■	■
Ireland	●	▲	■	■	■	■
Italy	●	►	►	■	■	■
Japan	●	●	+	+	▲	▲
Korea	●	+	●	●	●	+
Mexico	●	●	●	●	●	+
New Zealand	●	+	+	+	■	►
Norway	●	●	●	+	▲	▲
Poland	●	▲	►	▲	▲	▲
Slovenia	●	+	▲	▲	▲	►
Spain	●	■	■	■	■	■
Sweden	●	+	▲	+	+	►
Switzerland	+	▲	►	■	►	■
The Netherlands	●	+	+	+	▲	▲
Turkey	●	▲	+	+	■	▲
United States	+	▲	►	►	►	►
United Kingdom	●	●	●	●	▲	●
OECD Total						
● Always	20	6	5	3	4	2
+ Often	4	9	5	11	4	4
▲ Sometimes	2	7	5	3	6	8
► Seldom	0	1	4	2	3	4
■ Never	0	3	7	7	9	8

Source: OECD (2014), Mini-Survey on Supreme Audit Institutions and Performance-related Budgeting.

StatLink  <http://dx.doi.org/10.1787/888933248766>

Box 4.4. Links between Performance Budgeting and Performance Auditing

While financial audits are usually undertaken according to fixed and well-recognised standards, performance auditing is more flexible. The International Organisation of Supreme Audit Institutions (INTOSAI) has issued a standards and guideline document (Standards and guidelines for performance auditing based on INTOSAI’s Auditing Standards and Practical Experience, ISSAI 3000) that discusses performance audits and how these can relate to measurement by the Government of its own performance. With regard to the latter, the standards and guidelines document only sets out that external auditors might be involved in the check on the quality of performance-related information produced by the executive branch for the legislature.

According to the ISSAI 3000, “(...) one topic for performance auditing is whether performance measurement systems in government programmes are efficient and effective.

Box 4.4. **Links between Performance Budgeting and Performance Auditing** (cont.)

For example, questions could be developed that address whether the performance indicators measure the right things or whether the performance measurement systems involved are capable of providing credible measured results.” The standard does not specify, though, if this “quality check” should be undertaken regularly – that is annually, before the Government presents its performance information (either in the financial statements or in a dedicated report).

Therefore, while SAIs in OECD countries invariably have a statutory role in auditing the accounts of public entities and undertaking regular performance audits, comparisons between practices in different countries on auditing the governments’ own performance measurement system show variations in audits performed and methods used.

In France, performance budgeting started in the 2000s. Since then, the Court of Audit (Cour des comptes – CC) annually performs a review of ministries’ key performance indicators. The methodology developed by the CC mentions that auditors should assess i) the indicators’ relevance; ii) their consistency over time; and iii) their usefulness (i.e. “is the performance indicator used for improving the efficiency or effectiveness of a given public policy?”). Auditors are also asked to comment on the performance achieved by each ministry over the year.

In the Netherlands, since the 1990s, the Ministry of Finance obliges line ministries to evaluate their own policy areas once every 4-7 years (so-called policy reviews). The Court of Audit (Algemene Rekenkamer – AR) devotes about half of its time to performance audits – that is 10 to 15 reports per year and numerous other products such as fact sheets and letters to Parliament. In the performance audits, an important source of information are policies reviews’ evaluation, analysis, and conclusions of the ministries themselves, which allows the AR to assess whether policy reviews provide relevant and reliable information on the effectiveness and efficiency of spending. The performance audits are published during the year. In May the AR publishes its reports on the annual accounts of the ministries. Their focus is evolving from regularity spending to assessment of value for money.

In Sweden, the National Audit Office (Riksrevisionen), in addition to providing an assessment on whether agencies’ accounts are in accordance with the Budget Act, attests whether their annual reports contain factually correct qualitative information on performance. That is, where agencies report information on performance outputs and outcomes, the Riksrevisionen verifies that there is evidence in place to support the claim.

In the United Kingdom, with the introduction of the Public Service Agreements (PSAs) in 2002, the National Audit Office (NAO) evaluated the quality of PSA targets and data used to measure progress toward targets. This aspect of the NAO’s role was integrated in a phased approach, beginning with trial departments, and within five years covering all major government departments. It was later adapted as the UK government dropped PSAs and put a system of departmental Business Plans in their place (2010). These Business Plans were themselves dropped in 2015 – the NAO will publish in 2016 a report examining the Government’s recent development of Single Departmental Plans (SDPs) as a new tool for setting objectives, planning and reporting performance across government. As SDPs are still in their infancy, the NAO has yet to set out any plans for assurance work on this new set of performance indicators.

Overall, findings of national SAIs include issues relating to the relevance of the indicators on the effectiveness and efficiency of spending and quality of the performance evaluation data. Therefore, some SAIs prefer to define their own indicators for assessing the performance of a given policy, rather than rely upon those supplied by the executive.

This situation may also be attributable to the lack of formal, standardised assurance frameworks on the performance data corresponding to those in place for financial data – in other words, the prerequisites for the standardised and systematic audit of performance information are not met in most countries.

Against this background, leading practices with regard to the role of external auditors in performance budgeting systems include those of France and Sweden, where annual verifications of performance information provided in budget documents are undertaken by external auditors:

- a) In **France**, performance budgeting was initiated in the 2000s. Since then, the Court of Audit (*Cour des comptes*) annually performs a review of each ministry's key performance indicators. The methodology developed by the Court of Audit specifies that auditors should assess i) the indicators' relevance; ii) their consistency over time; and iii) their usefulness (i.e. "is the performance indicator used for improving the efficiency or effectiveness of a given public policy?") Auditors are also asked to comment on the performance achieved by each ministry over the year.
- b) In **Sweden**, the National Audit Office (*Riksrevisionen*), in addition to providing an assessment on whether agencies' accounts are in accordance with the Budget Act, attests whether their annual reports contain factually correct qualitative information on performance. That is, where agencies report information on performance outputs and outcomes, the *Riksrevisionen* verifies that there is evidence in place to support the claim.

4.3. Co-ordination of the ECA and national supreme audit institutions

It is not within the mandate of the ECA to express an opinion on the use of EU funds in individual member states.⁷ Therefore, the significant part of the EU budget that is spent via national programmes is not submitted to the ECA's performance audits.

The SAIs of most member states carry out audits on EU programmes, either because they are mandated to so by their Parliament, or because they have independently decided to include that topic on their work programme.⁸⁹

In general terms and in keeping with the ECA's own findings, these national audits have found that little information was available on the outcomes and impacts achieved through EU funding and EU policies either in the Government's units in charge of managing the EU funds, or in the national performance framework.

However, the performance audit of EU funds spent at national level remains scattered. To address this, co-operation between SAIs has increased. For example:

- In 2014, the ECA's examination of a sample of Partnership Agreements and Programmes was undertaken jointly with in partnership with the SAIs of Poland and Spain: The co-operation included parallel audit work, the exchange of planning documents and findings, and activities aimed at sharing knowledge and experiences.
- In 2015, a mandate was agreed by the Contact Committee of the Supreme Audit Institutions of the European Union to the Working Group on Structural Funds for carrying out a parallel audit on the "Contribution of the Structural Funds to the Europe 2020 strategy in the areas of education and/or employment".

However, there would appear to be scope for further collaborative work among SAIs, e.g. by promoting the input of national SAIs in annual declarations of national authorities certifying that EU moneys have been used properly.¹⁰ These national declarations could

indeed include a section on performance with a reference to the findings, if any, of the national SAI.

External auditors have an important role to play in providing independent verification of the performance information presented to Parliaments – that is both producing their own evaluation of the governments’ implementation of its policies and increasing the legitimacy and trust in performance information produced by other stakeholders across the system.

4.4. How might the role of the ECA in performance budgeting be enhanced?

Among stakeholders in the EU, the role of the ECA is highly valued, and the ECA’s capacity for conducting financial, compliance and performance audit is considered a primary source of information for the Budgetary Authority. However, the ECA’s capacity to increase the trust in performance information generated throughout the budget process is limited, to the extent that the ECA is not in a position to provide annual quality assurance on the performance data system as a whole – a limitation that is a characteristic of the stage of development of performance auditing internationally.

However, there is scope for the ECA to draw upon international practices to maximise the relevance and impact of its audit activities related to the EU performance budgeting framework. For example, subject to discussions and agreement with the Commission on issues of practicability and procedure, certain basic criteria regarding the quality of performance data could be more clearly specified and centralised: This would include issues such as the traceability of performance data and quality controls in the measurement of outcomes and/or impacts. Such standards would be prerequisites for a move towards annual verification by the ECA of the relevance and accuracy of the key performance figures/headline targets reported in the AMPR (or in the evolved/systematised version of the AMPR proposed in the previous section).

Taken together, these developments would tend to i) encourage the development of more robust and appropriate performance measures supported with accurate and up-to-date data ii) increase the confidence and interest of the Budgetary Authority in this information, and iii) promote a more integrated and systematic approach to the use and audit of performance data in the EU budget. Such an approach should also help to shift the Budgetary Authority’s traditional emphasis upon proxy issues such as “absorption rates” (the extent to which financial allocations are successfully “drawn down” and spent) and “error rates” (measures of waste and misuse of funds), in favour of substantive issues of performance and policy impact.

Over the medium to long term, deepening the co-operation between the ECA and EU member countries’ appears desirable, including with regard to comparison of national and EU programmes’ performance indicators and performance data quality.

In addition, the annual declarations of national authorities certifying that EU moneys have been used properly could include a section on performance with a reference to the findings, if any, of the national SAI.

Notes

1. At the time of their work in preparing this report, Mr Shaw and Ms Léon were working on secondment to the Budgeting and Public Expenditures Division, OECD (respectively from the Office of the Parliamentary Budget Officer of Canada, and the European Commission). Mr Blondal and Mr Downes are respectively Head and Deputy Head of this division. Mr Areosa Feio is a Counsellor with the Portuguese Delegation to the OECD. The information and views set out in this report are those of the authors and do not necessarily reflect the official views of the OECD member countries or the European Union.

2. <http://ec.europa.eu/eurostat/web/europe-2020-indicators>.
3. IIA of 2 December 2013 (2013/C 373/01).
4. IIA of 13 April 2016 (OJ L 123 12.5.2016, p.1-214).
5. COM(2015) 215 final, 19.5.2015.
6. The consolidated financial statements are established by the European Commission's Directorate for Budget.
7. ECA annual and special reports therefore do not include an opinion on the efficiency and effectiveness of EU programmes implemented in the member states.
8. One example of such audits is the Dutch Court of Audit's EU Trend Report 2016: Developments in the financial management of the European Union.
9. In the United Kingdom, the Parliament's Committee of Public Accounts, following a briefing by the NAO on the financial management of the EU budget (report on Financial management of the European Union Budget in 2014: a briefing for the Committee of Public Accounts) have recommended that "HM Treasury (...) publish a strategy for using EU funds in the UK, setting out the performance and value for money expected from this spending".
10. It is to be noted that only three SAIs (those of Denmark, the Netherlands and Sweden) currently audit such national declarations.

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ANNEX A

Budget focused on results

The EU at present is experiencing lower levels of economic growth than in past decades, with lower revenues available to support traditional budget expectations; budgetary pressures from a range of complex social pressures and fiscal risks; and increasing demands from citizens and stakeholders for assurances about the impacts and efficiency of public spending.

Against this background, the **EU Budget Focused on Results initiative** was launched in 2015 to accentuate the performance aspects of the EU budget system, in order to improve accountability and public trust, and to maximise the impact of limited EU resources. The President of the Commission, Mr Juncker, made it a priority that the Commission should “*demonstrate the value added of the EU budget and contribute to a stronger performance culture in relation to the EU budget, including by enhancing performance-based budgeting across the Commission.*” In order to succeed, this objective required close co-ordination within the Commission and ownership by the various actors involved. For this purpose a Network of Commissioners on “EU Budget Focused on Results” was created under the chair of Commission’s then-Vice-President Ms Georgieva, to provide the political steer, leadership and co-ordination. The network agreed on an overall strategy encompassing three strands: 1) In what areas does the EU spend, 2) how does it spend and 3) how is it assessed? The network agreed to pay particular attention to communication on the EU budget. In addition, technical meetings are held with representatives from Parliament, Council, Commission, Member States, the Court of Auditors and other stakeholders.

In order to follow a clear and realistic approach to overall performance and budget performance issues, the EU Budget Focused on Results initiative aims to address EU budget decision-making *ex ante* (i.e. prior implementation) and *ex post* (i.e. based on implementation). **Ex ante** measures aim to reinforce the performance-informed decision-making process by ensuring delivery of results that matter to citizens, the best possible monitoring and measurement of performance against the indicators set out in programme statements and work programmes and improving the use of performance information in the management of the EU Budget. **Ex post** measures focus on management of the residual error rate through implementation of cost-effective controls in view of setting a benchmark for a reasonable risk of error per area of activity/programme and thus also achieving better budget performance.

The EU BFOR initiative is carried forward through **six main “operational workstreams”**:

1. Simplification

The objective is to continue the administrative simplification of EU funding following-up on the Simplification Scoreboard which accompanied the negotiations on the legal bases under the MFF 2014-2020.

2. Indicators

Under the MFF 2014-2020, performance indicators are defined in the programmes' legal bases and delegated/implementing acts. The objective is to analyse these indicators to identify those that provide evidence for the MFF policies and their results against main stakeholders' expectations and can be used to communicate better on the achievements of the EU budget. In doing so, the process will widen the management of priorities from expenditure, control and compliance to a greater focus on performance.

3. Cost-effectiveness of controls

Inefficient control systems misuse resources, which would otherwise contribute to the achievement of results. Furthermore, they impose a significant administrative burden on beneficiaries and discourage participation to the programmes. Thus, ensuring the cost-effectiveness of the control systems for managing legality and regularity risks is a key factor for improving performance. The objective is a process to assess and improve the management and control systems at both Member States and Commission levels. This would allow reallocating resources to those controls yielding the most benefits while appropriately managing legality and regularity risks within the risk environment set in the regulatory framework.

4. Discharge and declaration of assurance

The Commission intends to continue to develop its methodology to estimate the amounts at risk with the budget implementation, to simplify the rules and improve the cost-efficiency of controls, and to estimate on this basis the appropriate residual error rate corresponding to sound financial management for each policy area and the corresponding materiality threshold. This should lead to a substantiated basis for a positive assessment by the Discharge authority.

5. Project database

A search tool is being developed, based on existing project databases covering the main spending Directorates General of the Commission and those with projects closer to the citizen (e.g. agriculture, development co-operation, education and culture, humanitarian aid, employment, growth, maritime affairs, neighbourhood policy, regional policy, research and development) and presenting data on individual project funding, objectives, results and impacts as well as information on the beneficiaries. The project results website is: <http://ec.europa.eu/budget/euprojects>. It should improve public communication on the EU budget, allowing citizens better to see the impact of EU-financed initiatives on their lives. Furthermore, this exercise should reinforce the provision of information on the societal impact of policies and programmes.

6. External communication on EU budget focused on results

The overall objective of this work-stream is to improve communication on EU budget along the taxpayers and beneficiaries' expectations of effectiveness, added value, efficiency and, accessibility of EU funds. So far, it has resulted for example in:

- ❖ Annual Conferences on EU Budget Focused on Results to communicate about the increased focus on performance in the EU budget and create a common ground for all actors responsible for the implementation of the budget allowing exchange of views and best practices.

- ❖ Experts meetings on Performance-Based Budgeting in operation since 2015, gathering the Institutions involved in the budgetary process (Commission, Parliament, Council, and Court of Auditors) with the objective to create a shared understanding of the performance-based budget concept, its key features, the role and responsibilities of EU Institutions and Member States in ensuring EU budget implementation.

Current developments on the EU Budget Focused on Results can be found at: <http://ec.europa.eu/budget/budget4results>.

ANNEX B

Legal and institutional context of the EU budget framework

The European Union (EU) comprises 28 sovereign member states with over 500 million inhabitants. The EU's key objectives, as set out in its founding Treaties, include promoting peace and fostering "ever closer union" among the peoples of Europe; ensuring economic and social progress by overcoming barriers, particularly to trade and commerce; promoting balanced regional development; and continually improving people's living and working standards and overall well-being.

As a multi-national political and administrative entity, involving some prescribed elements of "pooled sovereignty" as well as inter-governmental action in areas of collective interest, the EU is perhaps unique in global terms. The EU budget process in particular reflects this unique character, combining features common to sovereign national budgeting, with elements that support the distinct relationships of accountability and inter-dependence between the EU and its constituent countries. The EU budget in 2017 amounts to EUR 158 billion, representing about 1% of EU-wide GDP and 2% of overall public expenditure in the region.

Legal and institutional aspects of EU budgeting

The EU is founded upon two treaties, the "Treaty on the Functioning of the European Union" (TFEU) which is the successor to the original 1957 "Treaty of Rome", and the "Treaty on the European Union" (TEU) – together referred to as "the Treaties". The Treaties specify the areas of competence where the EU is authorised to pursue actions: Either "exclusive competence" where only the EU may act (e.g. the customs union, the regulation of the EU internal market); "shared competence" where member states may legislate to the extent that the EU has not done so (e.g. agriculture and fisheries) and where, in general terms, implementation is carried out jointly by both the EU and the member states or regions; or certain other areas where the EU may act in support of member states (e.g. health).

The EU acts through its institutions. The key institutions of relevance to the budget process are as follows:

- the **European Commission ("Commission")** functions as the executive arm of the EU for most areas of EU competence
- the **European Parliament ("Parliament")** is a legislative assembly elected on a proportional basis by the citizens of the EU

- the **Council of the European Union (“Council”)** brings together the representatives of national governments, and is a “co-legislator” and “joint budget authority” alongside the Parliament.
- the **European Council** (not to be confused with the Council mentioned above) comprises the heads of state or government of EU member states, and provides political direction for the work of the EU
- the **European Court of Auditors (ECA)** is a “supreme audit institution” which audits the accounts and assesses qualitative aspects of the EU budget and prepares reports for the Parliament, and
- the **European Court of Justice (ECJ)** is a “supreme court” which resolves disputes relating to EU law, and to the interaction of EU and national laws.

EU legislation takes the form of Directives (which must be “transposed” or written by member states into their national laws), Regulations (which apply directly at national level) and Decisions (which apply in specific cases). The Commission alone has the right of initiative in bringing forward such legislative proposals. EU legislation is considered by both the Parliament and the Council and is adopted if approved by both bodies, following a procedure that allows for amendments and conciliation between the two institutions.

The EU’s budget procedure is a distinct legislative process grounded on **Title 2 TFEU – Financial Provisions** (Articles 310-324). The procedure is notable, among other reasons, for the clear legal grounding in principles, including sound financial management. In addition to specifying the procedural steps for adopting the budget, the Treaty provisions lay down a number of key features of the EU budget process, including the following:

- Authority:** The Parliament and Council establish the EU’s annual budget, acting on the basis of a Commission proposal
- Multi-annuality:** The budget takes place within a multiannual framework, which sets out annual budget ceilings for the main sectoral categories of expenditure for a period of at least 5 years
- Soundness:** “the budget shall be implemented in accordance with the principle of sound financial management”
- Responsibility:** The Commission implements the budget “on its own responsibility”
- Cooperation:** Member states co-operate with the Commission in implementing the budget and in ensuring that the principles of sound financial management are upheld
- Accountability:** The Commission submits annual accounts regarding the preceding year’s budget implementation along with a financial statement of assets and liabilities, and also an “evaluation report on the Union’s finances based on the results achieved” (Article 318)
- Discharge:** Parliament, acting on a recommendation from the Council, gives a discharge to the Commission regarding implementation of the budget, on the basis of consideration of *inter alia* the above-mentioned reports and the annual report of the ECA.

A **Financial Regulation**¹ provides much more specific detail regarding issues of presentation, implementation and accounting for the EU budget. Of particular relevance for the purposes of this report, the Regulation provides in Article 30 that appropriations shall be used in accordance with the principle of sound financial management, “namely in accordance with the principles of economy, efficiency and effectiveness”.² The Article goes on to specify as follows:

- The principle of effectiveness concerns the attainment of the specific objectives set and the achievement of the intended results.
- Specific, measurable, achievable, relevant and timed objectives³ shall be set for all sectors of activity covered by the budget. The achievement of those objectives shall be monitored by performance indicators for each activity, and the information referred to in point e) of Article 38(3)⁴ shall be provided by the spending authorities to the European Parliament and the Council. That information shall be provided annually and at the latest in the documents accompanying the draft budget.
- In order to improve decision-making, institutions shall undertake both *ex ante* and *ex post* evaluations in line with guidance provided by the Commission. Such evaluations shall be applied to all programmes and activities which entail significant spending and evaluation results shall be disseminated to the European Parliament, the Council and spending administrative authorities.

EU budgeting is strongly multi-annual in character

While the EU budget has a well-defined annual procedure (as outlined below), in practice the EU process is marked by a strong multi-annual dimension which governs the annual processes of resource allocation, to a degree unmatched in any EU member state or OECD country. Since 1988, **Multiannual Financial Frameworks (MFF)** lay down the maximum annual amounts (“ceilings”) which the EU may spend in different policy fields (“headings”) over a period of at least 5 years. These multiannual ceilings are adopted by the EU member states via a Council Regulation and implemented on the basis of an Interinstitutional Agreement between the Council, the Commission and the Parliament. Five MFFs have been adopted since 1988: “Paquet Delors” I (1988-1992), “Paquet Delors” II (1993-1999), “Agenda 2000” (2000-2006), MFF 2007-2013 and MFF 2014-2020, which is ongoing with overall ceilings of EUR 960 billion (commitment appropriations) and EUR 908 billion (payment appropriations).

The present MFF is currently the subject of a scheduled mid-term review which provides an opportunity for political re-assessment of spending priorities over the remainder of the MFF period.

The annual budget procedure follows a well-specified course

Within the ceilings laid down in the MFF and taking account of the budget guidelines provided by the Parliament and Council for the coming year, the European Commission prepares the draft annual budget and submits it for the approval of the Council and the Parliament, which together form the European budgetary authority. Over the decades since the EU’s inception, Parliament’s role in the budgetary process has gradually been enhanced. The Lisbon Treaty, signed in 2007 and in effect since 2009, gives Parliament an equal say with the Council in the entire EU budget.

Over the years, the budget approval procedure has also been simplified and now consists of four stages.

- In **Stage 1** the Parliament and the Council provide guidelines on their priorities for the budget and the Commission draws up a draft budget by 1 September.
- At **Stage 2** the Council adopts its position on the draft budget and forwards it to the Parliament by 1 October.

- **Stage 3** is Parliament's reading, where it has 42 days
either
 - ❖ to approve the Council's position or to decline to take a decision, in which case the budget is deemed finally adopted
 - or
 - ❖ to send an amended draft back to the Council and the Commission. In such a case, the Parliament and the Council must then immediately convene a meeting of the **Conciliation Committee** (composed of an equal number of representatives from both institutions).
- At **Stage 4** the Conciliation Committee has 21 days to agree on a joint text. If the procedure is successfully completed, the President of the Parliament declares that the budget has been definitively adopted.

In practice, the most substantial changes to the budget occur during **Stage 2** when the Council is negotiating with the Commission. By the time the Parliament is involved at **Stage 3**, much of the groundwork for designing and specifying the details of the budget has already been undertaken. At this stage, it is most usual for the Parliament to approve the budget after a number of smaller amendments are adopted. However, the Parliament has rejected the budget as a whole on two occasions (in December 1979 and December 1984) since acquiring the power to do so in 1975. Under the new rules agreed in the Lisbon Treaty, the Conciliation Committee has also failed to reach agreement three times (on the 2011, 2013 and 2015 budgets). In all three cases, the new draft budget presented by the Commission, reflecting the near-compromise in conciliation, was finally adopted.

The **implementation phase** of the EU budget is carried through mostly by the EU member states and the European Commission. On average, 80% of the EU budget is allocated to the EU Member States to implement via the process of "shared management". The European Commission itself directly pays out only a relatively small part of the EU budget. However, as Article 317 makes clear, the Commission bears the ultimate responsibility for the implementation of the entire annual budget of the EU. Member states are required to co-operate with the Commission in ensuring that the resources are used in accordance with the principles of sound financial management. All actors involved in implementing the EU budget have to observe a comprehensive set of rules defined by the EU legislator.

The annual budget **discharge** procedure examines how the European Commission implements the EU's annual budget. It verifies whether implementation was carried out in accordance with relevant rules (compliance), including the principles of sound financial management (performance seen as economy, efficiency and effectiveness) and looking at inputs, outputs, results and impacts. On the recommendation of the Council of the EU, the Commission is given discharge by the European Parliament on the implementation of the annual budget, having considered a range of accountability reports. For this purpose the Council and the Parliament examine:

- the EU's accounts for the financial year in question, as prepared by the Commission;
- the financial statement;
- the Synthesis Report on the Commission's management activities;
- the Evaluation Report on the EU's finances based on the results achieved (Art 318 TFEU)⁵
- the Annual Report and the Statement of Assurance by the European Court of Auditors
 - ❖ the Annual Report includes a special chapter on: "Getting Results from the EU Budget".

The discharge decision formally “releases” the Commission from its responsibility for managing a given year’s budget. The Commission may however be obliged to provide follow-up reports informing about its actions in response to issues specified in the statement of discharge.

The EU Budget includes some limited flexibility mechanisms

While multi-annual budgeting has several advantages, especially in providing medium-term assurance regarding resource availability and thereby promoting effective planning, it also carries some heavy disadvantages. Chief among these is the relative lack of responsiveness, i.e. reduced freedom of action for policy-makers to reallocate resources from one area to another, from year to year, in response to emerging policy priorities and exigencies.

To mitigate this limitation, the EU system includes a number of specific mechanisms aimed at allowing for a degree of flexibility from year to year. It is notable that most of these mechanisms are overlaid upon the MFF, rather than integrated within it. The flexibility mechanisms are summarised below.

- a) **Emergency Aid Reserve – maximum EUR 280 million per year:** The Emergency Aid Reserve is designed as a rapid-response fund to provide humanitarian aid in unforeseen crisis situations.
- b) **Solidarity Fund – maximum EUR 500 million per year:** The EU Solidarity Fund is a rapid-response emergency aid fund available for EU member states and candidate countries.
- c) **Flexibility instrument – maximum EUR 471 million per year:** The Flexibility instrument allows for funding for specific, unavoidable expenses that cannot be covered elsewhere in the EU budget.
- d) **European Globalisation Adjustment Fund – maximum EUR 150 million per year:** The European Globalisation Fund aims to help workers reintegrate into the labour market after they have lost their jobs due to major structural changes in world trade patterns.

In addition to these pre-existing instruments, the following **new flexibility measures** have been introduced in the MFF 2014-20:

- e) **Flexibility for payments:** Under certain conditions, unused payment appropriations and margins can be carried over from one financial year to the next, while adjusting the payment ceiling in other years so that the overall ceiling remains unchanged.
- f) **Flexibility for commitments in growth and employment:** Commitment appropriations left unused in 2014-17 will form a reserve for additional expenditure in 2016-20 in the area of growth and employment (in particular for youth employment).
- g) **Special flexibility for youth employment and research:** In order to concentrate a maximum of funds where they are the most needed as early as possible, up to EUR 2.1 billion could be brought forward to 2014-15 for the Youth Employment Initiative and up to EUR 400 million for research, Erasmus and SMEs.
- h) **Flexibility for aid to the most deprived:** On a voluntary basis, Member States can increase their allocation for aid to the most needy by EUR 1 billion.
- i) **Contingency Margin:** This is an instrument of last resort, used as required in reaction to unforeseen circumstances, and amounts to 0.03% of the EU’s gross national income (GNI).
- j) **Performance reserve:** While not explicitly recognised as a flexibility measure in the MFF, the regulations covering EU Structural and Investment Funds (see Annex C) provide that

6% of the allocation for priorities under these Funds is allocated to a performance reserve, and may be made available for reallocation to other priorities based on results of a performance review.

Performance information is designed into the EU Budget

As outlined above, the Financial Regulation lays down requirements regarding the type of information that should be included with the draft budget. These information requirements are designed *inter alia* to promote transparency regarding the objectives that justify the budget allocations. In practice, the budgetary documentation provided by the Commission is extremely comprehensive and voluminous. Along with the 2017 draft budget (June 2016) which shows the detailed financial allocations down to line item level, the Commission submitted eleven working documents in compliance with its obligations under the Treaties and the Financial Regulation. The first of these, “Programme Statements of operational expenditure”, provides extensive information about performance, outputs and evaluative material. The draft budget (“Statement of Estimates of the European Commission for the financial year 2017”) runs to over 600 pages, while the working paper on “Programme Statements” runs to less than 500 pages. The other budget-related working documents vary widely in size, with some smaller documents and with one report on the various EU agencies also running to over 600 pages.

The structure of the Programme Statements is intended to facilitate a contextualised, informed consideration of the strategic, financial and performance aspects of budgetary allocations. Box B.1 overleaf provides a summary of the type of information provided for each Programme.

Box B.1. Information provided by the European Commission in “Programme Statements”

I. Programme update:

- Implementation status: A short introductory outline of how the Programme is being put into effect, with some key facts and figures about the sub-programmes
- Key achievements: Brief narrative on what has been accomplished under each sub-programme
- Evaluation/studies conducted: Summary of evaluations completed that are relevant to the budgetary consideration of the Programme, including précis of key conclusions
- Forthcoming implementation: Measures envisaged for programme implementation in coming years

II. Programme key facts and performance framework

- Financial programming: The legal basis of expenditure, overall allocation and annual financial ceilings for the 7-year MFF period
- Implementation rates: Percentage of allocated expenditure actually spent in the previous two years. This “absorption rate” is a commonly used, broad proxy indicator of programme implementation.
- Contribution to EU strategies:
 - ❖ EU added value: Explaining why there is a rationale for policy action at EU-level rather than at the level of individual member countries

Box B.1. Information provided by the European Commission in “Programme Statements” (cont.)

- ❖ Contribution to EU 2020 headline targets: A recap of the strategic targets relevant for this programme (where relevant)
- ❖ Contribution to EU 2020 priorities: The level of resources allocated via this Programme to the relevant EU 2020 priorities (where relevant)
- ❖ Contribution to mainstreaming of cross-cutting issues: The level of resources allocated via this Programme to the relevant objectives/outputs of the cross-cutting programmes in the areas of climate change, biodiversity and/or gender equality (where relevant).
- Performance information
 - ❖ General objectives: for the Programme as a whole
 - Baseline: Starting situation is outlined, against which progress is to be assessed
 - Indicator*: For each general objective, one or more SMART annual objectives are set
 - Milestones foreseen: Linkage to key target levels for each indicator at appropriate stages during the 7-year MFF period (or longer period)
 - Actual results: The actual data, using the specified indicators, are shown in each year
 - Target 2022: The desired end-point at the conclusion of the MFF period; or desired long-term goal
 - ❖ Specific objectives: for each of the sub-programmes within the Programme, a similar range of performance information is supplied (baseline, indicator*, milestones etc.)
 - ❖ Expenditure-related outputs: The activities and outputs to be delivered by the Commission and/or implementing bodies, and which are intended to contribute to achieving general/specific objectives
 - ❖ Justification for changes: Explanation of any changes to financial programming or performance information, relative to that presented previously.

* Note that in the absence of results for 2015/2016, most indicators are not yet included under the “general objectives” and “specific objectives” for the 2017 Programme Statements; the Commission has stated its intention that these indicators will be re-integrated from the 2018 edition, as data becomes available.

III. Performance of the predecessor programme

- The results from evaluations of previous iterations of the Programme are presented, summarising lessons learned that have been taken into account in the design of the current programme, including the assessment of EU added value and how it may be promoted.

Better regulation for better results

The EU’s long-standing agenda of Better Regulation aims to ensure that the body of EU laws and procedures agenda are effective in achieving objectives, efficient in doing so, and proportionate as regards “administrative burden”. In its 2015 Communication on “Better Regulation for Better Results”,⁶ the Commission outlined an enhanced, integrated approach to quality in policy-making, grounded in evidence and with clear professional reporting on the expected and actual impacts of policies.

While the focus of Better Regulation has been on assessing the impacts of legislation and policy initiatives, and on cutting down perceived “red tape”, the initiative has not generally been perceived as closely relevant for the budget process. In this regard, practice at EU level has not been greatly different from that in many OECD member countries, where the

regulatory process (with its strong focus on *ex ante* Regulatory Impact Assessment or RIAs) and the expenditure management process (with its comparative focus on *ex post* evaluations) have not traditionally been well-integrated in overall policy-making.⁷

The 2015 re-casting of the EU Better Regulation agenda has the potential to foster a more integrated, holistic approach to assessing results in policy-making. In particular, the 2015 Better Regulation Guidelines and the Better Regulation Toolkit with more specific guidelines, place a clear focus on the need for high-quality, objective, standardised evaluation processes which can report frankly on whether EU policies are achieving results. The standard methodology for conducting evaluations, as set out in the Guidelines, requires assessment against core criteria: Effectiveness, efficiency, coherence with broader EU rules, and EU added value. Indeed, it is notable that the legal foundations for various EU programmes provide explicitly for such evaluations across the policy cycle: For example Article 32 of Regulation No. 1291/2013 establishing Horizon 2020 requires the conduct of an interim evaluation against these core criteria, along with a number of other programme-specific criteria.

As indicated above, the 2016 IIA on Better Law-Making has already triggered a more closely-aligned approach among the institutions on setting the EU's policy agenda. It must be acknowledged however that the thrust of the Better Regulation initiative, even in its most recent form, leans towards assessment and review of EU laws and is not specifically oriented towards using evaluation results as a basis for informing budgetary discussions.

The European semester

The EU's economic governance arrangements have been modified over recent years, including a distinct annual cycle of monitoring, co-ordination and harmonisation of EU-wide policy efforts known as the European Semester. Its main purpose is to strengthen economic policy co-ordination and to allow the EU's policy-makers – at national and EU levels – to draw together policy messages from parallel policy domains such as fiscal and budgetary policy (the Stability and Growth Pact), structural economic reform (principally via the Europe 2020 strategy) and boosting investment. As outlined in Annex C, the management framework for ESI Funds allows for “macroeconomic conditionality”, i.e. the principle of fund availability in member states being linked to compliance with broader economic and fiscal policy guidelines.

Notes

1. Current version is No. 966/2012 effective from 1 January 2016.
2. Financial Regulation Art. 30.1.
3. These criteria are often referred to using the acronym of “SMART” objectives.
4. Article 38(3)(e) relates to annual “activity statements”.
5. As of 2016, the Synthesis Report and the Article 318 report are integrated within an Annual Management and Performance Report. The various accountability documents listed above are discussed in more detail later in this report.
6. COM(2015) 215 final, 19.5.2015.
7. See e.g. OECD (2015), *Public Governance of Inclusive Growth*.

ANNEX C

In focus: Performance and evaluation of ESI funds

The bulk of EU resources are spent at national at regional level, across a wide range of programmes and projects and involving a multiplicity of implementing and oversight bodies at each level – regional, national and EU. Ensuring that the funds are used in a way that supports overall EU goals is a major challenge in such an environment and requires special attention at all stages of the programme and project cycles.

Some major EU Programmes are handled via “direct management”, i.e. the Commission itself is directly responsible for allocation and management of funds. A primary example of this approach is the Horizon 2020 framework programme which allocates funding to research and innovation projects. However, approximately 80% of EU resources are subject to “shared management” arrangements, in which member states and the Commission are jointly responsible for managing the national and regional institutions undertake programme delivery subject to closely regulated monitoring, reporting and evaluation arrangements. The bulk of these “shared management” programmes – representing over half of EU resources – are accounted for by “European Structural and Investment funds” (ESI Funds), which are analysed in more detail in this section, to prove an illustrative case of how performance information is embedded within the design and monitoring of EU programmes.

Performance frameworks for ESI Funds are closely linked to EU 2020

The five ESI Funds have distinct objectives, but share a broad aim of promoting sustainable economic growth and job creation across the EU. The five funds are as follows:

1. the **European Regional Development Fund (ERDF)** promotes balanced development in the regions of the EU
2. the **European Social Fund (ESF)** supports employment in the EU through investment in “human capital” and in projects that support activation and development of the labour force
3. the **Cohesion Fund (CF)** supports economic growth through investment in transport and environmental projects in “catch-up” EU countries
4. the **European Agricultural Fund for Rural Development (EAFRD)** addresses challenges to economic growth and development facing rural areas
5. the **European Maritime and Fisheries Fund (EMFF)** promotes sustainable fishing practices and economic diversification in coastal communities.

In addition to their own specific Regulations, all five funds are governed by a **Common Provisions Regulation** (No. 1303/2013) which recognises that the ESI Funds “should play a significant role in the achievement of the objectives of the Union strategy for smart,

sustainable and inclusive growth”, and which accordingly provides a Common Strategic Framework to promote a co-ordinated management approach designed to support the achievement of these EU goals. The Regulation also outlines the **monitoring and evaluation** arrangements that should be applied.

Box C.1. **Monitoring, Evaluation and Performance Framework for ESI Funds**

The European Structural and Investment (ESI) Funds are subject to a specific monitoring, evaluation and performance framework, which is largely spelled out in the Common Provisions Regulation (No. 1303/2013) and supplemented with more specific provisions in the Regulations specific to each of the five constituent Funds, as summarised below:

- **Thematic and specific objectives:** The Common Provisions Regulation sets out 11 thematic objectives which are designed to support the EU strategy for smart, sustainable and inclusive growth; the individual Regulations provide complementary Fund-specific objectives.
- **Partnership Agreements:** Each EU member state draws up a Partnership Agreement in consultation with key stakeholders (e.g. sub-national governments, civil society bodies) on the basis of dialogue with the Commission. The Agreement takes, as its starting point, the need to support the EU strategy for smart, sustainable and inclusive growth and outlines how the ESI Funds will be used at national and regional level, including the analytical basis for the approaches selected.
- **Ex ante conditionalities:** The Partnership Agreement summarises the member state’s analysis of how the various relevant conditionalities (as laid down in the Regulation as fulfilled) and this analysis is subject to assessment by the Commission.
- **Programmes:** Funding is channelled and managed via specific Programmes – generally referred to as “Operational Programmes” (OPs), or “Rural Development Programme” in the case of the EAFRD Regulation – which break down the overall strategic priorities (as set out in the Partnership Agreement) into investment priorities, specific objectives and concrete actions. Each Programme sets out a strategy for its contribution to the EU strategy for smart, sustainable and inclusive growth.
- **Performance framework:** Each investment priority must be accompanied by milestones (intermediate targets) for the year 2018 as well as final targets for 2023, using the simple format shown below.

Standard format for Performance Framework for each Programme

Priority	Indicator and measurement unit	Milestone for 2018	Target for 2023

- **Performance review:** The Commission conducts a review of the performance of each Programme in 2019 by reference to the performance framework/milestones, using information supplied by member states in their annual implementation report
- **Performance reserve:** As a rule, 6% of ESI Fund allocations under each Partnership Agreement, split across each Programme priority, are set aside in a “performance reserve” which may only be re-released on the basis of a positive performance review. In the case of a negative assessment, the resources will be re-allocated elsewhere by the member state.

Box C.1. Monitoring, Evaluation and Performance Framework for ESI Funds
(cont.)

- **Monitoring & Reporting:** Each Programme is overseen by a Monitoring Committee (including a Commission representative) to review progress towards achieving objectives, including towards milestones. Each Programme is also the subject of an Annual Implementation Report (AIR), including financial and performance data and a synthesis of findings from evaluations. From 2019, the AIR must also report on how the Programme supports the EU strategy for smart, sustainable and inclusive growth. In 2017 and 2019, member states must submit a Progress Report on the Partnership Agreement.
- **Evaluation:** Expert evaluations shall be carried out at all stages of Programme roll-out – *ex ante*, during implementation, and *ex post* – to improve the quality and impact of the Programmes.
- **Political oversight and debate:** The Commission submits an annual “summary report” of Programme performance to Parliament, Council and other institutions based on AIRs and evaluations, and a “strategic report” in both 2017 and 2019 which summarises the Progress Reports. The institutions are invited to debate these reports; the Council shall debate the strategic report in particular regarding the contribution of ESI Funds to the EU strategy for smart, sustainable and inclusive growth.

The Regulation lays down **11 “thematic objectives”** which each ESI fund should support, and which are designed to underpin the achievement of the EU 2020 goals (e.g. “promoting climate change adaptation, risk prevention and management”; “enhancing institutional capacity of public authorities and stakeholders and efficient public administration”). The Regulation also lays down a number of ***ex ante* conditionalities** – i.e. conditions that must be fulfilled before funds may be made available. These conditionalities range from criteria linked to the 11 thematic objectives (e.g. “active labour market guidelines are implemented in light of the Employment guidelines”; “the development of procedures and tools for monitoring and evaluation”) to general prerequisites for all funds (including “The existence of a system of result indicators necessary to select actions, which most effectively contribute to desired results, to monitor progress towards results and to undertake impact evaluation”). In principle, these conditionalities should ensure that an appropriate regulatory and evaluative framework is in place before the start of investments.

More generally, under so-called “macroeconomic conditionality”, ESI Funds may be tied to progress by the member state in implementing recommendations under the EU’s economic governance/multi-lateral budgetary surveillance mechanisms including the Stability & Growth Pact.

In general, the management of the ESI Funds is marked by a **systematic attention to performance and results**, which is explicitly tied to the EU 2020 agenda. Box A.2 above provides an overview of the various performance-related elements that apply to the ESI Funds. In essence, each member state is required to articulate an evidence-based strategy for supporting the EU 2020 goals of smart, sustainable and inclusive growth; must develop a “performance framework” including indicators and milestones; and is held accountable for delivery of its objectives – including by reference to a Commission performance review which is linked to the release of a “performance reserve”.

Challenges in Responding to esi fund Monitoring and Evaluation

The standing arrangements for monitoring and reporting are elaborate and have the potential to yield much high-quality information about programme performance. The comprehensive cascade of performance information (thematic objectives, strategic/investment priorities, SMART objectives and associated indicators) facilitates an informed and critical dialogue among stakeholders – including the Commission representatives – through the Monitoring Committees and annual reviews. In principle, this information – coupled with the annual reporting and (from 2017) strategic reporting by the Commission to the institutions – could contribute to an informed qualitative debate during the processes of scrutiny at Parliament and Council level.

In addition, **sanction mechanisms** are, in principle, available to the Commission where programmes are deemed to be non-performing (or where financial irregularities are detected). Article 142 of the Common Provisions Regulation allows the Commission to suspend payments “where there is evidence resulting from the performance review for a priority that there has been a serious failure in achieving that priority’s milestones relating to financial and output indicators and key implementation steps set out in the performance framework” or where (e.g. as a result of systems audit) “there is a serious deficiency in the quality and reliability of the monitoring system or of the data on common and specific indicators”.

In practice, however, the monitoring framework appears to have little direct impact on how resources are used from year to year. The suspension powers for non-performance are linked to the performance review (a once-off exercise which takes place in 2018) rather than to any performance weaknesses discerned via the annual monitoring procedures; and the suspension power relating to the “quality and reliability of the monitoring system” is seen as an option of last resort – in effect a “nuclear option” – rather than a routine tool of management control and programme adjustment.

Moreover, the complex cascade of indicators, however well-designed, remain but a proxy for objectives and goals, and Commission staff are reluctant to penalise national authorities for slippage in indicators, in the absence of solid data regarding the actual objectives.

This is why the role of **evaluation** has a particular significance: In principle, evaluation allows for more in-depth, qualitative judgements about the relationship of inputs, outputs and outcome goals. The requirement for evaluation is built into all EU programmes – whether directly managed (as in the case of Horizon 2020) or via shared management (e.g. the ESI Funds). The use of evaluation results is, however, hampered by mismatches in timing: The results from interim and *ex post* evaluations often become available after the original programme has been revised, and are not available in “real time” to inform annual monitoring and review discussions.

In practice, the annual “summary report” on programme performance (see Box A.2) and the annual Article 318 Report on results achieved in the budget (now the Annual Report on Management and Performance, AMPR) attempt to synthesise key messages from evaluations conducted to date, including (where relevant) *ex post* evaluations from predecessor programmes. Collating this information in a manner that conveys meaningful, practical information on programme performance is a challenging task given the timing and institutional factors involved.

The **performance reserve** is an important innovation and represents a clear adoption of the principle that information of performance and results should have budgetary

consequences. It must be acknowledged that the performance reserve is modest in scope (up to 6% of each Fund allocation, subject to various exclusions) and that the penalty for failure to pass the Commission's performance review mechanism is not especially onerous (the member state proposes a reallocation of the reserve to other priorities). It remains to be seen whether the flexibility mechanism – involving a public judgement on programme effectiveness and potential loss of funds to another more effective area – will be effective in introducing a new behavioural spur towards more rigorous focus on results.

Budgeting in Oaxaca

by

Camila Vammalle, Ana Maria Ruiz and Ronnie Downes*

Oaxaca recently experienced a period of rapid growth of public expenditure, in response to social and economic priorities. These increases in expenditure were not accompanied with corresponding increases in actual revenues, thus leading to the build-up of deficits. In 2013, the state embraced a consolidation plan, increasing revenue collections and cutting public expenditure and investment, aiming to restore budgetary balance by 2016. The Secretariat of Finance of Oaxaca has recently introduced a more robust legal framework to ensure fiscal sustainability, and avoid such policy fluctuations in the future. Despite recent improvements, there is still space to improve budget practices towards a more planned, accountable, participative and transparent budget process, as well as having an institutional and legal framework in place to ensure these practices have continuity between administrations. In particular, the Budget Review identified three main pillars of reform: 1) Consolidate and strengthen annual budget processes, including clear revenue forecasting and reliable spending envelopes for line ministries; 2) Need for fresh look at infrastructure governance so that public investment can be allocated in a coherent manner via the budget process, allowing for prioritisation of investment plans, aligned with State Development Plan; and 3) A new model of civil-society participation that channels the sentiments and priorities of Oaxaca's highly-organised (and often militant / disruptive) groups in a more positive way into the budget process.

JEL Codes: H70, H71, H72

Keywords: Oaxaca, Supreme Audit Institution, own-revenues, budget deficit, consolidation policies

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Foreword

In June 2015, the Secretariat of Finance of the state of Oaxaca, Mexico, requested the OECD to carry out a review of its budget practices and procedures, and provide recommendations on how these could be reinforced, in order to strengthen fiscal sustainability. In recent years, the state of Oaxaca has embraced a consolidation plan to put the public finances on a sustainable course, with a view to addressing the rapid increase of public expenditure that had arisen in response to social and economic priorities. This expenditure increase had been weighing upon credit ratings, debt levels and overall budget balance. The corrective measures have involved cutting public expenditure and investment and introducing a more robust legal framework for fiscal sustainability. The Secretariat of Finance of Oaxaca is aware of the negative effects of sharp policy fluctuations, and would like to ensure that the lessons from this episode and the recovery measures undertaken can inform the development of robust, modern budgetary procedures.

The OECD team visited the state of Oaxaca in March 2016 and held extensive interviews with stakeholders involved at the state and federal level in the budget process and fiscal policy: Governor's office, state Congress (budget committee), state Audit Institution (Supreme Audit Institution of the state of Oaxaca, ASE), Secretariat of Finance, line ministries and agencies, as well as independent observers. Additional meetings and conference calls were carried out with the federal government (State Governments Coordination Unit, UCEF), parliamentarians from the federal Congress and rating agencies.

The views contained in this report are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisation or individual consulted for this report.

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Executive summary

The state of Oaxaca has traditionally been one of the Mexican states with the lowest level of public debt – in spite of being one of the least developed. However, Oaxaca recently experienced a period of rapid growth of public expenditure, in response to social and economic priorities. These increases in expenditure were not accompanied with corresponding increases in actual revenues, thus leading to the build-up of deficits. In 2013, the state embraced a consolidation plan, increasing revenue collections and cutting public expenditure and investment, aiming to restore budgetary balance by 2016. The Secretariat of Finance of Oaxaca has recently introduced a more robust legal framework to ensure fiscal sustainability, and avoid such policy fluctuations in the future. In particular,

Oaxaca is the first state in Mexico which has reformed its legal framework to comply with the 2016 Federal Financial Discipline Law for States and Municipalities.

In economic and developmental terms, Oaxaca has particular strengths and rich potential in various areas. The state is endowed with a vibrant cultural, linguistic and ethnic heritage, a strategic geographical location and under-developed touristic potential. In balance with these strengths, some other features present major challenges for the governance of the state: a complex geography which hinders state-wide connectivity; the high number of municipalities with frequent leadership turnovers, which impedes capacity building at the local level; and a comparatively low level of productive development, which hinders efforts to increase own revenues. Oaxaca also has a long cultural tradition of active trade unionism and of organised social groups, which advocate vigorously for their own priorities, putting extra pressures in managing the state's budget.

On the institutional side, Oaxaca has a very well-specified legal framework, which covers all key areas of public financial management. There are still some problems however with the implementation of, and institutional compliance with, this legal framework: Addressing these challenges will be an important element of effective policy development and implementation within Oaxaca.

The budget process in Oaxaca is particularly complex for two reasons:

First, Oaxaca has a high reliance on federal transfers, with own revenues only representing about 6% of the state's total revenues, and revenues of free disposal (own revenues plus tax sharing transfers not shared with municipalities) representing only a quarter of total revenues. Federal transfers coming through different funds, are earmarked for specific types of expenditure and have different requirements and matching rates. This makes budgeting in Oaxaca highly challenging, in particular for public investment. The state of Oaxaca finds it very difficult to estimate the amount of each fund and matching requirement before they are precisely known, during the first quarter of the budget year. The state therefore prefers to set resources aside to cover these matching requirements, and only allocates them once the precise federal transfers are confirmed. This implies that the budget process in Oaxaca only applies to operating expenditures.

Second, the budget process in Oaxaca is highly fragmented in practice, with each spending unit designing its annual programme, and submitting its funding requests to the Secretariat of Finance. While spending units receive a proposed limit on available resources for current expenditure, in practice this does not serve as a binding constraint or as a focus of early discussion during the budget formulation and annual funding requests from the line ministries tend to be above the fiscal capacity of the state. Several negotiation processes then need to take place to accommodate funding requests with available resources. This fragmentation of the budget process makes it more difficult to prioritise expenditure and link the annual budget to the medium-term State Development Plan (*Plan Estatal de Desarrollo*, PED).

The state Congress has ample faculties for amending the budget, but in practice, is not equipped to do so. Citizens do not seem to look primarily towards the Congress as a forum to ensure that their interests are duly reflected in the budget allocations. In the absence of such a role played by Congress, there has been a movement towards strong and active social groups (*organizaciones sociales*) frequently associated with clientelism, which put pressure directly on the Secretary of Finances (SEFIN) to receive funds for the execution of public works mainly in rural areas.

Institutional and legal reforms carried out in the last couple of years are well intended and closely aligned towards ensuring an open, transparent and realistic budget process. However, there remains space for further ambition and improvement:

- Oaxaca would benefit from having a more precise, credible and reliable estimation of the revenues expected to be collected during the year ahead. This would increase predictability and transparency in the budget process, and correct the incentives for organised social groups and line ministries to negotiate for additional resources during the execution phase of the budget.
- This estimation of revenues should be carried out early in the budget cycle, and the Secretariat of Finance should communicate spending envelopes to line ministries at the beginning of the budget formulation phase. This would allow Line ministries and spending units to prioritise the programmes to be implemented during the budget year, based on a clear estimation of the resources they will receive.
- In particular, funds for public investment should be allocated in the budget process, so that line ministries can prioritise their investment plans based on the resources they will have for matching federal transfers.
- Existing fiscal rules could be clarified and communicated in a more comprehensive way. Furthermore, enforcement mechanisms should be developed to ensure that reforms in the legal framework have a real impact in public finances.
- Revenues of free disposal (*Ingresos de libre disposición*) and state expenditures (*gastos estatales*) should be clearly stated in the budget documents. This would increase transparency and the usefulness of budget documents for debating on spending priorities.
- Although it has shown political independence and technical capacity to audit (OECD, 2016b), the role of the Superior Audit of the State of Oaxaca could be strengthened, ensuring it has sufficient institutional support (both in terms of staffing and financial resources) to carry out its tasks. The responsibility of the Superior Audit of the State of Oaxaca could be broadened towards auditing the efficiency and effectiveness of budget execution, public policies and programmes.
- Organised social groups could be given a greater role during the pre-budget phase in collective discussion and structured civic dialogue on the priorities to be funded. Such an involvement during the priority setting phase should reduce incentives for direct requests for additional resources during the budget execution phase. Resources transferred to organised social groups should be monitored and included in the budget in a transparent way.

1. Political, economic and social context in Oaxaca

Oaxaca's political, economic and social context is essential to understand the particular dynamics and challenges faced by different stakeholders in the budget cycle. Changing the political composition of government in Oaxaca for the first time in more than 80 years in 2010 required alliances from a wide range of political parties and interest groups. In any country or region, such broad-based alliances can promote the legitimacy and harmony of policy-making in a context of multi-party power-sharing, but can also pose challenges in terms of reconciling these various interests with fiscal objectives. Oaxaca's long cultural tradition of active trade unionism and of organised social groups, which advocate vigorously for their own priorities, presents extra pressures in managing the state's budget.

In economic and developmental terms, Oaxaca has particular strengths and rich potential in various areas. The state is endowed with a vibrant cultural, linguistic and ethnic heritage, a strategic geographical location and under-developed touristic potential. In balance with these strengths, some other features present major challenges for the governance of the state: It is the state in Mexico with the highest number of municipalities (570 municipalities for 3.8 million inhabitants). Many of these municipalities have less than 1 000 inhabitants, and are governed by customs and traditions (*usos y costumbres*), implying frequent leadership turnovers, which impedes capacity building.

1.1. Recent power alternation

In political terms, the Institutional Revolutionary Party (PRI) has been the traditional custodian of power and governance in Oaxaca since 1929. In July of 2010, a new government was formed with a different political composition, headed by an elected governor in Oaxaca from a coalition that included the National Action Party (PAN), the Democratic Revolutionary Party (PRD), the Labour Party (PT) and the Convergence Party (*Convergencia*).

The change of governance (*alternancia*) involved coalition-building among political parties with varying political perspectives as well as negotiations with different interest groups. The broader context included long-running discontent among various interest groups and a tradition of public demonstrations (see for example Box 1.1 regarding the 2006 Oaxaca teacher protests), and a challenging economic outlook which left little discretion for meeting all of the social and economic demands facing the state.

Against this background, the administration on Oaxaca has had to try to reconcile high citizen expectations for policy renewal, on the one hand, with limited social and economic room for manoeuvre, on the other hand. Addressing these challenges involves a consideration of the overall processes of budget formulation and execution.

1.2. Active unionism and proliferation of organised social groups

The state of Oaxaca has been, traditionally, a state of active trade unionism and organised social groups. The education sector in particular has strong and powerful trade unions (section 22 of the National Teacher's Union SNTE, and National Coordinator of Education Workers CNTE¹) that exert an influence on decision making and service provision in the state. As outlined in greater detail in Section 3, trade union pressures have contributed to rapid growth of salaries and benefits in the public sector in general, and in the education sector in particular.

Active advocacy and demonstrations for sectoral interests have spilled over into major clashes between union representatives and the police in the past years. In particular, in 2006, there was a heated confrontation involving trade union activists, social organisations and the government. The confrontation lasted for more than five months and led to major economic losses, and indeed to some injuries and fatalities. Another important confrontation occurred in summer 2016 after the state government regained control of the education sector (see Box 1.1).

In addition, Oaxaca has one of the largest numbers of social and political groups in all of Mexico. The number of organised social groups has increased rapidly during the last years, with around 500 registered in 2016, of which 80 are particularly worth noting as they are big and very active in requesting public resources. From time to time, organised social

groups participate in public demonstrations in pursuit of demands for resources for social projects, sometimes blocking access to public offices and, in some cases, affecting service provision and mobility in the region. Demands from these groups have put extra pressure in expenditure levels (Section 3).

1.3. Particular strengths and strategic assets of Oaxaca

1.3.1. Cultural and linguistic diversity

Oaxaca has a rich cultural, linguistic and ethnic heritage. According to the catalogue of national indigenous languages, there are 364 different variants of indigenous languages in Mexico. In Oaxaca, there are 15 languages and 176 linguistic recognised variants. The most spoken languages are Zapotec, Mixtec and Mazatec with more than 850 thousand speakers. Oaxaca is also the state with the highest concentration of culturally-distinct indigenous ethnic groups, with 16 in total.

1.3.2. Potential for the tourism industry

Oaxaca's economy has great potential to continue developing the tourism sector. The main attractions of the state are linked to its rich cultural heritage, as well as to natural attractions. The state produces high quality craftsmanship, traditional food and beverages, such as *mezcal* and *pulque*. Oaxaca has renowned beaches for surf and historical Pre-Hispanic and colonial cities. The state has two sites in the UNESCO Heritage List, which are the historic centre of Oaxaca City and the archaeological site of Monte Albán, as well as the prehistoric caves of Yagul and Mitla in the Central Valley of Oaxaca.

1.3.3. Strategic geographic location

Oaxaca is one of the two states (with Veracruz) located on the Isthmus of Tehuantepec. This is a strategic geographic location, as it connects the Gulf of Mexico with the Pacific Ocean, and North and South America. However, the lack of infrastructure does not allow Oaxaca to exploit the benefits from this location. The recently voted Federal Law of Special Economic Zones (April 2016)² should help, as it has created a special economic zone in the corridor of the Isthmus of Tehuantepec (benefitting Oaxaca and Veracruz). This project will connect the Gulf of Mexico with the Pacific Ocean through a land bridge. The law will create tailor-made incentives, which will include tax benefits, special customs regimes, and investments in infrastructure, facilitation of red tape, amongst other. If implemented correctly, this could benefit Oaxaca and also promote its strategic location for ports, as well as developing the potential for renewable energy.

1.4. Particular challenges of Oaxaca

1.4.1. Municipal fragmentation

The federal state of Oaxaca is divided into 570 municipalities, which represent 23% of all municipalities in Mexico. From those 570 municipalities, 152 are elected through an electoral process and 418 are managed by uses and customs (*usos y costumbres*). The system of *usos y costumbres* was integrated into the Constitution of the state in 1995 to recognise the indigenous heritage and to provide some municipalities a certain political autonomy from the state and national government. The mechanism works with the community choosing a representative as a community leader through a public assembly, with no political party and no electoral process. The duration of the term varies, with some municipalities having a one-year term only and with frequent leadership

Box 1.1. Education trade union in Oaxaca and teachers protests

2006 conflict

In May 2006, members of the Section 22 of the national teacher's union (SNTE) began a protest demanding an increase of salary, as they did every year. Since the state education authorities did not grant the salary increase demanded by the teacher's union, the protesters occupied the historical centre of the City of Oaxaca.

By mid-June, state government forces tried to evict protesters from the historical city centre. After violent altercations from both sides, the teachers forced a withdrawal of the state government forces. Protesters took over the main square (*zócalo*), built several barricades and remained there until the end of October. The act of eviction of the state government forces triggered local and national protests against the use of force from authorities. In Oaxaca, different social organisations came together with the SNTE to establish the Popular Assembly of the Peoples of Oaxaca (APPO). The goal of APPO was to make a unified response to the government.

A series of actions were taken by the SNTE and the APPO across the state, including: blocking access to the Oaxaca international airport, occupying toll booths, preventing the distribution of oil from PEMEX and taking over the State Attorney General's office as well as the State Institute of Public Education in Oaxaca (IEPPO). Teacher protests spread to other states and to Mexico City.

As the negotiations between both sides resumed in early October, the SNTE accepted all the terms and voted to return classes after several months of inactivity. The state government also accepted several of the demands made by the SNTE. This created a difference of opinion and an important detachment between the APPO and members of the SNTE.

By the end of October, while the Section 22 teachers were back in the classrooms, federal government forces started an offensive to retake the historical city centre and the state government ministries and agencies still occupied by the APPO, most notably, the IEPPO. The clashes continued in November, and in early December the last barricade from the APPO was removed from the *zócalo*.

Consequences and Education Reform

After the conflict, the CNTE (National Co-ordinator of Education Workers) kept managerial control of the IEPPO.

In 2012, the newly elected President Enrique Peña Nieto announced a National Education Reform, including a legal framework for the professional development of teachers, principals and supervisors, and mandating a National Evaluation System. The SNTE and the CNTE mobilised protests all over the country to oppose to the reform. The reform was approved and enacted in February 2013.

In 2015, in the context of the education reform, the governor of the state, Gabino Cué, with support from the federal government created a new IEPPO. With this action, the state government reassumed control of education in Oaxaca, with the purpose of starting a structural transformation process. Some of the measures of the reform include reducing posts of the SNTE and the CNTE in the new IEPPO headquarters, a payroll decrease to teachers who are absent more than 3 times in one month and a regular evaluation of competences for teachers.

In May 2016, members of the Section 22 of the SNTE sieged the headquarters of the new IEPPO to demand a discussion with the federal and state government regarding the new education reform. In mid-June, federal state forces were ordered to remove the protestors and to retake the IEPPO. This resulted in a confrontation. After the state police arrested two leaders of the CNTE, protests grew with blockades all over the state. In late June, as police tried to scatter protesters from one of the blockades, a violent confrontation took place. Following the event, both the CNTE, the SNTE agreed to reopen discussions but now directly with the federal government, with the Federal Ministry of the Interior and the Federal Ministry of Education.

Source: CISEN (2006) and Comisión de Seguimiento a los hechos ocurridos en Nochixtlán, Oaxaca (2016).

turnovers. *Usos y costumbres* is also used to define and execute municipalities' priorities on a variety of topics. While *usos y costumbres* allows municipalities to have certain autonomy and flexibility in their decision making processes, they remain economically dependent on federal and state transfers.

1.4.2. Low productive development

The social and political plurality, as well as the municipal fragmentation, makes Oaxaca a particular and complex environment for policy makers. While the government is one of the major formal employers in the state, the main economic activity comes from the tertiary activities, in particular from trade and services. The state ranks, together with Guerrero and Chiapas, in the lowest levels of the Human Development Index in the country (UNDP, 2015). With 4 million inhabitants, representing only 3.3% of the total population in Mexico, its contribution to the national GDP is of 1.6%. The informal economy is also high in the state, according to a recent study, Oaxaca ranked as the state with most informal employment relationship in the country with a rate of 80% (INEGI, 2015).

The low level of productive development in Oaxaca has caused widespread migration. It has become an important component of the social and economic dynamic of the state. First, there is a local migration that takes place within the state, where farmers or unemployed people move either to production sites to be close to farms or to bigger cities to sell their products or work in services. There is also a migration of people from Oaxaca to other states of Mexico (e.g. to work in agriculture or tourist services) or further afield towards the United States. Oaxaca is also an important transit state within the migration route of people from Central and South America towards the United States. Remittances are an essential part of the economy, with more than USD 680 million from January to June in 2016 (BANXICO, 2016).

1.4.3. A complex geography

The geographical features of Oaxaca help to explain the continuing cultural diversity of the state: extensive mountains and several rivers impede economic connectivity within the state, but shelter the various ethnic communities from external influences; and only 9% of land is arable. Oaxaca is the state with the highest number of rural municipalities in Mexico, 80.7%, and 23% of rural population. Territorial ownership and rights are also complex; Oaxaca has one of the highest percentages of social land in the country. Only 24% of the land is private, while 76% is under agrarian law – divided in communal and *ejidal*³ – making land ownership complicated and therefore, discouraging for foreign investment.

2. Institutional characteristics of Oaxaca's budget process

One of the key characteristics of Oaxaca's budget process is that the state's budgetary room for manoeuvre is very limited. Indeed, in spite of a recent important effort to increase own revenues (through tax increases and improvement of fee collection), these still only account for 6% of total state resources. 94% of resources consist of federal transfers, which are mainly earmarked for spending in particular areas. In addition, around 27% of general purpose tax sharing transfers (*participaciones*) are directly transferred to municipalities. Revenues of "free disposal" (*ingresos de libre disposición*), i.e. revenues which can be freely allocated through the state's budget process, only represent 24% of Oaxaca's total revenues (and thus, of total expenditure).

On the institutional side, Oaxaca now has a very well-specified legal framework, which covers all key areas of public financial management, including the stages of planning, budgeting, authorisation of budget execution and budget accountability, as well as a recent law on fiscal responsibility. As the following sections will show, the legal framework is in line with international standards for a modern, well-functioning governance system and thus lays a solid foundation for future development. There are still some problems however with the implementation of, and institutional compliance with, this legal framework: Addressing these challenges will be an important element of effective policy development and implementation within Oaxaca.

2.1. Revenue and expenditure framework in Oaxaca: a limited room for manoeuvre

More than three quarters of Oaxaca's revenues are federal transfers that are earmarked for particular purposes or sectoral areas. While these revenues appear in the budget of Oaxaca, they have already been discussed and approved by the Federal Congress and so their allocation is not discussed during the state budget process. In addition, the tax sharing law of the state of Oaxaca (*Ley de Coordinación Fiscal para el Estado de Oaxaca*) establishes that a share of each revenue stream of the state of Oaxaca must be transferred directly to the municipalities. Therefore, budget allocation decisions in Oaxaca only concern about a quarter of the state's total revenues (consisting of a share of own revenues and a share of tax sharing transfers [*participaciones*]). With such a limited room for manoeuvre in budgetary decisions, it is all the more important to rely on sound and efficient budget practices.

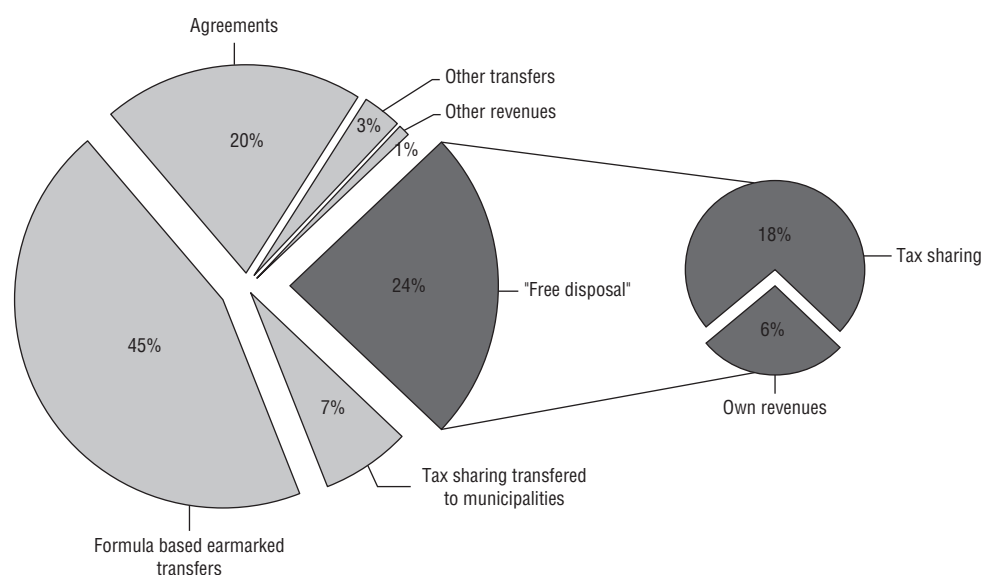
2.1.1. Structure of revenues in Oaxaca

Oaxaca is one of the states in Mexico with the highest dependency on federal transfers. Only about 24% of Oaxaca's revenues are available for general purpose allocation via the state budget process. In 2014, 94% of Oaxaca's revenues came from federal transfers (Box 2.1). The formula-based earmarked federal transfers (*aportaciones*) represent about half of total revenues and are mainly allocated towards education. Earmarked agreements (*convenios*) represent a further 15% of revenues. General purpose tax sharing transfers (*participaciones*) represented 23% of total revenues. However, following the tax sharing law of the state of Oaxaca (*Ley de Coordinación Fiscal para el Estado de Oaxaca*), almost a third of these general-purpose resources are transferred to municipalities. Own revenues represent only 6% of total revenues (Figure 2.1).

2.1.2. Recent evolution of federal transfers

While growth in tax sharing (*participaciones*) and formula based earmarked transfers (*aportaciones*) is rather stable, the level of resources transferred through agreements tends to vary from one year to the next (Figure 2.2). However, as the revenues from tax sharing are subject to the variations of the national and international economy, the resources that Oaxaca and other states have received in 2015 and 2016 have decreased due to the fall in oil prices. In early 2016, the Fund for Revenue Stabilisation of States (*Fondo de Estabilización de los Ingresos de las Entidades Federativas*, FEIEF) has made transfers to federal states to compensate for the shortage.

Recent efforts to increase Oaxaca's own revenues through legislation and increased collection efforts should be recognized. According to the National Institute of Statistics and Geography (INEGI) data, from 2010 to 2014, own tax revenues increased by 295% and duties by 63%. However, own revenues only represent 6% of the total revenues.

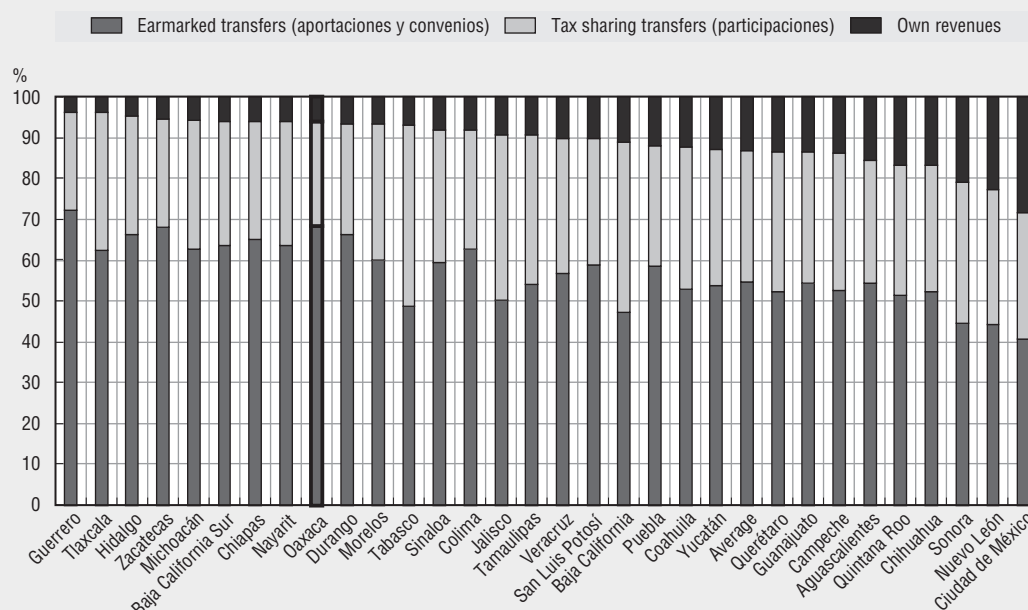
Figure 2.1. **Structure of Oaxaca's revenues (2014)**

Source: Secretary of Finance of Oaxaca.

Box 2.1. Fiscal federalism framework in Mexico

States in Mexico have three main types of revenues: own revenues, tax sharing transfers (*participaciones*) and federal earmarked transfers (*aportaciones y convenios*) (see figure below).

Share of federal transfers in states' total revenues (2014)



Source: INEGI, Statistics of public finances on federal states and municipalities.

Box 2.1. Fiscal federalism framework in Mexico (cont.)

1) Own revenues

The revenues from own sources come from taxes, duties (*derechos*), products, special assessments (*contribuciones de mejoras*) and advantages (*aprovechamientos*). Taxes represent the most important source of own revenues for federal states. Revenues from duties (*derechos*) come from the civil registry, public property registry, certificates, licenses and permits, roads and transportation, drinking water and services. Revenues from products refer to use or sale of goods and other products. Special assessments (*contribuciones de mejoras*) come from charges of running public projects. Advantages (*aprovechamientos*) refer to revenues from fines and penalties, donations, contributions and others.

2) Federal Transfers

Federal transfers are the main source of revenues for states in Mexico. On average, federal transfers represent almost 90% of state revenues (figure above). There are two main types of federal transfers:

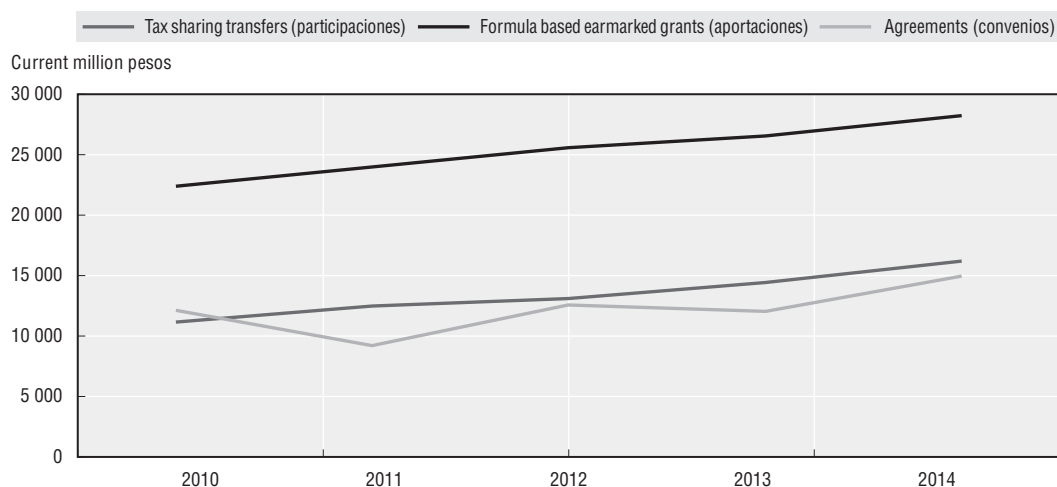
i) **Earmarked transfers** are the most important source of revenue for all states. These earmarked transfers represent on average 50% of total revenues of states on average. Earmarked transfers are divided into formula based earmarked transfers (*aportaciones*) (68%) and Agreements (*convenios*) (32%).

- **Formula based earmarked transfers (a *portaciones*)**, also known as Branch 33 (*Ramo 33*) are transfers for the areas of education, health, basic infrastructure, financial strengthening and public security, food and social assistance programmes and educational infrastructure. The transfers are made via eight contribution funds. Each fund is targeted to a specific topic and has a formula to determine the amount to be transferred to each state. The variables taken into account in each formula depend on the area. For example, the health services contribution is based on three variables: inventory of medical infrastructure, staff and resources allocated the year before.
- **Agreements (*convenios*)** are reallocated federal resources used for public works, education, culture and sports projects on an *ad hoc* basis. They are managed, either directly by the states and/or co-ordinating with the federal government.

ii) **Tax sharing (*participaciones*)**, also known as Branch 28 (*Ramo 28*), are general purpose resources allocated by the federal government to the states and municipalities. On average, they represent 30% of the total revenues of states. The resources are allocated through nine federal funds, which come from the Tax Sharing Federal Revenue (*Recaudación Federal Participable*, RFP). Federal taxes, mining rights and some oil revenues compose the Tax Sharing Federal Revenue. The amount of resources of the Tax Sharing Federal Revenue is subject to the variations of the national and international economy, and as a consequence, the resources that the federal states and municipalities receive are cyclical. In contrast with contributions, the resources from tax sharing do not have a specific purpose and are considered of free disposal for federal states.

3) Fund for Revenue Stabilisation of States

When the tax sharing allocated to a state is less than what that federal government had approved in their revenue law, the federal government can compensate the shortage through the Fund for Revenue Stabilization of States (*Fondo de Estabilización de los Ingresos de las Entidades Federativas*, FEIEF). This fund is very relevant today: With falling oil prices, effective transfers from tax sharing have decreased significantly. In April 2016 this fund was activated to compensate states for the difference between the tax sharing revenues approved in the federal budget and the tax sharing effectively allocated to states.

Figure 2.2. **Evolution of federal transfers to Oaxaca (2010-14)**

Source: INEGI, Statistics of public finances on federal states and municipalities.

2.1.3. Structure of expenditures in Oaxaca

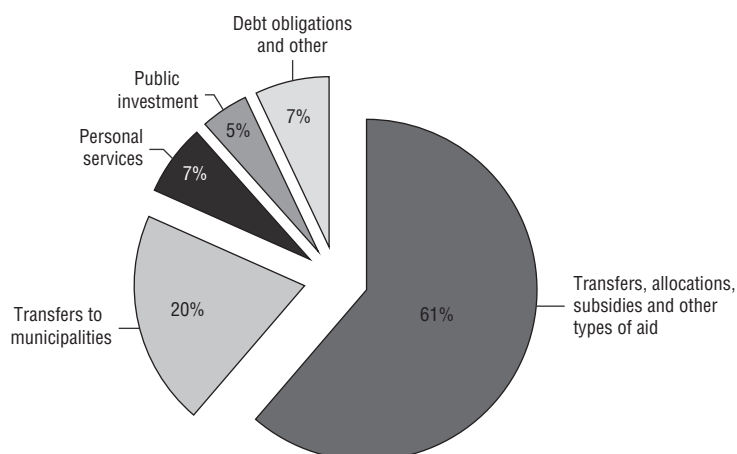
In practical terms, the federal government of Mexico mandates most of the expenditure obligations of Oaxaca. More than 60% of expenditures in Oaxaca are earmarked for transfers, allocations, subsidies and other types of aid. This is significantly higher than the national average of 42%. The bulk of those earmarked expenditures are transfers made to the judicial and legislative powers as well as to public services such as education, health and social insurance.

Transfers to municipalities represent around 20% of total expenditures. These transfers are revenues directly assigned to municipalities and come from three sources: tax sharing (*participaciones*), formula based earmarked transfers (*aportaciones*) and agreements (*convenios*). Tax sharing and contributions come directly from the federal government, and agreements are assigned either by the federal government or by the state.

The remaining expenditures are mainly used in public investment, personal services and public debt obligations (Figure 2.3).

2.2. Legal framework and key actors

Oaxaca has a very well specified legal framework, which covers all key areas of public financial management, including planning, budgeting, authorisation of budget execution, accountability and recently, a fiscal responsibility law. More specifically, the budget process is regulated by the Articles 59, 61, 99, 114, 137 and 138 of the Political Constitution of the Sovereign and Free State of Oaxaca. These define respectively, the role of Congress in discussing and approving the revenue law and the annual expenditure budget; authorises the legislative, executive and judicial power, and the autonomous government agencies to execute budget allocations; states that the judicial power manages its own budget, which cannot be lower than the previous year's; states that autonomous government agencies have autonomy in the management of their budgets; that no payment can be executed in the absence of a specific budget allocation, and finally, article 138 regulates the remunerations of civil servants.

Figure 2.3. **Structure of expenditures in Oaxaca (2014)**

Source: INEGI, Statistics of public finances on federal states and municipalities.

In 2011, Oaxaca issued a new Budget and Fiscal Responsibility law (*Ley Estatal de Presupuesto y Responsabilidad Hacendaria*) and in 2015, it issued a new State Planning Law (*Ley Estatal de Planeación*). In 2014, the state issued the Budget and Fiscal Responsibility Law regulatory decree. This legal framework has been recently updated (July 2016), and Oaxaca is now the first state to have a legal framework fully aligned with the Federal Financial Discipline Law for States and Municipalities.

The main actors in the budget process are:

a) The Secretary of Finances (SEFIN)

- Normative entity for strategic planning of expenditure, responsible for the State System of Public Investment (*Sistema Estatal de la Inversión Pública*)
- In charge of the programming, budgeting and monitoring of the expenditure budget.
- Carries out the integration of the annual budgetary and operational programmes of the spending units.
- Presents the draft expenditure budget law of the state to the Governor of the state

b) State Management Secretariat (*Secretaría de Administración*)

- Carries out the integration of the budget to accommodate expenditure on wages (*servicios personales*) and to accommodate the annual wage increase. Computes the grid for wages and salaries of the Executive Power of the state.

c) Technical Evaluation Body

- Evaluates the integration of the Logical Framework Methodology (*Metodología del Marco Lógico, MIR*).
- Reports on the results of these evaluations.

d) State Congress

- Analyses, rules and approves the Expenditure Budget Decree and its annexes.

e) General Secretariat of the Government (*Secretaría General de Gobierno*)

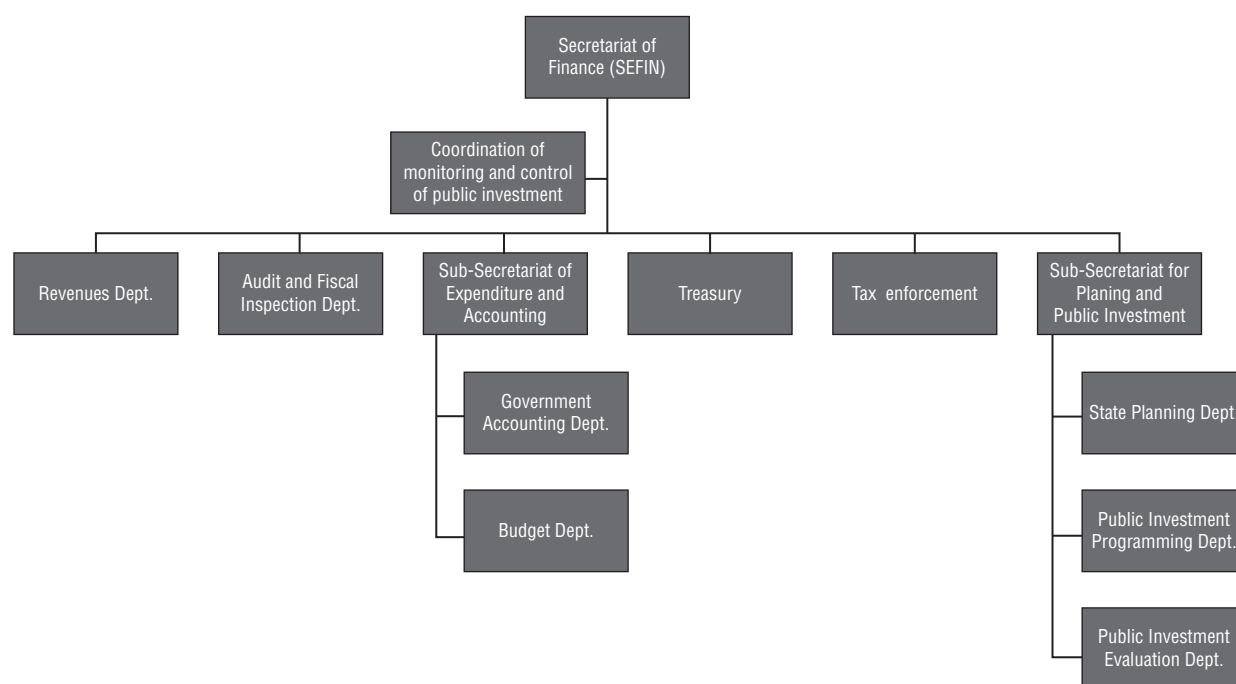
- Signs the Decree and orders its publication

f) Legal Department

- Publishes the budget decree in the State Official Paper

The Secretariat of Finance (SEFIN) is divided into six departments (Figure 2.4). In particular, the revenues department, which estimates revenues in the budget preparation phase, and often updates its revenue estimations during the year; the sub-secretariat for expenditure and accounting, responsible for preparing the expenditure budget decree, and of allocating additional revenues, when the revenue department updates its revenue estimation; the Treasury, responsible for transferring authorised funds to the banks accounts of the spending institutions; and the sub-secretariat for planning and public investment, which receives the investment project proposals from the different executing units, and allocates funds for public investment.

Figure 2.4. **Simplified organigram of the Secretariat of Finance (SEFIN)**



Section 3: Ensuring fiscal sustainability

Oaxaca is one of the least developed states in Mexico, but has also been one of those with the lowest levels of public debt. However, public expenditures increased sharply from 2010-13, leading in turn to a strong consolidation effort. Restoring fiscal sustainability remains a key priority for the state. From 2010-13, the state experienced a period of rapid growth of public expenditure, mainly driven by human resources expenditure. Increases in actual expenditure were not accompanied with corresponding increases in actual revenues, thus leading to the build-up of deficits. Overdue balances were carried over from one financial year to the next, generating liquidity problems. By the end of 2013, the state had a deficit of more than MXN 7 billion (around 1.7 times the own revenues collected

in the same year). A fiscal consolidation process was initiated in 2013, aiming to reduce expenditure and increase own revenues to restore fiscal sustainability.

Recent fiscal trends underline the value, and the necessity, of further improvement in Oaxaca's budget practices towards a more planned, accountable, participative and transparent budget process. During the past years, the Secretariat of Finances has constantly been under pressure to manage cash flows and disbursements, in a context of uncertainty regarding both the inflow of revenues and the final level and incidence of expenditures. This situation has led to multiple challenges in terms of liquidity and short- and long-term debt management, and in terms of ensuring an open, transparent and realistic public debate about policy priorities and trade-offs.

Institutional and legal reforms carried out in the last couple of years are well intended and closely aligned towards these objectives. However, there remains space for further ambition and improvement. In particular, Oaxaca would benefit from having a more precise, credible and reliable estimation of the revenues expected to be collected during the year ahead, increasing predictability and transparency in the budget process, and correcting the incentives for organised social groups and line ministries to negotiate for additional resources during the execution phase of the budget. In addition, existing fiscal rules could be clarified and communicated in a more comprehensive way, allowing for "top-down" (integrated) budgetary management approaches to be applied. Furthermore, enforcement mechanisms are needed to ensure that reforms in the legal framework have a real impact in public finances.

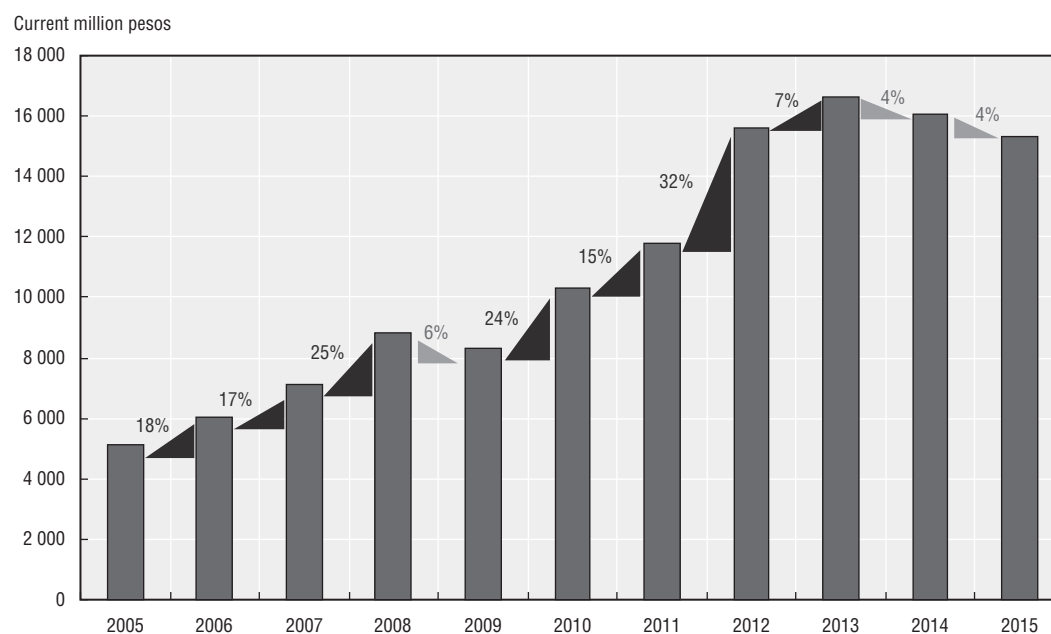
3.1. Recent fiscal trends in Oaxaca

3.1.1. Deficit expansion phase (2010-13)

During the period 2010-13, fiscal deficits increased steadily. This was due to a rapid growth in expenditure, associated with a mismatch between initially projected revenues, revised revenue projections and actual revenue collections.

3.1.1.1. 2010-13: a rapid increase in public expenditures. Total state expenditures increased rapidly during the first years of the administration, reaching 32% increase between 2011 and 2012 (Figure 3.1). This increase was mainly driven by current expenditure, against a background of high public expectations regarding the need to tackle social and economic difficulties in the state, and largely took the form of increased human resources expenditure. The organic law enacted in 2010 created new departments and agencies (e.g. Human and Social Development Secretariat, General Coordination Unit for Secondary Education, Science and Technology, and several sectoral specialised cabinets), increasing the number of employees. In addition, salaries increased and additional benefits were granted (in particular in the education sector). Between 2010 and 2013, total state expenditure in human resources increased by 61% (Figure 3.2).

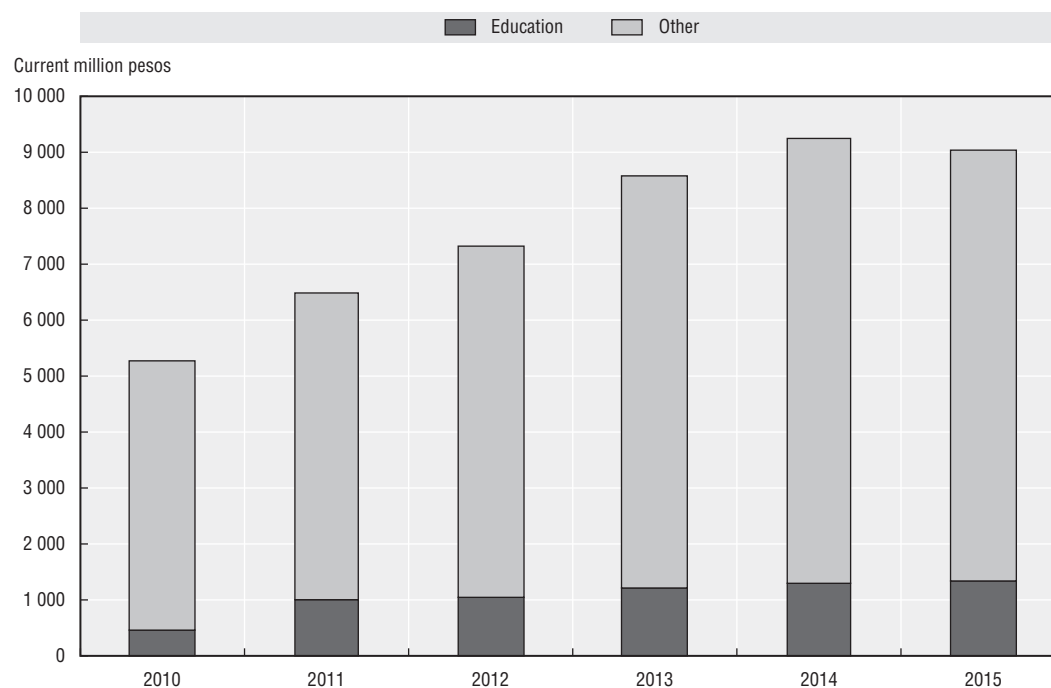
As explained in Section 1, Oaxaca has a long culture of active trade unionism. In particular, the education union has had strong political power in the state (Box 1.1). For more than 20 years, the education union had a strong influence in the management of the State Institute of Public Education in Oaxaca (IEEPO). As a consequence, salaries and benefits in the education sector have tended to increase at a faster pace than in other sectors. Between 2010 and 2013, total expenditure in human resources in this sector increased by 185% (Figure 3.2). Such increases have had a negative impact on the fiscal sustainability of the state's overall public finances.

Figure 3.1. **Actual state expenditure trend (2005-15)**

Notes:

1. Figures refer to state expenditure (do not include expenditure from earmarked grants or resources transferred to municipalities).
2. Expenditures do not include debt, donations, or municipal contributions from tripartite contracts.

Source: Secretary of Finance of Oaxaca (2016).

Figure 3.2. **Trend of Oaxaca's human resources expenditures (2010-15)**

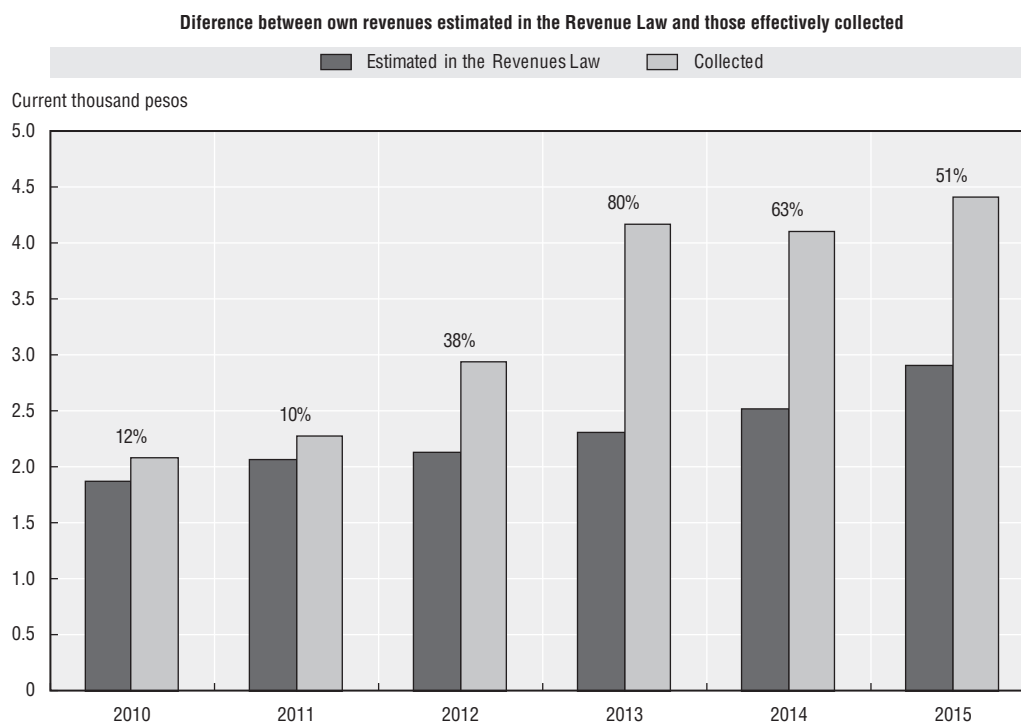
Note: Figures refer to state expenditure (do not include expenditure from earmarked grants or resources transferred to municipalities).

Source: Secretary of Finance of Oaxaca (2016).

The period 2010-13 also saw a rise in demands from organised social groups: The number of such groups increased, together with the number and cost of their demands, thus leading to increasing expenditure and putting additional pressure on the state's budget.

3.1.1.2. Unrealistic revenue estimations led to (ex post) fiscal deficits, in spite of balanced (ex-ante) budgets. The revenue law estimates the revenues that the government of the state of Oaxaca will receive in a given fiscal year. Usually, the submitted revenue law makes a rather conservative estimation of own revenues for the coming year, and own collected revenues tend to be higher than those used in the expenditure budget (Figure 3.3). During the course of the year, the revenues department in SEFIN updates the estimations of own revenues to be collected during the fiscal year, and informs the sub-secretary of expenditures of SEFIN on the additional revenues which can be allocated. As a consequence, actual expenditure in a given year can be substantially different from the initial budget approved by the Congress of Oaxaca (Figure 3.4). Until the new State Budget and Fiscal Responsibility Law of 2011 (*Ley Estatal de Presupuesto y Responsabilidad Hacendaria*), these additional revenues could be discretionally allocated by SEFIN during the budget year.

Figure 3.3. **Difference between own revenues estimated in the Revenue Law and those effectively collected (2010-15)**

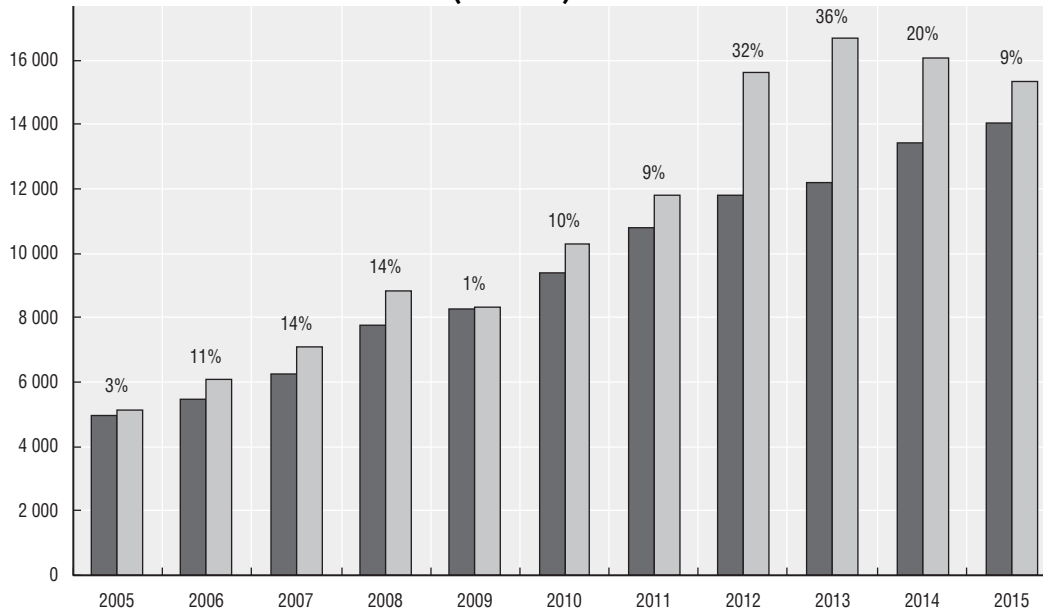


Note: Figures refer to own revenues.

Source: Secretary of Finance of Oaxaca (2016).

While initial revenue estimations have tended to be too conservative, the in-year re-evaluations of revenues have tended, on the contrary, to be over-optimistic (this was especially the case from 2010-13). In-year increases in expenditures were therefore

Figure 3.4. **Difference between the approved budget and the actual expenditures (2005-15)**



Notes:

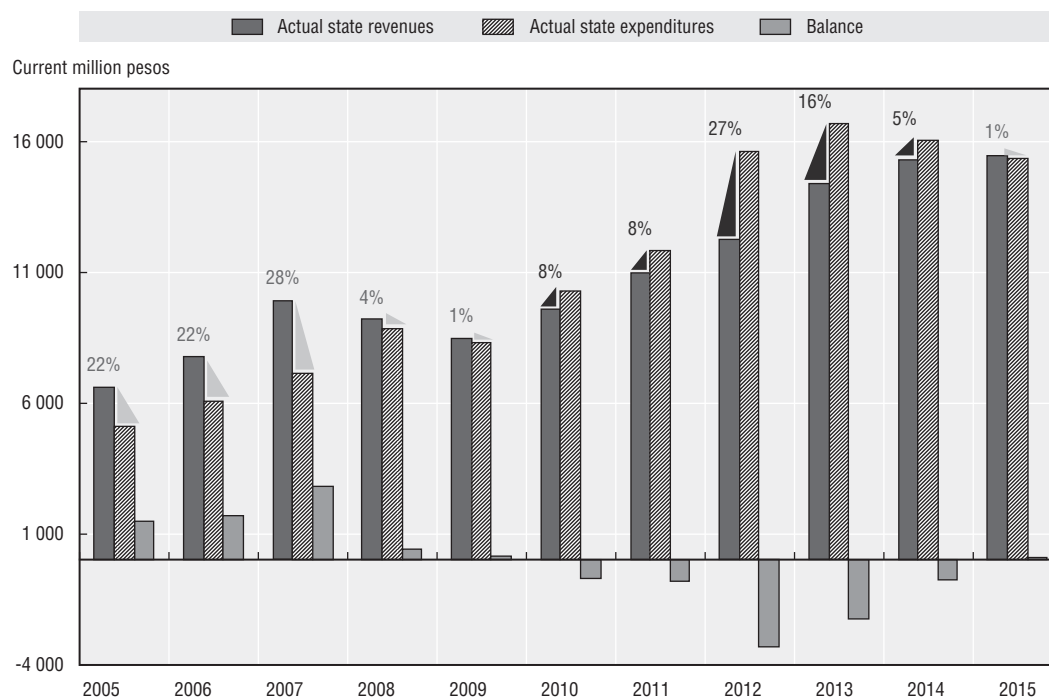
1. Figures refer to state expenditure (do not include expenditure from earmarked grants or resources transferred to municipalities).
2. Approved and actual expenditures do not include debt, donations, or municipal contributions from tripartite contracts.

Source: Secretary of Finance of Oaxaca (2016).

consistent with revenue estimations, but above the actual revenue collection, thus leading to unforeseen budget deficits (Figure 3.5). As these unpaid balances were not included in the following year's budget, deficits were allowed to build up and the capacity of the state to fulfil its financial obligations was reduced. By the end of 2013, the state had a deficit of more than MXN 7 billion (around 1.7 times the own revenues collected in the same year). In the short run, the mismatch between actual revenues and authorised expenditure created important liquidity problems, which were handled by the Treasury sub-secretariat of SEFIN by delaying payments to providers, and availing of short-term payment facilities with commercial banks.

3.1.1.3. Other factors increasing deficits. In addition to the structural issues described above, other factors have also contributed to the weakening of Oaxaca's state finances during the period 2010-13:

- **Unrecoverable loans to municipalities:** SEFIN granted bridging loans to municipalities, many of which subsequently proved to lack adequate repayment capacity. Where municipalities failed to pay back these loans, the state had to recognise these transactions as expenditure in its budget.
- **Federal transfers lower than anticipated:** Some decentralised institutions (in particular in health and in education) receive earmarked transfers from the Federal Government.

Figure 3.5. **Budget Balance: Actual expenditure vs. collected Revenues (2005-15)**

Notes:

1. Revenue figures refer to “free disposal revenues” (i.e. revenues which can be freely allocated through the State’s budget process).
2. Expenditure figures refer to state expenditure (do not include expenditure from earmarked grants or resources transferred to municipalities).
3. Expenditures do not include debt, donations, or municipal contributions from tripartite contracts.

Source: Secretary of Finance of Oaxaca (2016).

These decentralised institutions also need to make payments to the Federal Government, for example for the social security and health systems. As some of these decentralised institutions have been late in their payments to the Federal Government, the Federal Government has been cutting transfers by the amount due since 2013. However, the state government is still obliged to transfer the full amount to the decentralised institutions, and thus had to absorb the lower revenues in its own budget. The claim on decentralised institutions thus passed from the Federal government to the state government.

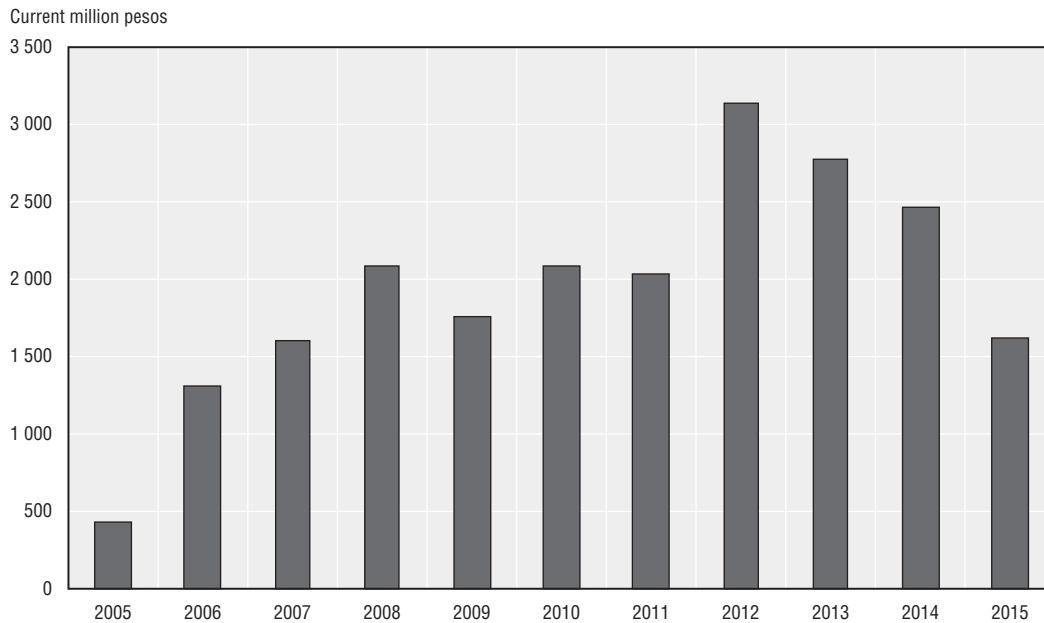
3.1.2. Consolidation policies (2013-16)

By the end of 2013 the situation of the public finances in Oaxaca had become critical. Liquidity became an important concern and regular use was made of short term debt. The amount of payment arrears to providers increased and the Secretariat of Finance (SEFIN) had to prioritise payments. Spending units experienced significant uncertainty regarding the timely release of funds for their planned expenditure, and the Secretariat of Finance was under continual pressure to manage and respond to these financing demands.

3.1.2.1. Cutting expenditures. The effect of the deficits created during the first years of the administration was fully visible in 2013. Overdue balances were carried over from one financial year to the next, generating liquidity problems. With the appointment of a new leadership and management team in SEFIN at this time, a priority task was identified to

collect information and present a clear picture of the finances of the state. Based on this assessment, a fiscal consolidation process was initiated, aiming to bring public expenditure under control and move the state finances back onto a sustainable course. Some inefficient programmes were identified and eliminated through the use of performance evaluations. Public investment also suffered major cuts, dropping almost 50% from 2012 to 2015 (Figure 3.6).

Figure 3.6. **Evolution of Oaxaca's capital expenditure (2005-15)**



Note: Figures refer to state expenditure (do not include expenditure from earmarked grants or resources transferred to municipalities).

Source: Secretary of Finance of Oaxaca (2016).

SEFIN also took measures to contain human resources expenditure growth. In particular, growth rate of wages was controlled through more strict negotiations. Between 2013 and 2015, total expenditure in human resources only increased by 6% (compared to 63% during 2010-13) (Figure 3.2). Reforms to address other structural issues such as reducing the total number of employees and eliminating the possibility to sell or inherit civil servants "base" contracts (Box 3.1) were raised for consideration, although such issues have not been implemented to date.

One of the most important actions taken during this fiscal consolidation process was the recovery of the State Institute of Public Education in Oaxaca (IEEPO) in 2015. This measure was directly supported by the federal government, allowing the state government to re-assert orderly governance of the education sector in Oaxaca (Box 1.1). The reform had a positive impact on the finances of the state, since payroll payments are now directly made by the federal government through a specific fund (*Fondo de Aportaciones para la Nómina Educativa y el Gasto Operativo*, FONE). In the long run, the reform aims to stabilise the number of employees in the sector, and standardise salaries and benefits in line with the federal level (*tabuladores*). However, the reform process in the sector is still met with strong resistance from within the education trade union (Box 1.1).

Box 3.1. **Sale and inheritance of civil servant contracts in Oaxaca**

The public sector in Mexico has two categories of employees, union-affiliated (*base*) and free appointment (*confianza*). The union-affiliated are permanently appointed, with full employment stability and occupy mainly administrative positions, while free appointments have more often high positions and change with each government.

In certain sectors, a union-affiliated job can be inherited or sold. They are seen as an “asset” by these workers, which sometimes incurred into debt to “buy” them. The state cannot reduce the number of “base” workers by not replacing them after retirement, as a worker wishing to retire would either sell his contract, or give it to a member of his family. The state cannot choose the person who will acquire the contract either, which generates important mismatches between the profile and capacities of “base” workers, and the profile and capacities needed for the job. This often obliges public entities to hire additional workers, on other types of contracts, to carry out the tasks they need.

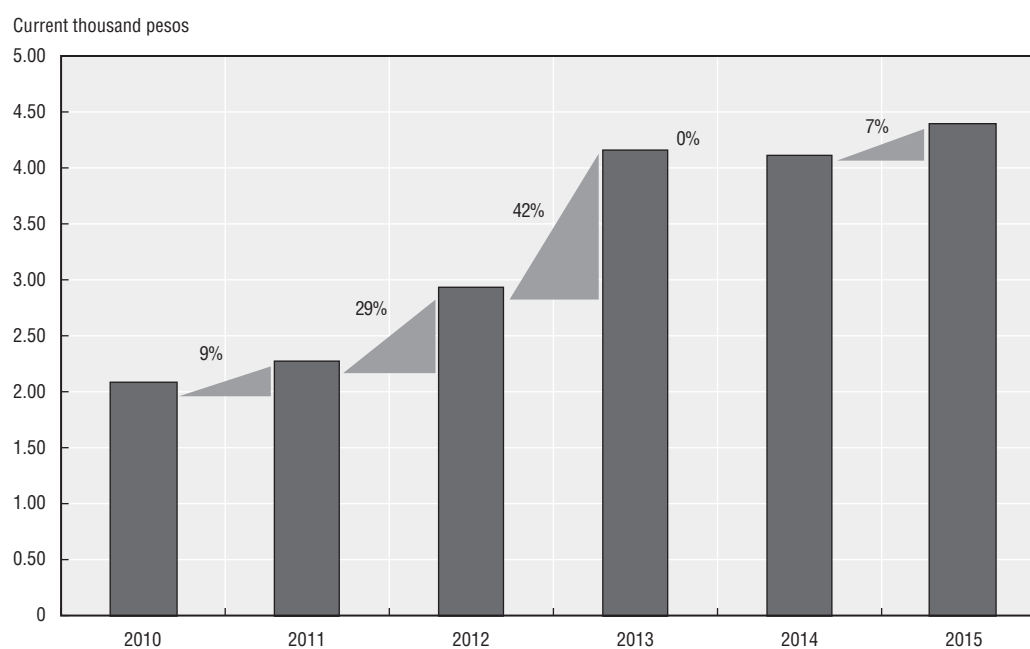
These cost containment measures have been successful in slowing down the upward trajectory of expenditure and have begun to reduce the high deficits of earlier years. However, Oaxaca’s current financial situation is still fragile. Sustainability in the long term requires structural reforms and a continuing commitment to implement sound budgeting practices into the future.

3.1.2.2. Great efforts to increase own revenues. Between 2010 and 2015, Oaxaca doubled its own revenues (Figure 3.7). This was achieved mainly by increasing efficiency in revenue’s collection.⁴ For example, the State Duties Law (*Ley Estatal de Derechos*) was enacted in 2012, as a part of a wider reform package of the financial institutional framework of Oaxaca, with the purpose of increasing the state’s own revenues. The state duties law refers to the contributions paid to the state for the use or exploitation of goods of public domain, as well as the received services provided by the state. According to the INEGI, revenues in duties increased by 63% between 2010 and 2014. The use of the banking system was promoted for collecting taxes and duties, helping to reduce theft and increasing trust that money would reach the public vaults. Revenue collection was also increased by sending letters and formal requests to taxpayers in arrears and increasing tax controls. For example, making sure hotels actually transferred to the state the day tax collected from tourists. The surcharge on personal income tax was increased from 2% to 3%, and a package of tax benefits was created to incentivise voluntary early payment.

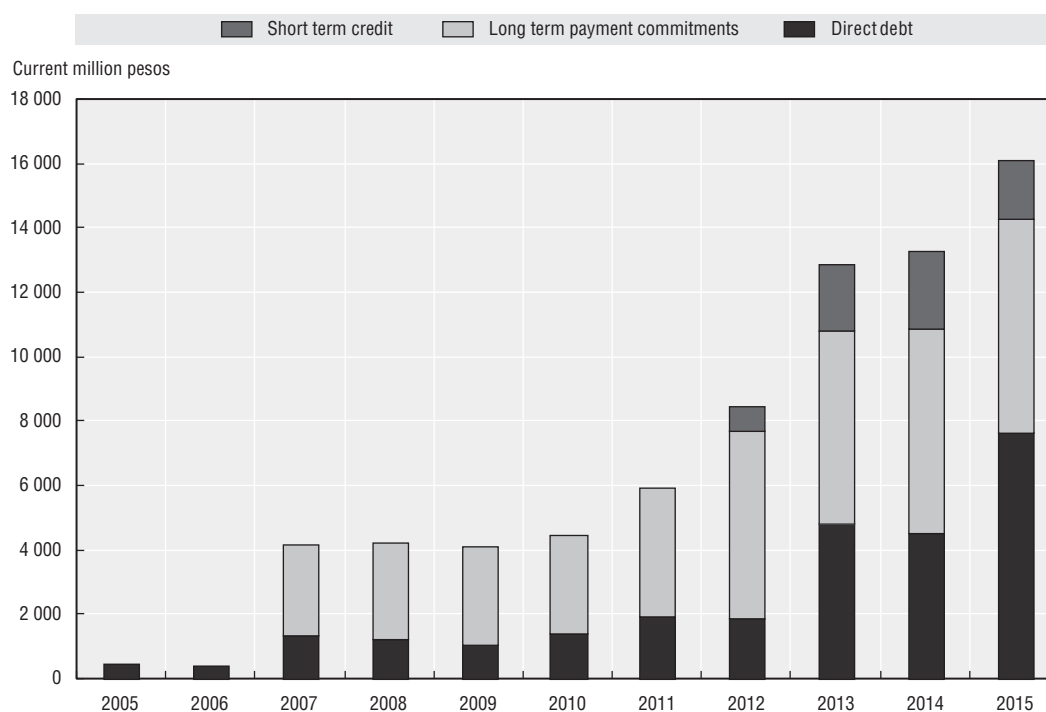
3.1.3. *Evolution of public debt and liquidity issues*

Despite the actions implemented to improve the financial situation of the state, liquidity continued to be a major issue, public debt increased, and the state’s rating classification declined. Between 2012 and 2015, Oaxaca’s financial obligations increased by 130%. This increase was mostly driven by an increase in short term credit in 2013, and the acquisition of public debt in 2013 and 2015.

Debt level as a percentage of GDP is still moderate compared with other Mexican states such as Quintana Roo, Chihuahua and Coahuila (Figure 3.9). However, since 2013, debt as a percentage of GDP increased above the national average. Credit rating agencies have highlighted this situation by reducing the state’s qualification. Some reductions in debt levels are projected for 2016. The important recent efforts must be continued to improve budgeting practices and cost containment strategies in order to maintain sustainable debt levels.

Figure 3.7. **Collected own revenues (2010-15)**

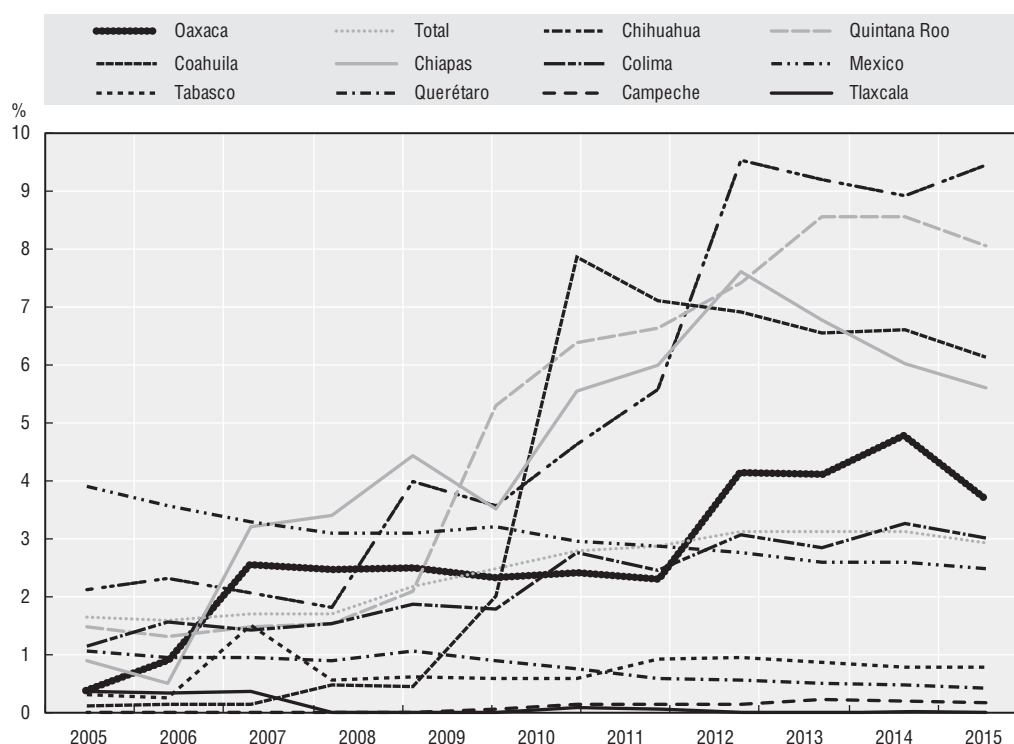
Source: Secretary of Finance of Oaxaca (2016).

Figure 3.8. **Financial Obligations by type (2012-15)**

Note: Long term payment commitments include securitisation from 2007.

Source: Secretary of Finance of Oaxaca (2016).

Figure 3.9. Debt as a percentage of GDP Oaxaca Vs other states (2005-16)



Note: Year 2016 considers preliminary figure from June.

Source: Debt statistic from the Federal Budget Transparency database (Transparencia Presupuestaria).

3.2. Recent reforms in the institutional and legal framework

In order to improve the state's financial situation, major reforms have recently been implemented to control and monitor expenditure and increase own revenues. These reforms have helped to slow down the expenditure trend and started offsetting the negative effects of the deficits accumulated in earlier years. A full set of fiscal rules was developed in order to comply with the Federal Financial Discipline Law for States and Municipalities (Box 3.2).

3.2.1. Institutional framework update

In 2014, the Secretary of Finance separated the Treasury from the Revenues Sub-secretariat, in order to separate the forecasting function from cash management. In addition, some formal and informal mechanisms were created to ensure that expenditure increases were supported with additional revenues. Furthermore, coordination mechanisms were improved to ensure communication between the different Sub-secretariats of SEFIN (the Sub-secretariat of revenues, of expenditures and of Planning). This new institutional set-up within SEFIN promotes fiscal control and ensures better alignment between collected revenues and actual expenditure.

3.2.2. Legal framework update

A new Budget and Finance Responsibility Law of the State of Oaxaca was enacted in December 2011. In 2014 the state issued the Budget and Fiscal Responsibility Law

regulatory decree. Two years after reforms were made to harmonise this legal framework with the Federal Financial Discipline Law for States and Municipalities. This law aims to improve budgeting practices and promote balanced budgets. Oaxaca was the first state to have a legal framework fully aligned with the federal Financial Discipline Law for States and Municipalities (Box 3.2).

Box 3.2. The 2016 Federal Financial Discipline Law for States and Municipalities

The objective of the law of financial discipline of states and municipalities (*Ley de Disciplina Financiera de las Entidades Federativas y los Municipios*) is to promote sustainable public finances, a responsible use of public debt, and to reinforce accountability and transparency. The law responds to a national trend of accelerated growth of debt in states and municipalities. It was enacted in April 2016. The main components of the law are the following:

- A warning system (*sistema de alertas*) will be created, through which the federal Ministry for Finance and Public Credit (SHCP) will bind states and municipalities to the agreements signed in the new law. Together with the public registry, it aims to facilitate transparency, monitoring and evaluation mechanisms for debt.
- A single public registry (*registro publico único*) dedicated to public debt management will be created, containing the details of all financial obligations of every state and municipality. The single public registry will also work as a means for transparency, monitoring and evaluation mechanisms for debt.
- Through the warning system, the federal Ministry for Finance and Public Credit will evaluate debt levels for each state with the information from the single public registry.
- Debt for personnel and current expenditures will be capped. New debt will be admissible only for investment or infrastructure.
- The growth rate for personnel expenditure will be limited to a maximum of 3% with respect to the previous year.
- All new debt shall be acquired by means of public biddings.
- Public officials who acquire debt for their state or municipality will have a legal responsibility in the case of misuse of resources.
- The debt levels of Oaxaca were placed in the category of “debt in observation”, which implies that the cap for new funding or debt can only represent a maximum of 5% of the revenues of free disposal.
- New debt will be authorized by the state Congress with a transparent process, exposing clear motives for the reason and destination of the debt, as well as detailed information on the debtor, creditor, amount, interest rate, term, type of guarantee and/or sources of payment.
- The federal government can act as a guarantee (*aval*) for subnational debt under certain strict conditions.

Source: Financial Discipline Law for States and Municipalities (2016).

Recent reforms introduce a wide set of fiscal rules in Oaxaca, including balanced budget requirements, expenditure limits, borrowing constraints, and process rules (Box 3.3):

- *Balanced budget requirements*: The government budget proposal, the budget law and the budget executed during the year should contribute to a sustainable budget balance. At the end of the fiscal year, and in an accrual bases, budget balance should be equal or more than zero.
- *Process rules – Golden rule escape clause*: Deficits are only allowed in three particular cases: reduction of tax share transfers due to GDP falls in real terms, natural disasters, and to implement measures that will have a significant positive impact in long-term fiscal balance (for example, paying compensations to reduce payroll). Strict process rules apply in order to trigger this clause (i.e. plan from the executive to finance and eliminate deficit, and Congress approval and reporting requirements).
- *Expenditure limits for human resources expenditures*: Increases in total expenditure for human resources should be less than the smaller amount between 3%, an annual real GDP growth.
- *Borrowing constraints – Golden rule*: Borrowing is only allowed for productive public investment projects. A clear definition of productive public investment projects is included in the regulation. In addition:
 - ❖ Public debt should be acquired following a detailed procedure to ensure that debt is purchased under the best market conditions;
 - ❖ Public debt should be authorised by three quarters of the Congress;
 - ❖ Borrowing is capped depending on the classification received in the federal alert system. Currently, Oaxaca has a classification of debt “under monitoring” (*endeudamiento en observación*), which entails a borrowing limit of 5% of “free disposal” revenues.
- *Borrowing constraints – short term debt*: Is only allowed without legislative approval when outstanding balance is below 6% of total revenues. In addition, all short term debt must be fully repaid three months before the end of the administration term. The state is not allowed to acquire additional short term debt during this period.

In addition, the new framework includes the following improvements:

- Specifying rules on how to spend revenues that exceed the initial amounts forecasted in the Revenues Law.
- Requiring that every expenditure increase is accompanied with the availability of additional revenues or reduction in other expenditures.
- Implementing an electronic system to plan, program, approve, control and oversight public expenditure.
- Requiring that every law decree or project with a budgetary implication has a budgetary impact assessment from SEFIN.
- Requiring spending units to have a budgetary availability certificate from SEFIN before signing agreements (*convenios*) with the federal government.
- Regulating a bank of investment projects.

These reforms are essential to improve the budget process and manage the finances of the state in a more sustainable way. However, their impact has been limited, due to delays in the regulation and yet insufficient enforcement mechanisms. The Budget and Finance Responsibility Law and its regulation came into force in January 2015, so its success in practical terms will need to be assessed over future years.

Box 3.3. Different types of fiscal rules for sub-national governments

Four types of rules can be used to support fiscal sustainability and short-term stability:

- **Balanced budget requirements** in OECD countries vary according to whether they are applied to the current budget and/or the capital account (balanced budget requirement applied only to the current budget, thus allowing borrowing to finance net investments is usually referred to as the “golden rule” of public finance); whether they are set annually or multi-annually; and whether they are imposed from above or self-imposed. Most commonly, balanced budget requirements are applied to current and capital budgets, are set annually, and are imposed from above.
- **Borrowing constraints** are widely used in OECD countries, but with a substantial variation in terms of restrictiveness. They range from total prohibition (Denmark and Korea) to no restriction at all. In most cases, sub-national government borrowing requires prior approval by higher levels of government, and is often restricted to certain purposes (such as investment).
- **Tax and expenditure limits.** Overall limits on tax rates or reliefs are widely used in OECD countries, and usually take the form of an explicit limit on tax autonomy set by central government. Expenditure increase limits are usually linked to income, inflation or population growth. But explicit, binding, expenditure limits are rather rare (they exist only in Germany, Korea, Portugal and Turkey). In some countries such as Japan, the Netherlands, Poland and Spain, expenditure limits are not imposed by central government, but self-imposed.
- **Process rules** that govern implementation will determine the degree of commitment of sub-national governments to the set of rules described above (indeed, without a proper commitment mechanism, sub-national governments could either ignore, or change the rules binding their autonomy). Process rules include the obligation to produce financial accounts (transparency), monitoring and reporting, and eventual sanctions in case of non-compliance. But process rules should also allow for flexibility of response, as breaking the fiscal rules might be the appropriate response to an unanticipated shock such as large revenue shocks, downturns in the local economy, the impact of natural or other disaster, etc. This is why many countries incorporate escape clauses that allow sub-national governments to breach the rule in case of certain predetermined events.

Source: Vammalle, Charbit (2010).

3.3. Recommendations for ensuring fiscal sustainability

Fiscal sustainability is the ability of a government to maintain public finances at a credible and serviceable position over the long term (OECD, 2013). According to OECD Principles for Budgetary Governance, budgets should be managed within clear, credible and predictable limits for fiscal policy. In order to do so, at minimum, government should have a stated commitment to pursue a sound and sustainable fiscal policy; that means avoiding the build-up of large, unsustainable debts, and using favourable economic times to build up resilience and buffers against more difficult times. Overall budget targets for each year should ensure that all elements of revenue, expenditure and broader economic policy are consistent and are managed in line with the available resources (OECD, 2014).

Cost containment strategies implemented in the last years of the administration have been effective to slow down the expenditure trend and start offsetting the negative effects of the deficits accumulated in the first years of the administration. Furthermore, recent reforms in the institutional and legal framework are fully aligned with OECD principles for budgetary governance.

However, there are additional measures that could be implemented in order to improve budgetary practices and prevent sharp expenditure increases and high, persistent deficits from happening again. Existing fiscal rules should be communicated in a more comprehensive way and the quality and reliability of revenue estimates could be improved. Furthermore, enforcement mechanisms are needed to ensure that recent reforms in the legal framework can have a real impact in public finances.

In addition, the implementation of the new legal framework could be reinforced with a training programme for the actors involved in the budget process. This effort will need the support of the Office of the Comptroller of the state, as it is the internal control body of the public administration, and the state's Supreme Audit Institution in order to implement criteria, follow-up controls and full identification of conduct liable to negligence, misappropriation of resources and corruption.

3.3.1. *Ensuring compliance with fiscal rules*

Fiscal rules can help governments promote short term economic stability, encourage aggregate efficiency, and increase allocative efficiency of public spending. In particular, at the sub-national level, they are useful tools to realise the potential efficiency gains from local autonomy, while meeting the objectives of sustainable longer term finances (Sutherland, Price & Joumard, 2005).

Recent reforms have introduced a well-structured set of fiscal rules in Oaxaca. These could be powerful tools to manage the overall growth and development of public spending and to ensure sound budget practices. However, enforcement mechanisms and sanctions for non-compliance are also key elements to ensure that fiscal rules have the expected impact on economic stability and fiscal management. If governments and societal stakeholders feel there are no consequences when infringing fiscal rules, these may not be respected. Transparency, reporting requirements, clear responsibilities for monitoring, sanction and oversight are some of the requirements needed to allow fiscal rules to have the intended positive effects. In particular, the measures set out below could help to strengthen the credibility and enforceability of fiscal management in Oaxaca.

- *Communicate fiscal rules in a more comprehensive way:* Fiscal rules are usually embedded in complex budgeting and public finance laws, which makes it difficult for public officials and citizens to have a clear understanding of the key elements and constraints of these rules. Oaxaca would benefit from having a more comprehensive document compiling the different fiscal rules in one place and explaining their particularities and benefits. In addition, the implementation of the new legal framework could be supported with a training programme for the actors involved in planning, programming, executing, monitoring and accounting of public expenditure.
- *Have a clear definition of responsibilities regarding fiscal rules compliance and sanctions:* Having an independent overseer to assess budget actions and to draw attention to actual or potential violations is helpful in ensuring compliance. In Oaxaca's context, such a role could be exercised by an independent fiscal institution (Box 3.4) or other government

institution with technical capacity and certain level of autonomy. The Centre of Economic Research and Public Finances of Oaxaca (*Centro de Estudios Económicos y de Finanzas Pública*) could have a role in this monitoring process, subject to clarification of the precise mandate and to ensuring adequate technical capacities and resources. This could also strengthen the oversight role of the Congress (see Section 6).

- *Improve information on state fiscal performance:* Greater transparency on budgetary policies can help the Congress and civil society hold their governments accountable for fiscal management. In particular, Oaxaca could benefit from making revenues estimation more transparent (see following recommendation), and having a clearer treatment of free disposal revenues (*Ingresos de libre disposición*), clearly showing in the budget documents the expenditures which these revenues are intended to finance (see recommendations in Section 6).

Box 3.4. Sub-national Independent fiscal institutions

Many OECD countries are establishing independent fiscal institutions, which carry out economic and fiscal projections (with a short- to medium-term horizon, or long-term scenarios); baseline projections (assuming unchanged policies); analysis of the executive's budget proposals; monitoring compliance with fiscal rules or official targets; costing of major legislative proposals; and analytical studies on selected issues. These independent projections are either used by the executive for designing its budget, or act as benchmarks on which to compare the government's projections.

The trend towards fiscal decentralisation over the past 20 years has meant that there is also a need for credible budgeting at the sub-national level. In this context, it is perhaps not surprising to observe that a number of sub-national (IFIs) have now been established in OECD member countries.

- In the nation of Scotland in the United Kingdom the Scottish Fiscal Commission, established in 2014, provides independent scrutiny of Scottish Government forecasts of receipts and economy determinants from taxes developed for Scotland
- In the province of Ontario in Canada the Financial Accountability Office, established in 2013, provides the Legislative Assembly of Ontario with independent analysis on the state of the Province's finances and trends in the provincial economy, and on bills and other proposal to support the Assembly's performance of its constitutional responsibility.

3.3.2. Make a more precise and transparent estimation of the revenues expected to be collected during the year

The budget process and Congress approval should be the primary route for authorising and allocating revenues in a state. In most OECD countries, when revenues are significantly larger than originally estimated in the budget, either the surplus funds are used to reduce deficit levels or pay back debt, or their allocation must be submitted to and approved by the legislature.

Until the 2015 Fiscal Responsibility Law of the State of Oaxaca, which stipulates how extraordinary or "windfall" revenues are to be spent, SEFIN was effectively incentivised to underestimate revenues, in order to generate funds which it could prioritise and distribute freely in response to social priorities emerging during the course of the year.

Such practice is common in the case of governments which have undeveloped planning systems or which lack specific funding to cover for natural disasters and other catastrophic events. However, in Oaxaca's case, the practice of under-estimating revenues has become widely known and anticipated, and in turn tended to fuel a culture of reacting to the demands of organised social groups. Spending units also knew that there was a prospect of securing additional funds during the year provided they made sufficient efforts to convince SEFIN of the importance of their needs. Such practices tend to reduce the credibility of the annual budget: instead of having a centralised negotiation period once a year, to allow all of the competing priorities to be settled in the context of a realistic view of actual resource availability, instead all the year becomes a continual period of negotiation and fractious debate.

To avoid this, revenues should be estimated as precisely as possible from the outset of the annual process. Having an independent technical body in charge of the economic assumptions for revenues forecasting can reduce accountability gaps and increase quality, credibility and transparency of revenues estimates (Box 3.4).

Keeping the discretionary reserves of SEFIN to a minimum would reduce the inappropriate pressures on that organisation, and would transfer responsibility for deciding upon resource-allocation priorities back to the political and budget processes where they rightfully belong. Similarly, an annual public report about how these discretionary funds are spent would promote transparency and accountability.

A reserve for catastrophic events (earthquakes, hurricanes, etc.) could be created, with clear rules on when the money can be drawn from that fund. In that sense, the 2015 Fiscal Responsibility Law seems to be an important way forward – even if it is yet too early to assess how effective it is in practice.

3.3.3. Carry out a more structural human resources management reform

New fiscal rules aim to help governments increase control on their human resources expenditures. However, including the rule in the legal framework is not sufficient to achieve this objective. Oaxaca should carry out a more structural human resources management reform in order to achieve the expenditure targets set by the federal government. A full revision of existing contracts should be carried out to ensure that the type and form of the contract is aligned with the needs of each public institution. Union-affiliated contracts (*contratos base*) should be reduced to the minimum, and practices such as purchasing and inheritance of this type of contract should be phased out. This would not only contribute to reducing expenditure, but would also improve productivity in the public sector. Recent legal reforms give some financial flexibility to implement this type of measures aiming to have a significant positive impact in long-term fiscal balances.

3.3.4. Additional efforts to continue increasing own revenues

Oaxaca has been successful in increasing own revenues by increasing efficiency in revenue's collection. Additional measures that could be implemented to further increase tax collection are: strengthening tax delegations (*delegaciones fiscales*) to increase collection of the personal income tax; improving income tax collection by using cross databases to check personnel numbers (e.g. the IMSS does not pay the overhead tax "*impuesto sobre la nómina*", while ISSSTE does pay); increasing efficiency in collection of unpaid tax duties and sanctions for noncompliance, and creating mechanisms to ensure that people that have car plates from other states also pay tax on vehicular tenure.

4. The Budget process

The budget formulation process in Oaxaca, headed by SEFIN, is particularly complex, due to the multiplicity of revenue sources which come with different earmarks and requirements. Some of these revenue sources (transfers) are directly negotiated by the spending units with the federal government for specific expenditures, and in the case of public investment, often require state matching funds. SEFIN therefore has the challenging task of putting all these elements together, optimising its scarce resources of free disposal to answer matching requirements, while trying to allocate funds according to the state's own priorities.

An important characteristic of the budget formulation process in Oaxaca is that it only applies to operational expenditures. Resources for public investment are set apart on a special account managed by the Planning and Investment sub-secretariat of SEFIN. These resources are allocated by this sub-secretariat during the course of the budget year, mainly for meeting federal matching requirements (*acuerdos pari passu*).

The budget process in Oaxaca is decentralised. Each spending unit designs its annual programme, and submits its funding requests to SEFIN. While spending units receive a proposed limit on available resources for current expenditure, in practice this does not serve as a binding constraint or as a focus of early discussion during the budget formulation, and annual funding requests from the line ministries tend to be above the fiscal capacity of the state. Several negotiation processes then need to take place to accommodate funding requests with available resources.

The state Congress has ample faculties for amending the budget, but in practice, is not equipped to do so. Citizens do not seem to look primarily towards the Congress as a forum to ensure that their interests are duly reflected in the budget allocations. In the absence of such a role played by Congress, there has been a movement towards strong and active organised social groups, which put pressure directly on SEFIN to receive funds.

4.1. Budget calendar

A particularity of the budget process in Oaxaca is that the budget allocation process only applies to operating expenditure. Funds for public investment are set apart in a special budget line. This budget line is managed by the Planning and Investment Sub-secretariat, who distributes it to executing units during the budget year, depending on the availability of resources and the matching requirements of federal transfers. Planning for investment expenditure will be analysed in the next section.

The budget process in Oaxaca is formally divided into eight phases: 1) planning, 2) programming, 3) budgeting, 4) execution, 5) control, 6) monitoring, 7) evaluation and 8) reporting. However, there is no formal budget calendar in Oaxaca. The only fixed dates are the date for submitting the draft budget law to the Congress (25 November), and for approval (30 December). The previous stages may vary from one government to the next, or even during a government period. The process described below is the one that has been taking place between 2013 and 2016 (Table 4.1).

The budget formulation phase starts in April/May in the Budget Department of the Expenditure Sub-secretariat of SEFIN. The Budget Department of the Expenditure Sub-secretariat prepares a manual of planning, programming and budgeting (*planeación, programación y presupuestación*) where it defines the programmatic structure of the budget. Spending units then send their funding requests to SEFIN based on this programme structure.

Table 4.1. **Budget formulation calendar in Oaxaca (Operating expenditures)**

Year previous to budget year	April/May	SEFIN prepares a manual of planning, programming and budgeting (<i>planeación, programación y presupuestación</i>) defining budget programmes
		Spending units send their spending requests to SEFIN
	June to August	Planning and Expenditure sub-secretariats of SEFIN define the budgetary programmes
	31 August	SEFIN sends programme structure to Congress, which has 15 days to make observations
	September	Budget Dept. of the Expenditure Sub-secretariat of SEFIN starts working on financial ceilings for operating expenditure
	October	Revenue Direction of SEFIN prepares revenue projections for the coming year
	Mid-October	Budget ceilings for operating expenditures are sent to spending units
	Mid-October to mid-November	Spending units aggregate the funds they will receive from federal transfers and from the state budget, and allocate them to their different programmes
	Mid-November	SEFIN receives all the budgets from the spending units, and “integrates” them in the state budget document. Funds for public investment are set aside in a budget line
	25 November	Draft budget decree sent to Congress
Budget year	30 December	Budget decree must be approved by Congress
	First days of January	Each spending unit is informed of its approved operating budget for the year(p1)Budget line for public investment is allocated to the Planning Directorate of SEFIN
	January to June (approx.)	Planning Directorate of SEFIN allocates funds for public investment
	During budget year	Revenue Direction of SEFIN may update (usually increase) its revenue forecasts. In this case, the Budget Dept. of the Expenditure Sub-secretariat of SEFIN can allocate new resources to spending units or to the Planning Directorate, for public investment

In June, the Planning secretariat and the Budget Department of the Expenditure Sub-secretariat start working together. In July/August, they define the budgetary programmes with the spending units (*ejecutores de gasto*). On the 31st of August, SEFIN hands over the programme structure to Congress. The Congress then has 15 days to review it and make observations. There are usually no observations.

In September, the Budget Dept. of the Expenditure Sub-secretariat of SEFIN starts working on the financial ceilings for operating expenditure, but at this stage, there is no evaluation of revenues and ceilings are calculated based on current year expenditure levels, wage increases, etc. Since 2013, three scenarios of financial ceilings are prepared (Box 4.2). These ceilings are then presented to the Sub-Secretary of Expenditure and Accounting (*Sub-secretario de egresos y contabilidad*). These ceilings only include operating expenditure, funds for public investment are set aside in a separate account.

Box 4.1. **Scenarios for expenditure ceilings**

Since 2013 and the need to consolidate, SEFIN reviews the operating expenditure requests from the 91 spending units (staff, basic services, furniture and specific services, furniture and general services). The Expenditure Sub-secretariat of SEFIN prepares ceilings for three scenarios:

- High scenario: Considers all expenditure which could be authorised on following year (that of current year, wage increases, new programs, etc.).
- Medium scenario: The budget is revised line by line, checking whether it can legally be reduced (for example, reducing the number of short term staff – *honorarios*).
- Low scenario: Budget lower than current year, only keeping legally mandated expenditure.

In October, revenue projections are carried out by the Revenue Direction of SEFIN, and compared to the expenditure scenarios. As expenditure ceilings are not grounded upon revenue projections, total expenditure tends to be higher than expected revenues. In that case, either the estimated revenues are increased, or expenditure ceilings must be cut. Since 2013, the latter solution is privileged due to consolidation needs.

Mid-October, budget ceilings are sent to spending units through an electronic system. Each spending unit then distributes its budget among its programme, and integrates these state funds with the Federal funds earmarked to them. Spending units then send the result of their integration to the Expenditure Sub-secretariat of SEFIN, who consolidates the budget. The budget only allocates state funds for operational expenditure: All the resources for public investment (which mainly consist of resources for matching federal funds) are set aside in one account, the Normal State Plan (PNE, *Programa Normal Estatal*), managed by the Planning and Investment Sub-secretariat of SEFIN. These resources are then distributed during the year to the different spending units.

In November, the draft budget decree and an explanatory memorandum (*exposición de motivos*) are sent to the Governor. On the 25th of November, these are sent to Congress.

In principle, Congress could propose any change to the draft budget, but in practice, it rarely does so. The main items that Congressmen regularly propose increasing are the budget for the Congress, and earmarked funds for their constituencies.

On 30 December the budget must be approved. During the first days of January, the Secretary of Finance informs all heads of the spending units of their approved budget for the year. Each spending unit receives an envelope (*oficio*) with its detailed budget (excluding investment) and a calendar for receiving the funds – however, this calendar is not made according to the calendar for revenue collection, so it is usually not met.

4.2. Revenue Law (*Ley de Ingresos*)

The revenue law estimates the revenues that the government of the state of Oaxaca will receive in a given fiscal year. The estimated revenues are broken down by type and quantity. In November, the Revenue Division of SEFIN prepares a budget revenue circular (*exposición de motivos*), which analyses the trends in revenues, and explains the proposal for revenue law. The revenue law is presented to the state Congress, for discussion and approval.

4.3. Medium-term strategic planning

When taking office, each elected governor has six months to prepare its state development plan (*Plan Estatal de Desarrollo*, PED), which states its government priorities and defines the government programmes which will be developed to reach them. While great efforts have been carried out to improve the relevance and quality of this document, it is still a long list of aspirations, with no clear costing or articulation of key priorities. Linking medium-term plans and annual budgets is a challenging task for all governments, as it requires important amounts of information which are often lacking (such as indicators of needs, costing of policies, estimation of available revenues, etc.). Oaxaca faces these common challenges, and still has room to improve its medium-term strategic practices and how they link with the annual budgets.

4.4. Budget discussion and approval

The constitution of Oaxaca gives significant powers to the Congress during budgetary discussion and approval. The state Congress can propose any change to the budget spending document. Regarding the revenues law, it can only update the total amounts, without increasing taxes or contribution rates. Despite these faculties, in practice, there is little debate about budget allocations during the budget approval phase. The approval process is perceived more like a formality, rather than an in-depth scrutiny and debate of the budget documents and spending priorities.

4.5. Civil society participation in the budget process

The lack of debate and weak participation of the Congress in the budget process could partially explain increasing demands and strong pressures of social groups in Oaxaca. In the absence of adequate representation by political elites, civil society has developed different mechanisms to directly participate in public decision making and resource allocation.

Oaxaca has a particular tradition of civil society engagement in the budget process. Instead of participating in the budget formulation process or in ensuring accountability of public spending through their elected representatives, organised social groups demand resources directly to SEFIN. These organisations are frequently associated with clientelism, putting pressure directly on SEFIN to receive funds to develop particular public works mainly in rural areas. Until a recent reform was passed in 2016, organised social groups were considered spending units for investment projects. As a consequence, they were allowed to present proposals to the “bank of public investment programme and projects” and received resources that were difficult to control and monitor.

The number of organised social groups has increased rapidly in Oaxaca during the last years, reaching around 500 groups registered in 2016. There are nearly 80 of these groups particularly worth noting as they have numerous members and are very active in requesting public resources. The challenging financial situation of the state has prevented SEFIN from fulfilling the requirements of the numerous new groups. As a response, organised social groups every so often protest and participate in public demonstrations, blocking access to public offices and, in some cases, affecting service provision and mobility in the region.

4.6. Results based budgeting

Since 2013, Oaxaca started implementing a results-based budgeting approach, aiming to shift the public sector towards a results-based management, which starts in the budgeting process and is sustained by the commitment to reach specific goals. Special efforts have been made to have a better link between state development plan, and programmes and objectives of spending units.

In 2015, Oaxaca carried out a financial reengineering based on results. Under this exercise, program structures were adjusted and simplified based on a logical framework methodology. This framework consists of gathering evidence on the specific actions which have the greatest impact on the targets, developing the concrete policies and programmes to implement these, making a cost evaluation of these actions, and making sure the budget allocates sufficient resources. In addition, the Secretariat of the Governor helped to create

a strategic performance framework with 36 outcome indicators and 96 output indicators that summarise the management performance.

Some of the key outcomes of this process were simplifying the program structure, linking the programme structure and the budget with the *ex post* evaluation, and developing a social program register and a catalogue of strategic and management indicators.

4.7. Recommendations on budget process

4.7.1. Clearly define a budget calendar

Clearly defining a budget calendar, clarifying what each actor has to do at each period of the year, and when important information will be available. This would help agents plan their work, and would clearly define the negotiation periods (and thus, periods where no negotiation should take place).

OECD countries generally divide the budget process into five phases (Table 4.2):

Table 4.2. **Typical budget calendar**

January	February	March	April	May	June	July	August	Sept.	October	Nov.	December
Year (t-1)											
Pre-budget phase: Discussions with civil society and Congress on budget orientations and priorities			Budget preparation: The budget authority (or an independent fiscal institution) makes an estimation of revenues and allocates expenditure ceiling to Line Ministries. Line Ministries define their budgets within their ceiling taking into account their programmes and priorities.								
									Budget discussion: The budget authority presents the budget bill to the Congress, and discusses with Congress on the allocation of funds to the different programmes and priorities		
Budget approval: Congress approves the budget bill											
Year (t)											
Execution: Line ministries carry out their programmes and provide the public goods and services based on their budget allocations											
Year (t+1)											
Evaluation and accountability: The Congress and the Audit Institution evaluate whether the programmes have achieved the expected results											

- **Pre-budget phase:** The executive discusses budget orientations and priorities with the civil society and with the Congress;
- Budget preparation phase:
 - ❖ The budget authority (or an independent fiscal institution) carries out projections of the economic parameters for the coming year (growth, revenues, interest rates, etc.);
 - ❖ Based on these projections and on the fiscal target, the Finance Secretariat/Ministry calculates the maximum amount for total expenditure, and updates expenditure baselines;

- ❖ The Finance Secretariat/Ministry and line ministries agree on budget ceilings for each line ministry, within the overall spending envelope previously defined;
- ❖ Line Ministries allocate their spending envelope to their programmes, according to their priorities
- **Budget discussion and approval phase:** The executive presents the budget bill to the Congress, and discusses with Congress the allocation of funds to the different programmes and priorities. Depending on the country, the ability of the Congress to propose new expenditure or redefine proposed programmes ranges from almost none (ex. Chile), to total freedom (ex. the United States);
- **Budget execution phase:** Each line ministry executes its programmes and provides the public goods and services based on the budget allocations. Flexibility in moving funds from one budget line to another or one spending area to another varies greatly across countries;
- **Evaluation and accountability:** The Congress and the Audit Institution evaluate whether the programmes have achieved their expected results. The results of these evaluations should feed the budget preparation phase of the following year.

4.7.2. Include clear targets and cost estimates in the State Development Plan, to make it a more useful document for the annual budget allocation process

The State Development Plan should be based on evidence of needs, and set achievable goals, given the time and resources available to implement it. It should therefore be based on the medium-term projection of available resources. It should determine what the government's priorities are, and what programmes will be implemented to achieve them. It should therefore determine a programme structure, which should be mirrored in the annual budget programme structure. For each policy, an indicator should be selected, and the reference value and target value clearly stated.

4.7.3. Clearly define fiscal targets and fiscal space at the beginning of the budget process

According to the OECD Recommendation on Budgetary Governance, the budget preparation phase is one of the most important phases in the budget process. Indeed, this is when the revenues for the coming year are estimated, and fiscal aggregates decided, thus determining the expected budget deficit. It is therefore crucial to count on reliable forecasts (growth rate, revenues, interest rates, exchange rates, etc.), so that the fiscal outcomes correspond to those planned in the budget. Mechanisms must be in place to ensure that budgets are managed within clear, credible and predictable limits for fiscal policy.

The budget formulation is also the phase when scarce resources need to be allocated to each spending area and specific programme. While the room for manoeuvre of governments is often constrained (mandatory expenditure, earmarked revenues, etc.), it is important to ensure that budgets are closely aligned with the medium-term strategic priorities of government. In particular, the capital budgeting framework must be designed during this phase, in order to meet national development needs in a cost-effective and coherent manner.

4.7.4. Move towards a stronger top down (integrated) budgeting practice, setting clear and credible spending ceilings earlier in the budget formulation process

To be effective, top-down budgeting requires that the executive sets clear and credible spending ceilings in the beginning of the budget formulation process, allowing spending units to plan according to previously defined public finance targets (Box 4.2).

Box 4.2. Top-down V. Bottom-up budgeting

In an effort to control deficits and constrain expenditure growth, many OECD countries began to adopt top-down budgeting practices in the 1990s. “Top-down budgeting” (integrated budgeting) refers to the budgeting practice whereby the fiscal targets are determined from the outset, with annual and multi-annual budgetary policies subsequently determined in conformity with these overall levels. Typically in top-down (integrated) budgeting, the executive first determines aggregate public finance targets (spending and revenue levels) given medium-term fiscal objectives and prevailing economic conditions. Within this aggregate, sectoral ceilings are set reflecting existing commitments, political priorities in general and key new policy initiatives. The detailed allocation decisions are typically delegated to individual sectoral units. To be implemented effectively, top-down budgeting requires rigorous and prudent economic forecasts and must be combined with complementary fiscal management practices such as medium-term expenditure frameworks.

Bottom-up (fragmented) budgeting is a reactive, expenditure-driven process that imposes no up-front constraints on sectoral requests; total spending is determined as the residual sum of individual appropriations and remains unknown until the final stages of budget preparation. The detailed appropriations characteristic of bottom-up (fragmented) budgeting foster agency-specific programme ownership and make it difficult to reallocate in accordance with new policy priorities. Such budgetary processes typically lead to unsustainable spending paths

Top-down (integrated) budgeting marks a significant reorientation of the budget process as compared to the traditional bottom-up (fragmented) approach (see table below).

Top-down budgeting vs. bottom-up budgeting

	Top-down (integrated) budgeting	Bottom up (fragmented) budgeting
Primary focus	Policy-driven process that aligns spending with key priorities (proactive)	Expenditure-driven process (reactive)
Role of Finance Minister/Secretary	Set aggregate spending level based on fiscal management target and monitor compliance	Negotiate details of individual spending proposals to control detailed allocations
Role of spending ministers/secretaries	Allocate financial resources to individual programmes within assigned spending ceilings	Submit budget requests and negotiate itemized appropriations
Economic forecasting	Aggregate fiscal analysis that takes into account economic forecasts.	Ministry by ministry analysis that largely ignores economic forecasts
Efficiency	Streamlined process reduces inefficient practices excessive requests	Inefficient and time-consuming negotiations process
Timeframe	Multi-year perspective	Annual appropriations process

Source: OECD (2014), *Budgeting practices and procedures in OECD countries*.

The budget formulation process in Oaxaca starts in April/May with the spending units sending their spending requests to SEFIN, without having a clear indication of their budget ceiling. This creates incentives for spending units to submit extensive wish lists of all the programmes they would like to finance, eventually overestimating needs, as they know that they will not receive the full requested amount. This results in total requests above the financial capacity of the state, and leads to long and tiring negotiation processes. Revenue projections for the coming year and communication of budget ceilings for operating expenditures are only sent to spending units in October. As a consequence, spending units need to adjust their initial requests before consolidating the budget and sending it to the State Congress. This dynamic in the budget formulation process generates frustration as some spending requests must be rejected, and expectations cannot be fulfilled.

As a first step towards implementing a stronger top-down budgeting approach, the budget process should start with a technical estimation of the total available revenues of Oaxaca. Given the fiscal balance the government is aiming to achieve and the revenue projections, the maximum amount of expenditures for the coming year can be calculated. This aggregate amount should then be distributed to the different spending areas, according to the priorities set out in the State Development Plan. This results in expenditure ceilings for each spending unit. These expenditure ceilings should be clearly communicated to all spending units at an early stage in the budget formulation and should be the base for any funding requests prepared by the spending units.

Oaxaca could also improve the credibility of the ceilings set during the budget formulation phase. The Secretary of Finance tends to increase the revenue forecasts and allocate new resources to spending units during the budget execution phase, undermining the certainty and credibility of the budget ceilings set in the beginning of the year.

4.7.5. Shift civil society participation from directly receiving resources to having a stronger role in budget formulation and monitoring

According to the OECD Principles of Budgetary Governance, debate on budgetary choices should be inclusive, participative and realistic. The legislature, citizens and civil society organisations should be able to participate and influence the discussion about key priorities, trade-offs, opportunity costs, value for money, and other budgetary policy options. A well-functioning civil society can have a positive effect in the budget process. Strengthening civil participation in the budget process can increase responsiveness, impact and trust in the way resources are spent. Heightened citizen engagement can potentially increase accountability, reduce opportunities for corruption and strengthen the culture of open democracy (OECD, 2017a).

Citizens and civil society should be key actors in the policy formulation, budget approval and audit stages. Allowing citizens and civil society organizations to participate during a pre-budget phase enhances the quality of democracy by encouraging direct participation of citizens in open and public debates. In a similar way, civil society participation in the monitoring phase can increase transparency and accountability, reducing government inefficiencies and corruption (Shah, 2007).

Oaxaca would greatly benefit from shifting civil society participation from simply requesting and directly receiving resources to having a stronger role in the budget formulation process and oversight. The government of Oaxaca could for example organise “citizen forums” during the pre-budget phase, in order to address in a multi-lateral and

transparent way, the different voices and requests from civil society. According to Shah (2007), one key feature associated with successful participatory budgeting programmes is that participatory budgeting projects are implemented through a regularised, bureaucratic process. Civil society should have a strong role in the decision making process, fostering a realistic dialogue about how scarce resources should be prioritised, but they should have a reduced role during the implementation phase of the project. This should reduce opportunities for corruption and clientelism. During the execution phase, citizens and civil society organisations can have oversight meetings to ensure that the policies are being implemented as planned, but they should not participate in the project execution itself.

Engaging citizens and civil society organisations in the budget formulation and monitoring process would also increase participation of unrepresented citizens. Current structure only allows participation of well-organised groups, restricting and discouraging participation of poorly organised and small groups.

Box 4.3. International experiences with participatory budgeting: Korea and Philippines

Korea is considered an international example for good practices for civil engagement in the budget process. Participatory budgeting was introduced in Korea in 2003. Six mechanisms are used that span the entire budget cycle. During the budget formulation stage, 1) formalised open discussions for the public are held; 2) representatives from the Ministry of Finance hold meetings with local government officials and citizens; 3) a fiscal policy advisory council reviews and finalises the budget and 4) an assembly expert hearing is conducted. During the implementation stage, 5) a budget waste reporting centre can be used by citizens to report any suspected misuse or waste of public funding. In the auditing stage, 6) citizens have the opportunity to make suggestions to the board of audit and inspection on which public entity operations or expenditures to audit.

The Philippines has also developed good practices to include civil society organisations in the budget formulation process. It established the Budget Partnership Agreement (BPA) as a mechanism for civil society organizations engagement with national government agencies in drafting budget proposals. This instrument is only one of many introduced in the Philippines to make budgeting more participative. A public participation score of 67 in the 2015 Open Budget Survey acknowledges these efforts.

Source: OECD, 2017a.

4.7.6. Resources given to organised social groups should be monitored and included in the budget in a transparent way

Transforming civil society engagement with the budget process would require time and effort from both civil society and the state government. In the meantime, sound budgetary practices should be applied to monitor the resources transferred to organised social groups, ensuring that they are spent according to the social purpose that they intend. In addition, these resources should be included in the budget in a clear and transparent way.

4.7.7. Allocate investment funds to the spending units in the budget law

Budget allocations to spending units in the budget law do not include (at least for the most part) investment. They only represent operational expenditures, and sometimes,

those federal funds that are clearly earmarked for a particular project or entity. Therefore, spending units do not know, at the beginning of the budget year, what funds they will have to carry out their programmes during the year.

The next section will address the issue of capital budgeting, and will explain why it is indeed very difficult to allocate funds for investment in the budget. However, it is essential that resources for investment follow the budget process, to ensure that investment projects are assessed in function of their relative costs and benefits, and financed according to their level of priority. In addition, spending units need to know from the beginning of the budget year the total resources they will have, so that they can plan their activities and prioritise their programmes, therefore improving efficiency and effectiveness of funds.

4.7.8. Consider integrating operational and investment budgets into a single ceiling communicated to spending units

Today, there is a distinction between running costs (*gastos corrientes*) (such as wages, basic services, etc.) and what is called “investment expenditure”, which seem to be additional funds needed to actually run the programmes. The former are negotiated with the Expenditure Sub-secretariat of SEFIN during the budget formulation process and the later are negotiated with the Planning Sub-secretariat of SEFIN during the execution year.

Such a procedure does not give visibility to spending units on their resources for the year, and therefore reduces their planning capacity. In addition, it does not give incentives to spending units to make efforts for reducing their running costs to free up resources to finance their actual operations and investments, as they would not be able to keep these.

If Oaxaca was to move to a stronger top-down (integrated) type of budgeting system where it gives clear budget ceilings to each spending unit, these ceilings should include both running costs and investment/programmes costs. A step even forward would be to allocate running costs to the programmes in order to have a true picture of their costs.

4.7.9. Capacity of Congress on budgetary issues could be reinforced, engaging the Congress more actively at the pre-budget and budget approval stage

In most OECD countries, the legislative branch plays a fundamental role in approving the budget law and in holding governments accountable for public spending. Legislative oversight of the budget is critical to promoting fiscal transparency and accountability. The Congress, as the institution through which the will of the people is expressed and through which popular self-government is put in practice, should have the opportunity to engage with the budget process at all key stages of the budget cycle. It should play a formal role in scrutiny and authorisation of the executive’s budget proposal and overseeing budget implementation on behalf of citizens (OECD, 2017a).

Reinforcing the technical capacity of the Congress of Oaxaca on budgetary issues could encourage a deeper debate on the pre-budget (Box 4.4) and budget approval stage. For example, the Congress of Oaxaca could benefit from having additional technical advice to support the work of the program and budget committee. Indeed, one of the main obstacles for congressional involvement in the budget process is often the lack of capacity of Congress members to understand and analyse the budget, which is a very technical and long document. It is therefore important for legislatures to rely on experienced staff and expertise to exercise their oversight functions properly. In that sense, the role of the Centre

of Economic Research and Public Finances (*Centro de Estudios Económicos y de Finanzas Pública*) could be strengthened to ensure that the Congress of Oaxaca has a strong and active role in the state budget process.

Box 4.4. Parliament engagement in the pre-budget phase

The pre-budget phase can also benefit from the distinct democratic legitimacy of parliamentary input. Parliamentary engagement in an early stage of the budget cycle allows parliamentarians' views on issues of fiscal and budgetary policy to inform the budget formulation process. Such engagement should:

- Be informed by the government's pre-budget report on fiscal policy intentions and potential budgetary options
- Be conducted in a realistic manner that takes account of overall fiscal constraints
- Provide opportunities for public input through mechanisms such as public hearings
- Result in a clear set of policy priorities, criteria and options from parliament to the executive
- Provide for parliamentary input into periodic spending reviews, particularly where these reviews will have a multi-year effect on actual spending allocations

Source: OECD, 2017a.

5. Public investment planning and budgeting

Planning and budgeting for public investment is difficult for all governments, especially sub-national governments, and Oaxaca is no exception. Indeed, there are several factors which make planning and budgeting for public investment particularly challenging in Oaxaca. First, more than 90% of the resources for public investment come from five federal funds, which each have a specific set of eligibility requirements. Second, most of these federal funds require state matching resources, and the precise amount of each fund and matching requirement is not known until the first quarter of the budget year. The state therefore prefers to set resources aside to cover these matching requirements and only allocate them once the precise federal transfers are confirmed. This implies that spending units do not know how much resources they will have for public investment, which undermines their capacity to develop their plans and activities. Third, all capital investment funds must be spent before the 31 December of the budget year. Given that funds are allocated rather late in the budget year, this leaves only a short period of time to spend the funds. The size and relevance of investment projects which can be carried out in such conditions is therefore limited. Finally, public investment planning, design and execution is a highly technical exercise, and many spending units and municipal governments lack the technical capacity to develop an investment project, let alone an investment plan.

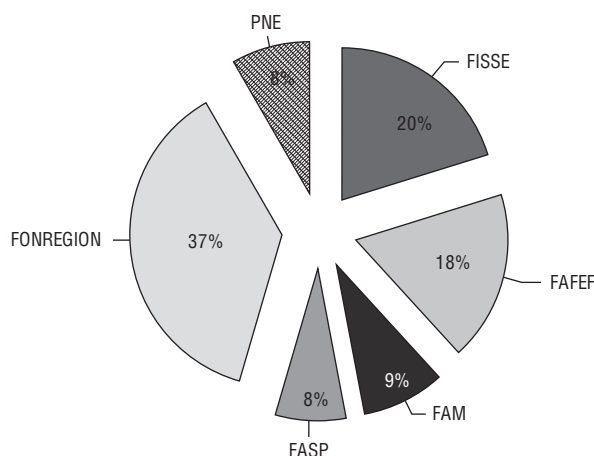
5.1. Financial resources for capital expenditure in Oaxaca

Financial resources for capital expenditure in Oaxaca flow from various sources. The resources that the State allocates for public investment are set aside in a budget line called Normal State Plan (*Plan Normal Estatal*, PNE). The total amount in the PNE is determined by the Expenditure Sub-secretariat of SEFIN, based on projected available funds. However this

amount to frequently increases in the course of the year. This budget line is transferred to the Planning sub-secretariat in the beginning of the budget year, and will be allocated to the different investment projects during the course of the year. It is also used to respond to demands from organised social groups.

The PNE finances less than 10% of total public investment (Figure 5.1). Indeed, Oaxaca also receives funds from the Federal government for public investment. Federal resources for public investment consist of the formula based earmarked transfers (*aportaciones*, *Ramo 33*), funds received from the FONREGION and ad-hoc agreements (*convenios*). Formula based earmarked transfers resources come via eight different contribution funds, each targeted to a specific area. Within that area, the state can choose which project to finance. *Convenios* are specific contracts between the Federal government and a state executing unit, to finance a specific project. Usually, these *convenios* require matching funds from the state. The rate of the matching varies from project to project, and resources for the matching are taken from the PNE budget line. Finally, the state can apply for resources from the Regional Fund FONREGION for programmes or projects in roads, education or health aiming to increase the state's human development index (Box 5.1).

Figure 5.1. **Financial resources for capital expenditure in Oaxaca**



Source: Interviews.

5.2. Institutional setting

Until 2010, public investment was managed by a decentralised public institution, the COPLADE. The Ministry of Finance allocated funds to COPLADE each year and COPLADE co-ordinated investment projects and needs. COPLADE had offices in the different regions of the state, and was politically linked to the PRI. COPLADE's centralised institutional framework probably favoured co-ordination of investment policies. However, COPLADE was not mandated to report on how funds were being spent and the results achieved. This lack of transparency led to accusations of corruption.

When the new government stepped in in 2010, it abolished COPLADE and created a sub-secretariat for planning in the Secretariat of Finance, which is responsible for planning and co-ordinating public investment. The Sub-secretariat of Planning and Investment is subdivided into three departments: 1) the planning department, 2) the programming department and 3) the evaluation department.

Box 5.1. Regional Fund FONREGION

The Regional Fund FONREGION was created in 2007 to solve one of the most severe challenges in Mexico: extreme poverty and inequality. This is why this fund was created to support the development of the most lagging regions and reduce the gap among regions. Resources allocated to this fund aim to finance investment programmes and projects in infrastructure and equipment in roads, health or education, with an impact on the development of the regions of the 10 most lagging states in terms of human development index.

States must apply to the resources of Fonregion by sending an application to the Federal Secretariat of Finance and Public Debt (*Secretaría de Hacienda y Crédito Público*) before the end of the first quarter of the current budget year. To do so, they must submit a portfolio of investment programmes and/or projects, a calendar for the *Avance Físico-financiero de la Cartera de Programas*, a technical note presenting the cost benefit analysis of the proposed projects, previously evaluated by the authorities of the state, and a summary of the main indicators which will be used to evaluate the project. Incomplete submissions will be notified and given 10 days to present missing documents.

The state must open a specific bank account for each project for which it is to receive resources from Fonregion.

50% of the requested amount is transferred when the request is complete, and 50% within the following three months.

Resources which are not spent, or formally committed on the last day of December of the current budget year will be reintegrated to the Federal Treasury.

5.3. Calendar and selection process of capital projects

According to the state budget and fiscal responsibility law voted in 2011 and which came into force in 2015, entities which are authorised to undertake capital expenditure (*ejecutores de gastos de capital*) must submit their investment projects to SEFIN. SEFIN should then make sure that these projects are aligned with the State Development Plan (*Plan Estatal de Desarrollo*) and approve the projects which are to be included in the “bank of public investment programme and projects” (*Banco de Programas y Proyectos de Inversión Pública*, BPPIP). Only projects included in this project bank can be financed. SEFIN then chooses among the projects in the investment bank the ones that will be financed during the year, places them in the “annual public investment programme” (*Programa Anual de Inversión Pública*, PAIP), and secures funding for these.

In practice, projects are submitted to the planning department of SEFIN by spending units from November of the previous year, to March of the budget year. Once approved by the planning department, and included in the project bank, the programming department analyses projects in the project bank, and tries to find, among the different funding sources available, which ones can be used to finance each project, based on its characteristics, the rules of each fund and the matching requirements. However, there is not a standard format under which projects have to be presented and they do not all include the necessary features to be eligible for the different federal funds (which usually require having a cost-benefit analysis, a physical and financial calendar, etc.). This implies that projects have to be revised before they can be assigned funds, and the technical capacity of the different spending units to do so is often insufficient.

Given that the state resources for investment are limited (PNE), the programming department allocates these resources in order to maximise the matching funds received from federal government. As earmarked agreements are often not signed until late in the year, the programming department does not allocate all available resources (PNE) at the beginning of the year, in order to keep some funds available to match possible future earmarked agreements. Projects applying to resources from FONREGION are those projects which are deemed at political level to be particularly strategic or high-priority.

There is no formal date for allocating public investment resources to the different projects and spending units. However, the Programming department tries to allocate these funds before March of the budget year. Still, executing units often do not receive the funds before mid-year, and it is common that they do not succeed in implementing their project before the end of the year. All funds which are not spent by the end of the fiscal year must be returned to the state (or federal in the case of federal funds) budget.

In July 2016, Oaxaca was the first states in Mexico to reform its state budget and fiscal responsibility law, in order to comply with the requirements of the new Federal Financial Discipline Law for States and Municipalities. The 2016 state law presents several improvements compared to the previous version. Among others:

- It gives a new, more restrictive definition of what constitutes public investment. To be classified as public investment, expenditures must be directed to gross fixed capital formation (*formación bruta de capital fijo*), and must contribute to sustainable human development. Public investment projects are classified as real or physical investment; human development; and mixed.
- The entities which can implement public investment projects have been reduced: before, the organised social groups were part of the possible executor of public resources for investment. In this new regulation, organised social groups are not executors of public investment anymore. They may still, however, receive resources from state entities (with the approval of SEFIN). In the 2016 reform, only the public bodies and dependencies (*dependencias y entidades*), the judicial power, the autonomous bodies and municipalities can plan, programme, execute and use public resources for public investment projects.
- The nature and role of the public investment project bank (*banco de proyectos de inversión pública*, BPIP) are more clearly defined. It is clearly stated that projects included in the project bank may not all be financed during the budget year. It also states that projects are included in the project bank for only one budget year. If they are not financed, they must be re-submitted to the approval process on the following year.

5.4. Recommendations on public investment planning and budgeting

5.4.1. OECD Best practices

Capital expenditures are those expenditures to acquire or improve property which should yield benefits for many years. Capital expenditures usually imply large amounts of money, and contrary to operating expenditure, they do not recur each year. Given the large amounts at stake, and the importance of their impact on growth or social outcomes, it is important to have a well-developed capital budgeting process.

A capital budgeting process organises the roles, policies and procedures for planning, financing, authorising, implementing, monitoring and evaluating capital decisions. A well-functioning capital budgeting process should ensure the identification, prioritisation, and planning of capital needs on a multi-year dimension (Box 5.2 provides the example of

Germany). It should assess the financial capacity of the institution, and thus requires financial forecasting. It should ensure the development and use of suitable capital financing options, given the evaluation, design and costing of projects. Finally, it should provide rules for project authorisation and appropriation, project implementation, as well as reporting, monitoring and evaluating implemented projects (Vogt, 2007, in Local Budgeting Edited by Anwar Shah).

Box 5.2. Multiannual planning framework for transport in Germany

In Germany, the Federal Ministry of Transport and Digital Infrastructure uses a multiannual planning framework in the form of the federal transport infrastructure plan. The past plan, endorsed by the government, covers the period 2003-15. In essence, the plan takes the form of a “long list” of projects that are evaluated according to cost/benefit analysis. The “long list” of projects is constructed on the basis of the ministry’s assessment of pressing economic infrastructure and regional development needs, which in turn are informed by inputs from the political level, sub-national governments and other stakeholders.

The methodology for assessing projects is made public. If the result is positive (i.e. a benefit to cost ratio above one), the project is included in the plan. Projects are subsequently ranked according to their score, the expected need for the project and the assessed urgency in constructing the asset. Detailed agreements between different levels of government need to be reached before the plan is adopted. These requirement plans are discussed and adopted by Parliament.

Once the requirement plans are adopted, they need to be operationalised into the five year framework investment plan. This aligns with the medium-term financial planning framework and forms the basis for the budgeting for specific projects. **However, the fact that an infrastructure project is accepted into the above mentioned planes does not mean that its financing is assured. Financing for a project is allocated as part of the ordinary budget process.**

Line ministries request funds to the Ministry of Finance prior to submitting the budget to the Parliament. Given the long lead times for capital projects, a key role for the Ministry of Finance is to ensure that the capital project portfolio fits into the long-term capital budget envelope.

The Ministry of Finance is usually part of the steering committee of projects and thereby ensures that it can monitor the project as it moves from the project identification stage to the preparation stage, procurement stage and implementation stage.

The Federal budget code stipulates the documentation that has to accompany the project appropriation. The documentation includes plans, cost calculations and qualitative explanations of the project, as well as the proposed method of financing and the time table for the project. In addition, the project documentation must include an estimate of the required operational expenditure that is to be expected after the asset has been constructed.

Source: OECD (2014), *Budget Review: Germany*.

In most OECD countries, the budgeting process for capital projects is integrated into the ordinary budget process. Capital investment is identifiable in the budget, but it is treated as any other expenditure in the process rather than having a separate framework and process. However, many developing countries, especially in the LAC region, prefer to

have a separate budget process for capital budgeting. Indeed, given the large infrastructure gap they usually face, and the need to bring public goods and services to all places, the rationale for having a strong and specific planning process for public investment is understandable. Usually, capital budgeting is the responsibility of a Planning Ministry, while the rest of the budget is managed by the Ministry of Finance.

Sub-national governments, defined as federated states, regions and other municipalities, undertook almost 60% of total public investment in 2015 across the OECD area in terms of volume. More effective public investment has a critical role to play to address inequalities, rebuild trust, restore growth and enhance well-being. The impact of public investment depends to a significant extent on how governments manage this shared competency across levels of government. Effective public investment requires substantial co-ordination across levels of government to bridge information, policy or fiscal gaps that may occur, as well as critical governance capacities at different levels to design and implement public investment projects. To help governments co-ordinate public investment and achieve the most value for money, the OECD has developed a recommendation on Effective public investment across levels of government (Box 5.3).

Box 5.3. **Recommendation on Effective Public Investment Across Levels of Government**

In 2014 the OECD adopted the *Recommendation on Effective Public Investment Across Levels of Government*. A Recommendation is an OECD instrument adopted by the Council. Recommendations are not legally binding, but practice accords them great moral force as representing the political will of member countries.

The purpose of these Principles is to help governments assess the strengths and weaknesses of their public investment capacity in a multi-level governance perspective and set priorities for improvement. An Implementation Toolkit provides guidance with details for all countries (available at: www.oecd.org/effective-public-investment-toolkit/)

OECD Recommendation of the Council, adopted on 12 March 2014:

OECD Member countries should take steps to ensure that national and sub-national levels of government effectively utilise resources dedicated to public investment for territorial development in accordance with the Principles set out below:

Pillar I: Co-ordinate public investment across levels of government and policies.

- Invest using an integrated strategy tailored to different places.
- Adopt effective co-ordination instruments across national and sub-national governments.
- Co-ordinate among sub-national governments to invest at the relevant scale

Pillar II: Strengthen capacities for public investment and promote policy learning across levels of government.

- Assess upfront long-term impacts and risks of public investment.
- Encourage stakeholder involvement throughout the investment cycle.
- Mobilise private actors and financing institutions to diversify sources of funding and strengthen capacities.
- Reinforce the expertise of public officials and institutions throughout the investment cycle.
- Focus on results and promote learning.

Box 5.3. Recommendation on Effective Public Investment Across Levels of Government (cont.)

Pillar III: Ensure sound framework conditions for public investment at all levels of government.

- Develop a fiscal framework adapted to the investment objectives pursued.
- Require sound, transparent financial management.
- Promote transparency and strategic use of public procurement at all levels of government.
- Strive for quality and consistency in regulatory systems across levels of government

Source: www.oecd.org/effective-public-investment-toolkit/.

5.4.2. Improve planning for capital expenditure, to align it with government priorities

Linking annual budgets to medium-term plans is a challenge for all governments. Plans often do not include a clear costing of the programmes and investments required, and are not developed within clear fiscal limits. Annual budget decisions can therefore not be based on these plans, and are often taken without strategic considerations. Oaxaca faces the same challenges, and has carried out great efforts during this last administration period in order to improve the quality of plans, and their usefulness to guide annual budgets. Principles 1 and 10 of the OECD principles on effective public investment across levels of government gives useful guidance in this regards.

Oaxaca should establish a state-wide medium-term strategic vision that addresses infrastructure service needs. Ideally, this strategy should provide guidance on how the needs should be met, although there has to be room for adjustment as more information is gathered. The strategy should be politically sanctioned, co-ordinated across levels of government (both federal and municipal), take stakeholder views into account and be based on clear assumptions (OECD, 2017b).

The 2016 reform of the state budgeting and fiscal responsibility law brings clear improvements in the capital expenditure framework. However, it still favours small scale, fragmented, short-term projects. Indeed, the process for including investment projects in the project bank is very fragmented, with each spending unit or municipality preparing and presenting its project or projects. In addition, the calendar is such that projects must be designed, submitted, financed and funds committed in less than one year. This makes larger scale projects difficult to finance and implement. There is no work at SEFIN or state-wide level to develop investment projects which could respond to the State Development Plan's (*Plan Estatal de Desarrollo*, PED)'s priorities, involve several municipalities and/or public entities, and be carried out over a medium-term horizon.

5.4.3. Prioritise investment projects based on their impact on the priorities in the State Development Plan, rather than to maximise matching from federal funds, and allocate all funds in the budget law

Today, there is not one moment in the budget cycle when all the projects are examined and compared, and where the most effective investment projects for regional development are prioritised and funded. As agreements with the Federal government (*convenios*) are usually signed during the budget year, SEFIN keeps money aside to match future agreements. However, this generates incentives for spending units to negotiate as many

Box 5.4. Principle 1: Invest using an integrated strategy tailored to different places

Design and implement investment strategies tailored to the place the investments aim to serve.

Seek complementarities and reduce conflicts among sectoral strategies. Mutually reinforcing impacts in the form of policy complementarities are often required to make the most of public investment.

Encourage the production of data at the relevant sub-national scale to inform investment strategies and produce evidence for decision-making.

Principle 10: Require sound and transparent financial management at all levels of government

Adopt good practices for budgeting and financial accountability such as accurately costing public investment plans, reflecting them in budget strategies and allocation processes, fitting them into a medium-term budget framework and duly considering long-term operating and maintenance costs. This includes proper budgetary treatment of PPPs, local public enterprises, and any associated contingent liabilities.

Source: OECD (2014), Toolkit for effective public investment across levels of government, www.oecd.org/effective-public-investment-toolkit/.

agreements as possible, even though the state government will not have sufficient funds to match federal requirements for all of these projects.

Oaxaca could think of inverting the logic of allocation of resources for public investment, in particular, for matching federal agreements. Projects should be developed and selected independently of their funding mechanisms, based on their impact on regional development and government priorities. Instead of letting each spending unit negotiate agreements and allocate the funds as these are signed (which has no relation with the priority of the project), SEFIN could:

1. Assess all investment projects in the public investment project bank.
2. Classify them in order of priority, making sure to represent projects in all regions, and in different areas.
3. Allocate funds in the budget document, to the highest priority projects – with a conditionality that the funds will be made available only when the agreement with the federal government is signed or other sources of funds secured. In case where the agreement is not signed, funds could be put back in the common pool, and allocated to the highest priority projects which have not yet received funding.

Such a procedure would help spending units plan and prioritize their programmes and expenditures, and therefore increase their impact.

5.4.4. Be more selective on the projects integrating the public investment project bank, to ensure they are aligned with the State Development Plan, cost effective, and that they meet all federal requirements

Criteria for integrating a project in the public investment project bank should be clear, and selective. They should ensure that investment projects are feasible, aligned with the State Development Plan, cost effective, and that they comply with the same requisites as those requested by federal funds. Projects which do not meet these criteria should not be integrated in the public investment project bank.

For this to work correctly, it would need an accompanying measure.

5.4.5. Support spending entities and municipalities to develop and design public investment projects

Many spending units and municipalities lack the sufficient capacity to develop investment projects that would comply with all the criteria that should be requested to integrate the public investment project bank, and receive funding. SEFIN should therefore provide technical assistance and capacity building for those entities wishing to develop and submit investment projects.

5.4.6. Keep investment projects in the public investment project bank for more than a year (for example, until the end of the government term)

Today, projects are included in the BPIP for only one year. This implies that project which did not get funding in the current budget year must be re-submitted in the following year. It would be more efficient if projects were kept in the BPIP and automatically re-considered for funding in the following years. Ideally, the process to integrate projects in the investment bank should be more selective (with clear controls on how they will contribute to the state's priorities, a cost benefit analysis, etc.), and then projects in the investment bank should be prioritised over a medium-term horizon. Some projects would be financed on the first year, and other projects could be kept for following years. This would improve strategic planning, and thus help spending entities programme their activities. Funds of course could not be committed for following years, but projects should be classified in order of priority for funding, depending on the regions where they are developed and the areas they aim to improve, and their impact on key indicators.

5.4.7. Oaxaca could create mechanisms to finance projects over more than one fiscal exercise, and involving more than one stakeholder.

Decisions on which projects will be financed are taken until late in the budget year, and if funds are not executed before the 31st of December, they must be given back to the state budget. This favours small scale projects, which are easy and fast to implement, but which may not be the ones with the greatest impact on development goals. In addition, when budget allocations for capital expenditure are decided late in the year, spending units often lack the time to actually implement the projects and therefore have to give back the funds. Oaxaca could envisage creating a carry-over mechanism, allowing spending units to execute authorised funds until the first few months of the following budget year.

Achieving significant development improvements may require larger scale, more coordinated investment projects, whose design and implementation may go beyond one budget year. Following Principle 3 of the OECD Recommendation on effective public investment across levels of government, Oaxaca could provide incentives and/or seek opportunities for co-ordination among local governments to match public investment with the relevant geographical area.

5.4.8. Oaxaca would benefit from engaging with stakeholders throughout the investment cycle (Principle 5 of the OECD Recommendation on effective public investment across levels of government).

Traditionally in Oaxaca, civil society organisations do not feel that the state government is taking their needs sufficiently into consideration when designing their

investment programmes. This is one of the reasons why they constantly request money from the state government. Involving them during the investment cycle, from the design of the projects to their *ex post* evaluation, and integrating their feedback into investment decisions and evaluations may help in limiting their demands. However, caution must be paid to have a balanced representation of stakeholders, to avoid capture situations.

5.4.9. Promote transparency and strategic use of public procurement.

More strategic, efficient and transparent procurement processes can be a powerful tool to reduce costs of public investment, and reducing opportunities for corruption. Galicia (Spain) for example has developed a web platform for public procurement procedures for all public entities, including municipalities. The goal is to integrate all public entities and private companies in a one-stop shop for public procurement. Public procurement is also often used as a policy lever to pursue strategic objectives, such as SME development, innovation and environmental protection. To make the most of public procurement as a strategic tool, Oaxaca should maximise transparency at all stages of the procurement cycle, and establish clear accountability and control mechanisms. It could also consider creating a professional workforce in SEFIN to provide technical assistance on procurement to other spending units and municipalities.

6. Budget reporting and accountability

The budget documents prepared during the annual cycle provide valuable information in terms of expenditure, revenues and debt levels. However, they could be improved, including clear information on the total free disposal revenues (*Ingresos de libre disposición*), and information on total state expenditure (excluding expenditure from earmarked federal transfers).

Strengthening the role of the Supreme Audit Institution is a key factor to ensure that legal reforms have the intended results in public finances. The Supreme Audit Institution of the State of Oaxaca plays a major role in ensuring that the public finance framework is respected and sound budgeting practice are enforced. However, the capacity of the institution is limited, undermining its ability to fully audit the public accounts of the state. The current difficult financial situation of the state of Oaxaca requires major efforts to improve efficiency, effectiveness and economy in state expenditure. The Supreme Audit of the State can play a key role in achieving this objective by auditing the efficiency and effectiveness of budget execution, public policies and programmes.

6.1. Budget reporting in Oaxaca

Oaxaca has two main instruments for reporting budget execution: the quarterly financial management report (*informes de avance de gestión*) and the annual public account report (*cuenta pública*). The quarterly financial management report includes information on financial and physical progress and achievements of the objectives of the state and municipal programmes. It is presented every quarter to the Supreme Audit Office of the State, who checks formal compliance with the minimum reporting requirements defined in the law and reports to the Congress.

The public account report is a budget year-end report aiming to prove that revenues and expenditure collection, management, custody and execution were performed according to the approved budget and the legal framework. This report must be presented to the Congress on 30 April of the following budget year, and then audited by the Supreme

Audit Institution of the state of Oaxaca before 15 September. The report must then be approved by the Congress before 30 September. Oaxaca does not have a midyear implementation report.

The budget documents prepared during the annual cycle provide valuable information in terms of expenditure, revenues and debt levels. However, they do not include explicit and clear information on the total general purpose revenues of the state (*Ingresos de libre disposición*), consisting of own revenues (minus certain resources transferred to municipalities) and general purpose transfers (Ramo 28, minus formula based transfers to municipalities). In a similar way, these documents do not include information on total state expenditure (excluding expenditure from earmarked federal transfers).

6.2. The Supreme Audit Institution of the State of Oaxaca

The Supreme Audit Office of the State of Oaxaca (*Auditoria Superior del Estado*, ASE) is a technical body attached to the Legislative Branch. Since 2008, it has technical and managerial autonomy, being able to decide its internal organisation, functioning and regulation. Its budget and main managerial positions are however decided by the Congress. The Supreme Auditor of the state is elected by 2/3 of the members of the Congress and has a seven-year term with the possibility of one consecutive re-election.

The Supreme Audit Office of the State carries out external auditing function over the three branches of the state, autonomous bodies, municipalities, and any other entity or individual, when dealing with state or municipal resources. It reviews and audits the public accounts (year-end reports) and the state's financial management, checking compliance with the provisions of the legal framework and the annual budget and revenues law. In contrast with other Mexican states, auditing requests in Oaxaca are often initiated by citizens. While in Mexico on average, 1.5% of audits are requested by citizens and external actors, in Oaxaca this percentage reaches 12% (IMCO and CUCEA, 2013).

The Supreme Audit Office of the State of Oaxaca mainly focuses on auditing public accounts rather than evaluating efficiency in the use of resources. The Supreme Audit Office can carry out three different types of compliance audits: 1) financial management, 2) performance and 3) special audits (e.g. debt, licences and concessions). Nevertheless, in practice, performance audits are rarely carried out.

The Supreme Audit Office of the State also has the responsibility to investigate irregular or illicit actions and omissions regarding collection, custody and public resources management. However, since 2015, the Supreme Audit Office does not have the power to directly sanction public servants. The results of these investigations should be submitted to the Administrative and Accounting Court (*Tribunal de lo Contencioso Administrativo y de Cuentas*) to proceed with the sanctioning process.

Due to insufficient resources and lack of installed capacity, the Supreme Audit Office only audits 20% of total accountable entities in the state each year. As mentioned in the first section of this report, Oaxaca is the state with more municipalities in the country (570 municipalities), which makes auditing the full accounts extremely difficult and costly. In addition, auditing procedures are particularly difficult in Oaxaca, due to frequent leadership turnovers in the municipalities governed by “customs and traditions” (*usos y costumbres*) (see Section 1). As a consequence, the Supreme Audit Office of the State only reviews and audits the public accounts of a sample of around 70 municipalities and 60 state offices per year.

In order to make the auditing process more reliable and efficient, the Supreme Audit Office joined efforts with SEFIN to improve capacity at the municipal levels. Before, municipalities had different account systems and had a paper-based system. With the support from the Supreme Audit Office, municipalities now have a software to present their accounts electronically and in a harmonised way. This is a good example of collaboration between different agents in the budgeting process that encourages good practices, improving reporting practices and increasing accountability and transparency in resource management.

6.3. Recommendations on budget reporting and auditing

Budget reporting is a key element to monitor and ensure accountability of public spending. Good reporting practices are essential to have a comprehensive overview of the fiscal activities of the public sector in a regular and timely manner. These documents should be the base to inform better scrutiny and decision-making at each stage of the budget cycle. In particular, the year-end report, as a key accountability document that shows the situation of the government's accounts at the end of the fiscal year, should be submitted to audit by the supreme audit institution (OECD, 2017a).

Supreme audit institutions are responsible for overseeing and holding the government to account for the use of public resources. They have a fundamental role, as independent guardians of the public trust, in assuring the proper use of budgeted resources. According to OECD Principles of Budgetary Governance, a well-functioning supreme audit institution should deal authoritatively with all aspects of financial accountability, including through its audit reports which should be published in a timely manner, relevant for the budgetary cycle.

The external control exercised by supreme audit institutions is essential to ensure accuracy in the rendering of accounts and probity in the management of public money. It can also play a main role in auditing the cost-effectiveness of individual programmes and in assessing the quality of performance and governance frameworks more generally. In order to perform these tasks and hold the government accountable for its stewardship of public resources, supreme audit institutions should be independent external bodies, with full discretion and sufficiently broad mandates (INTOSAI, 2013).

6.3.1. Have a clearer treatment of free disposal revenues (*Ingresos de libre disposición*) and the state expenditures these finance in the budget documents

The quality and comprehensiveness of financial information contained in the budget reports are essential for transparency, accountability and good governance (OECD, 2017a). Budget reporting practices in Oaxaca are very good, but could be further improved, providing a more comprehensive and relevant overview of the government's financial position and sound budgeting practices.

Total free disposal revenues (*Ingresos de libre disposición*) and total state expenditures (excluding expenditure from earmarked federal transfers) are the base of budget allocation decisions in Oaxaca (see Section 2). Furthermore, free disposal revenues are the key element to define the fiscal rule on borrowing limits (see Section 3). Despite their relevance, they are not clearly stated in the budget documents. This reduces the usefulness of the budget documents for discussing priorities and involving stakeholders. This also creates difficulties to monitor public spending and to evaluate state's financial management practices. Oaxaca could greatly benefit from stating and analysing this

information in the budget documents, thus increasing transparency and accountability, and aligning its practices with the OECD Best Practices for Budget Transparency (2013).

6.3.2. Strengthen the role of the Supreme Audit Institution of the State of Oaxaca

The Supreme Audit Institution of the State of Oaxaca plays a main role in ensuring that the public finance framework is respected and sound budgeting practice are enforced. However, the capacity of the institution is limited, undermining its capacity to fully audit the public accounts of the state. Strengthening the role of the Supreme Audit Institution is a key factor to ensure that legal reforms have the intended results in public finances. Without institutional mechanisms to make the government and public servants accountable for their stewardship of public resources, compliance of new rules is unlikely.

The key role of the Supreme audit institution in ensuring sound financial management has been recognised by the Mexican Federal Government. The new auditing and accountability federal law enacted in 2015 expands the mandate of the Supreme Audit Office of the Federation, providing additional tools for a more efficient and comprehensive auditing process (Box 6.1). Similar effort is needed at the state level in order to ensure that the government is fully accountable for the use of public resources. Scaling up budgetary resources and addressing capacity gaps could be considered in order to help the Supreme Audit Institution of the State of Oaxaca fulfil its mandates.

6.3.3. Broaden the actions of the Supreme Audit of the State of Oaxaca towards auditing the efficiency and effectiveness of budget execution, public policies and programmes

One emerging good practice of Supreme Audit Institutions in OECD countries is to elevate findings on cross-cutting issues and trends in government to provide insight on efficiency, effectiveness and economy in public expenditure across government (OECD, 2017a). Through performance auditing (Box 6.2), Supreme Audit Institutions can promote accountability, examining whether decisions are efficiently and effectively planned and implemented and whether taxpayers have received value for money. They can also increase transparency by allowing the parliament and the citizens to have an insight into the management and outcomes of different government programmes and activities (INTOSAI, 2013b).

The current difficult financial situation of the state of Oaxaca requires major efforts to improve efficiency, effectiveness and economy in state expenditure. The Supreme Audit Institution of the State can play a key role in achieving this objective, supporting fiscal sustainability in the medium and long term. However, major adjustments are needed in order for this to happen.

The current legal framework allows the Supreme Audit Institution of the State of Oaxaca to carry out performance audits (i.e. exercises to verify the efficiency, efficacy, and economic, regional and social impact of certain programmes). However, in practice, these types of audits are rarely carried out. Additional resources, greater installed capacity and robust methodologies to carry out such type of analysis are needed in order to allow the Supreme Audit Institution of the State of Oaxaca to fully assume this function. In addition, it is essential to directly link the work of the Oaxaca's Supreme Audit Institution with the performance budgeting framework recently developed in the state (Section 4).

Box 6.1. **The National Auditing System in Mexico: Increasing the role of the Supreme Audit Institution of the Federation**

In May 2015, the Mexican Congress passed a series of governance reforms to enhance public sector accountability, integrity and transparency. These measures re-drew the national institutional map to advance these principles through the creation of the National Anti-Corruption System and the National Transparency System. The reforms also provide a legislative foundation for the National Auditing System (*Sistema Nacional de Fiscalización*, SNF) to contribute to good governance and accountability in Mexico.

Mexico's supreme audit institution, the Supreme Audit Institution of the Federation (*Auditoría Superior de la Federación*), is at the forefront of these efforts as Mexico's pre-eminent external control body. The reforms expand the Supreme Audit Office of the Federation's mandate and provide it with additional tools to carry out its work. In particular, the following:

More frequent reporting to Congress: Recent constitutional reforms will divide the year-end report into three reports, two of which the Supreme Audit Office of the Federation will submit to Congress at the end of June and October. These two intermediate reports are meant to divide the current year-end report into three instalments, including a third report that the Supreme Audit Office of the Federation will continue to submit 14 months following the end of the audited fiscal year, in February. The reform intends to improve the timeliness of the information the Supreme Audit Office of the Federation provides to the legislature, so that the results of audits can assist Congress in taking decisions about legislative initiatives and the budget.

Early audit planning and implementation: the Supreme Audit Office of the Federation can begin auditing one month following the end of the fiscal year to be audited (i.e. in January). Prior to the reform, the Supreme Audit Office of the Federation could begin the audit process only after receiving the public account, which occurred no later than 30 April (four months after the end of the fiscal year to be audited). In addition, the Supreme Audit Office of the Federation can request information from auditees during the fiscal year, in order to help planning and scheduling the audits it will undertake.

Real-time audit authority: The reform also eliminates the principles of posteriority and annuity, allowing the Supreme Audit Office of the Federation to audit accounts before the previous fiscal year as well as audit in real time. Real-time audit authority provides the Supreme Audit Office of the Federation with an additional mechanism to reorient its work outside of the established audit programme, react quickly to high-risk areas and suspected wrongdoing, and ultimately provide immediate insights to Congress on the performance of policies and programmes.

Source: OECD, 2017b.

6.3.4. Include effective follow-up mechanisms on the Supreme Audit Institution recommendations

Following up previous audit findings, recommendations and initiated procedures, is critical to strength the impact of the audit work. Oaxaca does not have formal mechanisms to ensure that the audited entities properly address their observations and recommendations as well as those made by the Congress (IMCO and CUCEA 2013). This responsibility should be clearly stated in the legal framework to ensure that observations made in the audit reports are taken into account and corrective measures are implemented.

Box 6.2. **International Standards of Supreme Audit Institutions Fundamental Principles of Performance Auditing**

Performance auditing is an independent and objective analysis to determine the extent to which government programmes, organisations, systems, operations or activities respect the principles of economy, efficiency and effectiveness. The following are some of the Fundamental Principles of Performance Auditing defined by the International Organization of Supreme Audit Institutions (INTOSAI):

- **Audit objective:** Auditors should set a clearly-defined audit objective that relates to the principles of economy, efficiency and effectiveness.
- **Audit approach:** Auditors should choose a result-, problem- or system-oriented approach, or a combination thereof, to facilitate the soundness of audit design.
- **Criteria:** Auditors should establish suitable criteria which correspond to the audit questions and are related to the principles of economy, efficiency and effectiveness.
- **Communication:** Auditors should maintain effective and proper communication with the audited entities and relevant stakeholders throughout the audit process and define the content, process and recipients of communication for each audit.
- **Skills:** Collectively, the audit team should have the necessary professional competence to perform the audit. This would include sound knowledge of auditing, research design, social science methods and investigation or evaluation techniques, as well as personal strengths such as analytical, writing and communication skills.
- **Professional judgement and scepticism:** Auditors should exercise professional scepticism, but also be receptive and willing to innovate.
- **Quality control:** Auditors should apply procedures to safeguard quality, ensuring that the applicable requirements are met and placing emphasis on appropriate, balanced and fair reports that add value and answer the audit questions.
- **Materiality:** Auditors should consider materiality at all stages of the audit process. Thought should be given not only to financial but also to social and political aspects of the subject matter, with the aim of delivering as much added value as possible.
- **Documentation:** Auditors should document the audit in accordance with the particular circumstances thereof. Information should be sufficiently complete and detailed to enable an experienced auditor having no previous connection with the audit to subsequently determine what work was done in order to arrive at the audit findings, conclusions and recommendations

Source: INTOSAI (2013b).

Notes

1. The CNTE is another teacher's union that was founded in Chiapas and Oaxaca in 1979 as an offshoot of the SNTE. The CNTE has had historical control of the IEPPPO since its creation in 1992.
2. The southern states of Mexico, especially Oaxaca and Chiapas, have a significant development gap in comparison with the rest of the country. They have the highest rates of poverty and the lowest for human development in the country. To close this gap, the federal government enacted the Federal Law of Special Economic Zones in April of 2016, which consists of designating three special economic zones that touch the five poorer states in the country in order to foster investment, infrastructure, and human development.
3. *Ejidal* are lands communally held, with farmers holding use rights to individual parcels (Brown, 2004).
4. Based on estimations made by Puente y Rodríguez (2011), the state is getting closer to its potential tax collection capacity, estimated in around MXN 730 million for 2011 (including vehicular tenure).

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Long-term fiscal sustainability analysis: Benchmarks for Independent Fiscal Institutions

by
Trevor Shaw*

External evaluation is one of the key principles recommended by the OECD for an Independent Fiscal Institution to function well. External evaluations could take the form of periodic reviews of selected pieces of work, regular annual evaluations of the quality of analysis, permanent installations such as an advisory panel or board, or peer reviews by an IFI in another country.

This paper benchmarks current practice for Independent Fiscal Institutions' long-term fiscal sustainability analysis but is by no means a final or immovable piece. It is however a first attempt to identify and classify a complete and comprehensive set of benchmark practices for IFI long-term fiscal sustainability analysis in OECD countries.

JEL codes: H11, H50, H83

Keywords: Independent Fiscal Institution, benchmarks, long-term fiscal sustainability, good practices

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1. Background

The OECD *Recommendation of the Council on Principles for Independent Fiscal Institutions* (the IFI Principles) states that IFIs should develop a mechanism for external evaluation of their work – to be conducted by local or international experts. This may take several forms: review of selected pieces of work, annual evaluation of the quality of analysis, a permanent advisory panel or board, or peer review by an IFI in another country.

An important aspect of evaluation is identifying a set of benchmark criteria for basic and leading practices, establishing a framework upon which an institution can be assessed. Recently, the OECD Network of Parliamentary Budget Officials and Independent Fiscal Institutions (IFI Network) took action on Principle 9.1 of the IFI Principles to pursue the development of an evaluation framework for IFIs. That evaluation framework applies to the broad operations of IFIs and is useful to legitimise the institution relevant to its environment, resources, products and perceptions of its legislated and non-legislated stakeholders; and examine the impact and effectiveness an IFI is having in pursuit of better fiscal outcomes.

Other, more narrowly-defined review practices would complement a full IFI evaluation to assess specific elements of an IFI's mandate: including peer review of products, stakeholder satisfaction surveys, and resource compliance audits. This project explores a final type of assessment: to review a single functional line of work at one or more IFIs. IFIs could opt to engage in this type of review for self-improvement, benchmarking to good practice or as a less resource-intensive assessment between full evaluations.

This paper benchmarks current practice for independent fiscal institutions' long-term fiscal sustainability analysis. It is a first attempt to identify and classify a complete and comprehensive set of benchmark practices for IFI long-term fiscal sustainability analysis. It provides additional detail to OECD Principles of Budgetary Governance, principle 9(d) "publishing a report on long-term sustainability of the public finances, regularly enough to make an effective contribution to public and political discussion on this subject, with the presentation and consideration of its policy messages – both near-term and longer-term – in the budgetary context."

This paper is by no means a final, immovable perspective on good or leading long-term fiscal sustainability analysis practices in OECD member countries. Nor are these benchmarks designed to be a binding, mechanical exercise. Consistent with IFI Principle 1, each organisation will account for its own local circumstances, priorities and capacity when developing long-term fiscal sustainability analysis.

The generalised benchmarks identified in this note are categorised as either good or leading practice. Good practices should be thought of as benchmarks for standard long-term fiscal sustainability analysis practices, while leading practices should be considered ambitious objectives at the frontier of the domain. It is unlikely that any single institution can or should satisfy all leading, or even good practice benchmarks. The relative importance of each benchmark may vary by country circumstance, institutional capacity

and gaps in the local fiscal policy discourse. This framework of benchmarks should instead be considered a reference upon which to identify organisational strengths and opportunities for improvement.

The benchmark practices identified in this report draw upon three sources:

- General literature on guidelines for long-term fiscal sustainability analyses and budget practices
- The recent long-term fiscal sustainability publications of OECD Networks of Senior Budget Officials and Parliamentary Budget Officials and Independent Fiscal Institutions (PBO)
- Input from a network peer group for long-term fiscal sustainability analysis

The relevance, appropriateness and rigour of long-term fiscal sustainability analysis benchmarks proposed in Section 2 are assessed against the current observed practices of OECD IFIs. The benchmarks are a summary and tend toward the general rather than the prescriptive. That being said, the project is intended to be a practical exercise, so there is an obligation to make each benchmark operational in design. Thus, each benchmark is supported by one or more country example. Section 4 aggregates this information in a crosswalk of proposed benchmarks and current practices at peer review group institutions. A matching interactive matrix available on the IFI web portal features web-linked references to detailed case examples for each institution.¹ The matrix is both “evergreen” and “open source”, so network members and portal users can update examples and highlight new or changed practices. Select case examples are included in the detailed Section 4 discussion.

This project is pilot of this work type, focused only on a single functional line of many IFIs’ operations: long-term fiscal sustainability analysis. Over time, the OECD intends to help support nodes of expertise to form around other common functions to permit benchmarking, exchange of good practice and peer reviews in other functional areas (e.g. cost estimation, medium term fiscal analysis and forecast endorsement).

The remainder of this paper is as follows:

- **Section 2** summarises initial benchmarks, with a detailed discussion of the logic supporting each benchmark set out in **Section 3**.
- **Section 4** is a crosswalk of proposed practices for IFI long-term fiscal sustainability analysis and current practices at peer review group institutions.
- The **Appendix** discusses basic methodology used to identify benchmark practices for Independent Fiscal Institutions’ long-term fiscal sustainability analysis.

2. Benchmarks summary: IFI long-term fiscal sustainability analysis practices

As part of long-term fiscal sustainability analysis IFIs *should* include good practice elements and *could* include leading practice elements:

A. Scope of Analysis	
Good practice	Leading practice
A.01 Address fiscal dimensions beyond the capacity of government to meet its current obligations, by addressing: solvency, growth and stable taxes.	A.11 Address fiscal dimensions beyond the capacity of government to meet its current obligations, by addressing fairness.

A.02	Present a full national overview of the public finances – encompassing central and subnational levels of government.	A.12	Cover the full range of fiscal activity and risk, including tax expenditures, extra-budgetary funds, and contingent liabilities. The analysis should show the full financial costs and benefits of budget decisions and comprehensively cover future public liabilities.
A.03	Examine a time horizon sufficient to assess the budgetary implications of demographic change, spanning 30 years or longer. The appropriate time horizon for long-term sustainability projections may vary depending on the nature of the problems to be analysed.		
A.04	Consider long-term effects beyond demographic changes in the projections, including health care and public pensions. The fiscal implications of other potential fiscal pressures could also be presented, including natural resource depletion, trade or technology changes that may affect the economy, or climate change.		
B. Assumptions			
Good practice		Leading practice	
B.01	Make explicit all key assumptions underlying the projections contained in the report.	B.11	Base all assumptions as the assumptions used in long-term equilibrium models.
B.02	Prepare baseline projections on the basis of current policy assumptions and adjusted for policy changes that are certain to happen. Forward projections should otherwise be based on “realistic” assumptions of possible policies in the future.		
C. Analysis			
Good practice		Leading practice	
C.01	Publish regularly enough to make a contribution to public and political discussion on public finances. Forecasts should be prepared, at minimum, every 5 years, ideally specified under law.	C.11	Illustrate the distributional impacts of alternative policies, where applicable.
C.02	Use indicators of fiscal sustainability that send a clear and easily understandable signal if current policy spending moves beyond a defined level of sustainability (e.g. fiscal gap). Indicators and their underlying methodology and assumptions should be sufficiently transparent so as to generate a sound understanding of how conclusions are drawn.	C.12	Feature international comparison, where applicable
C.03	Highlight the long-term fiscal costs of past and possible future policy changes.	C.13	Illustrate feedback mechanisms between macroeconomic and fiscal variables
C.04	Separate projections for revenues and expenditures, and their functional classifications should be made wherever long-term cost drivers may differ.		
C.05	Highlight changes to methods, assumptions and key findings relative to past reports.		
C.06	Include sensitivity or scenario analysis for key variables.		

Box 2.1. Defining fiscal sustainability

Before beginning a detailed discussion of fiscal sustainability analysis benchmarks, it is first helpful to define what is meant by fiscal sustainability in this note. Fiscal sustainability is most commonly measured using three key inputs¹:

- The current ratio of public debt to GDP
- A target debt to GDP ratio
- The sequence of government’s future primary balances

For a fiscal policy to be sustainable, a government which currently has a higher ratio of debt-to-GDP than desired must sooner or later run primary budget surpluses until the debt-to-GDP ratio hits the target over a time-limited horizon, usually between 25 and 75 years.

Box 2.1. Defining fiscal sustainability (cont.)

Future primary balances are calculated under current spending, transfer and tax rules. “Sustainable” fiscal policy will generate a sequence of primary deficits and surpluses leading to long-term debt at or below the target if spending and tax policy remains unchanged.

Similar, but alternative definitions exist in fiscal sustainability literature. In its 2015 Fiscal Sustainability Report, the European Commission defines fiscal sustainability as:

“solvency” of the public sector. A public entity is considered as solvent if the present discounted value of its current and future primary expenditure is smaller than (or equal to) the present discounted value of its current and future path of income, net of any initial debt level.

Solvency of the public sector can therefore be broadly defined as a situation where fiscal policy can be maintained unchanged over the post-forecast horizon (without changes in public spending, nor taxation, that would affect the government primary balance), without causing public debt to rise continuously as a share of GDP.²

In a similar vein, the IMF defines debt sustainability as:

a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure.³

These definitions all permit a range of potential interpretations. Various fiscal sustainability indicators attempt to quantify and put these concepts into practice. The merits of various sustainability measure (e.g. the European Commission’s S1 and S2 indicators) are discussed in Section 3.4 Table C.02 of this paper.

Sources:

1. Blanchard et al., “The Sustainability of Fiscal Policy: New Answers to an Old Question”, OECD Economic Studies, Autumn 1990, www.oecd.org/eco/outlook/34288870.pdf.

Source: 2. European Commission, Fiscal Sustainability Report 2015, Institutional Paper 018, 2016, http://ec.europa.eu/economy_finance/publications/.

Source: 3. IMF, Assessing Sustainability, 2002, p. 4, www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf.

3. Benchmarks discussion: IFI long-term fiscal sustainability analysis practices

Benchmarks for Independent Fiscal Institutions’ long-term fiscal sustainability analysis is an initial attempt to identify and classify a complete and comprehensive set of potential criteria for IFI long-term fiscal sustainability analysis practices.

IFIs *should* include good practice elements and *could* include leading practice elements with respect to the scope of long-term fiscal sustainability analysis:

A. Scope of Analysis**Good practice**

A.01 *Address fiscal dimensions beyond the capacity of government to meet its current obligations, by addressing: solvency, growth and stable taxes.*

Source: Schick, A. (2005), Sustainable Budget Policy: Concepts and Approaches.

A starting point for common benchmarks for long-term fiscal sustainability analysis is a discussion on what are the measures of sustainability.

Schick (2005) observes that “the shift to a long-term horizon has expanded the ways governments and international organisations think about sustainability. The term has retained its original meaning as a measure of the solvency of government, but it has acquired several dimensions that pertain to governments that have no difficulty meeting current obligations.” Given this, Schick proposes four core dimensions of sustainability, three of which are considered “good” practices: solvency, growth and stable taxes. The fourth and final dimension Schick considers is fairness, discussed as a “leading practice” in Section 3.3 Table A.11.

Solvency – the ability of government to pay its financial obligations

Solvency is typically measured in business in reference to the firm’s net worth. It is relevant for any government at risk of taking on excessive public debt and is central to sustainability analysis. However, applying this method to government is difficult because few have comprehensive balance sheets that cover all liabilities and assets. Moreover, net worth is an imperfect measure in government for several reasons.

Some key limitations concern the monetary valuation of public assets. Public asset valuations used to compute public net worth commonly include highly illiquid assets (e.g. military assets) that cannot easily be monetised to offset a liability. Hence, solvency does not imply liquidity. A solvent government on a fiscally sustainable path can confront liquidity constraints, where liabilities cannot be rolled-over in times of constrained credit. Fiscal sustainability analysis by IFIs may not assess liquidity risks to public finances.

Beyond valuation challenges for assets and liabilities included in public net worth, net balance sheet positions are further limited by public assets and liabilities not included. Net worth estimates do not include an important asset of the sovereign power to generate future revenue by raising taxes. Other assets, such as natural resource endowments and heritage assets are not included. On the liabilities side of the balance sheet, net worth estimates commonly exclude liabilities the state will accrue in the future, such as future pension liabilities.

Good practice in long-term sustainability analysis should focus on inter-temporal changes to asset (liability) values, rather than the value of the asset (liability) *per se*. The net financial position of government changes only when the present value of assets (liabilities) deviates from the existing valuation. Assets (liabilities) anticipated to have an unchanged value into the future can be excluded from long-term sustainability projections, with no net effect on public finances.

Balance sheets currently produced in national governments provide an incomplete but nevertheless useful statement of the public financial condition. Public balance sheets are most useful when complemented by other measures of longer term public finance prospects.

Box 3.1. The solvency dimension of sustainability

Good practice examples from OECD IFIs

All IFIs surveyed currently address long-term solvency issues, through projections of gross or net liabilities of government. As an example, the Danish Economic Council comments on the path of (gross) government debt relative to limits specified under the EU Stability and Growth Pact during all years until 2075.

Source: Author’s own analysis; Danish Economic Council, English summary. Dansk Økonomi, forår 2014, p. 331.

Growth – fiscal policy that sustains economic growth

Governments should manage their finances prudently so as to assure future growth. The best way for government to meet future obligations, which certainly will be greater than today's, is by having a robust economy which supplies government additional revenue from the dividends of economic growth. If fiscal imbalances constrain future growth, economic dividends will be smaller or vanish altogether and government will be hard pressed to cover its obligations.

Box 3.2. The growth dimension of sustainability

A good practice example from the United States

The Congressional Budget Office (CBO) estimates the macroeconomic and budgetary effects of various fiscal policies, to illustrate how federal tax and spending policies can affect the economy. The CBO examines how economic growth is affected by policy through many channels, including the amount of federal borrowing, marginal tax rates on labour and capital income, transfer payments to working-age people, and federal investment.

The CBO's analysis focuses on four policy changes and their macroeconomic effects:

- Higher debt draws money away from (that is, crowds out) investment in capital goods and thereby reduces output below what would otherwise occur.
- Higher marginal tax rates discourage working and saving, which reduces output.
- Larger transfer payments to working-age people discourage working, which reduces output.
- Increased federal investment in education, research and development (R&D), and infrastructure helps develop a skilled workforce, encourages innovation, and facilitates commerce, all of which increase output.

Source: Congressional Budget Office, The 2015 Long-Term Budget Outlook, p. 73.

Stable taxes – the capacity of government to meet future obligations with existing tax burdens

Assess the risk that tax burdens will rise in the future to accommodate spending pressures.

Box 3.3. The stability dimension of sustainability

Good practice examples from the Netherlands and the United States

Many IFIs follow similar practice in regard to long-term tax stability. As an example, the Netherlands Bureau for Economic Policy Analysis (CPB), assumes stable rates for taxes and social security contributions over the long-term, applying official indexing formulas to thresholds and maximum tax deductions.

The US CBO addresses the effects of certain types of tax legislation in its extended baseline projection. Tax revenues continue rising faster than GDP, largely for two reasons: real bracket creep continues, and certain tax increases enacted in the Affordable Care Act (ACA) generate a growing amount of revenues in relation to the size of the economy.

Source: Bos and Teulings (2013) and Congressional Budget Office (2015).

The solvency, growth and stable tax concepts provide a sufficiently diverse perspective for which IFIs can assess basic fiscal sustainability considerations. The three dimensions

reflect that governments may have accumulated long-term liabilities that do not appear in current budgets or balance sheets but may nonetheless affect future generations and the fiscal position of future governments.

A.02 *Present a full national overview of the public finances – encompassing central and subnational levels of government.*

Source: OECD Recommendation of the Council on Budgetary Governance, 2015.

Presenting a full national overview of the public finances – encompassing central and subnational levels of government provides essential context for a debate on budgetary choices.

The control of the public budget can be centralised at the national level or co-ordinated jointly across many levels of government. The degree of co-ordination and co-operation among the various levels of government varies from country to country reflecting local norms. A nation's finances, however, are seldom materially altered by the (re)organisation of financial responsibilities across different layers of government. Assets accrued at one level of government at the expense of another rarely have an effect on the overall financial prospects of the nation.

There are clear benefits to providing a comprehensive estimate of the long-term financial prospects of all levels of government. Citizens, as contributors to and beneficiaries of public spending are chiefly concerned with efficient, effective and fair public service provision irrespective of the entity responsible.

However, there are both conceptual and technical challenges to providing a whole-of-government perspective. Subnational governments in federal states function independently of central government and within a single nation state governments can be separate legal and financial entities. Assets of one level of government may not be used to offset liabilities accrued at another, so combining national and subnational government finance into a singular financial position may not be appropriate without caveat. Indeed, it can be computationally difficult to synthesise all public entities into singular asset and liability positions. State-owned enterprises, operating at arm's length of government with unique revenue and expense prospects, may not be suitably integrated into long-term sustainability projections.

Schick (2014) acknowledges that federal countries presenting a full national overview of the public finances – encompassing central and subnational levels of government, may resist presenting a full overview of public finances encompassing central and subnational levels of government. Nevertheless, a comprehensive view of all levels and sectors affecting public finances is an important role for IFIs in enhancing fiscal transparency.

Box 3.4. Breadth of analysis

Good practice examples from Canada and the United Kingdom

Canada's Parliamentary Budget Officer separately assesses the fiscal sustainability of Canada's federal government, subnational governments and public pension plans. The United Kingdom's Office for Budget Responsibility examines three alternative presentations of the public sector balance sheet – two from the National Accounts framework and one from the private sector-style Whole of Government Accounts (WGA).

Source: Canada's Parliamentary Budget Officer, Fiscal Sustainability Report 2015, p. 1; UK Office for Budget Responsibility, Fiscal sustainability report 2015, p. 15.

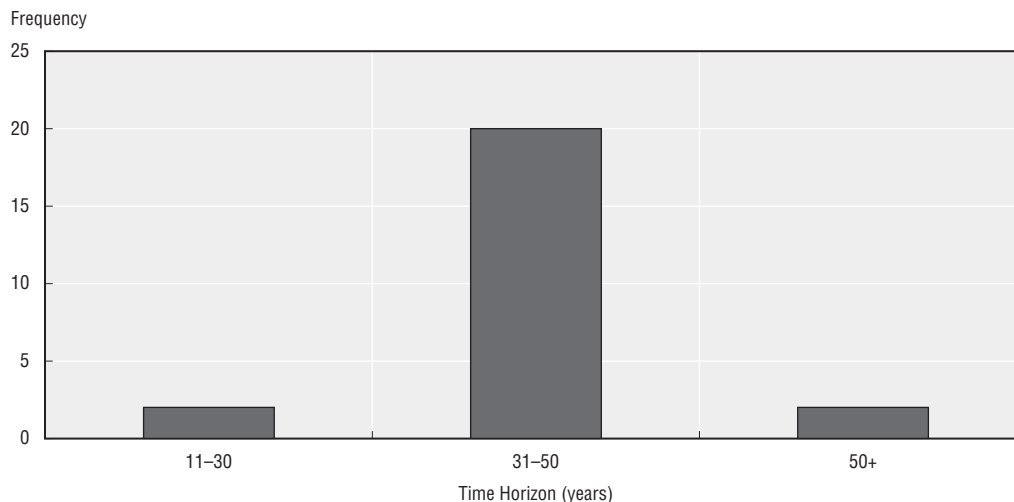
A.03 *Examine a time horizon sufficient to assess the budgetary implications of demographic change, spanning 30 years or longer. The appropriate time horizon for long-term sustainability projections may vary depending on the nature of the problems to be analysed.*

Source: Ulla, 2006 and OECD Recommendation of the Council on Budgetary Governance, 2015.

There is no consensus on the appropriate time horizon for long-term fiscal sustainability analysis. However, observed practice suggests a minimum length of 30 years or more. Over 80% of OECD governments (20 of 24) producing long-term fiscal sustainability analyses make projections over a time horizon of 31-50 years. The *OECD Recommendation of the Council on Budgetary Governance* suggests an approximate horizon appropriate for long-term analyses, of 10-40 years.

In many cases, projection horizons correspond with an existing external standard. European Union member countries have largely adopted the time horizon established by the European Commission's stability and convergence reporting requirements. In the United States, fiscal projections correspond with the length of actuarial projections for Social Security and Medicare trust funds (Anderson and Sheppard, 2007).

Figure 3.1. **OECD governments' long-term fiscal sustainability analysis: Time horizon of projections**



Note: Includes only governments that produce fiscal projections of 11 years or longer (24 of 34).

Source: OECD International Database of Budget Practices and Procedures, 2012.

Guidance from related literature is non-prescriptive. It instead tends toward principles based recommendations. Ulla (2006) suggests that “the time horizon for the projections will partly depend on the nature of the problems to be analysed. Balance coverage of important policy issues with the risks of making projections more and more uncertain further into the future.”

The International Public Sector Accounting Standards Board (IPSASB), an independent standard-setting body within the International Federation of Accountants (IFAC) indicates

that long-term sustainability analysis should “balance verifiability, faithful representation and relevance”.²

A.04 *Consider long-term effects beyond demographic changes in the projections, including health care and public pensions. The fiscal implications of other potential fiscal pressures could also be presented, including natural resource depletion, trade or technology changes that may affect the economy, or climate change.*

Source: Anderson, B. and J. Sheppard (2009), *Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?* and IMF Fiscal Transparency Manual (2007).

Fiscal sustainability reports are useful to enhance the understanding of the future costs of current policy decisions, help manage risks, increase support for sound macroeconomic policy. Ideally, they should provide a comprehensive assessment of the state of public finances. And so, the scope of analysis should extend beyond long-term demographics to examine unsustainable or time-variant revenues or expenditures. Health care expenditure and public pensions are two important spending categories to examine in IFI's current long-term fiscal sustainability analysis, as spending growth in both policy areas has historically had material non-demographic cost components.^{3, 4}

Other non-demographic aspects of public finance can also be featured. This includes resource revenues, potential long-term changes in commercial terms (e.g. in countries with significant agricultural exports, inclusion of the country in free trade areas, or effects of biotechnology in agricultural exports) or climate change.⁵

These effects may be most suitably explored in scenario or sensitivity analysis.

Box 3.5. Policy options

Good practice example from the United Kingdom

The UK Office for Budget Responsibility illustrates long-term production and price scenarios for oil and gas receipts on the UK continental shelf. It highlights that North Sea revenues are the most volatile revenue stream in the UK public finances and forecasting them over even short horizons is difficult. Long-term scenarios provide indicators of potential up-and downside risks to public finances stemming from resource revenues.

Source: UK Office for Budget Responsibility, *Fiscal sustainability report 2015*, p. 120; Congressional Budget Office, the 2015 Long-Term Budget Outlook Appendix B.

A. Scope of Analysis

Leading Practice

A.11 *Address fiscal dimensions beyond the capacity of government to meet its current obligations by addressing fairness.*

Source: Schick, A. (2005), *Sustainable Budget Policy: Concepts and Approaches*.

Schick (2005) observes sustainability “has acquired several dimensions that pertain to governments that have no difficulty meeting current obligations.” Three of these dimensions, solvency, growth and stable taxes were discussed in section A.01, and are

considered elements necessary for good practice long-term fiscal analysis for IFIs. Schick proposes a fourth dimension – fairness – now considered a leading IFI practice, relevant to, but not essential for good analysis of long-term fiscal sustainability.

Fairness – the capacity of government to pay current obligations without shifting the cost to future generations.

Generational accounting is used to assess the distributional implications of fiscal policy for different cohorts. This is accomplished by estimating the present value of net tax payments (taxes paid less benefits received) over the lifetime of different generations under current tax and spending policies. A generation is defined as including all males and females (separately accounted for, because of differing tax and benefits profiles) born in the same year. The technique has heavy data requirements and the results depend on a large number of simplifying assumptions. It is generally regarded as a supplementary technique for analysis of sustainability and intergenerational distribution.

Box 3.5. The fairness dimension of sustainability

A good practice example from the Slovak Republic and Korea

One of the aspects assessed by the Slovak Council for Budget Responsibility (CBR) in connection with the long-term sustainability of public finances is intergenerational fairness. The CBR quantifies the net contribution to/receipt from public finances of individual age cohorts. For this purpose, generational accounts are used, allowing the CBR to estimate the magnitude of fiscal expenditure or revenues for individual age cohorts during their lifetime.

Korea's National Assembly Budget Office produces analysis of how fiscal burdens associated with its baseline projection are distributed among generations of Korea's population using generational accounting techniques. They highlight the net present value of payments and benefits that each cohort of citizens can expect to pay and receive from general government.

Source: Council for Budget Responsibility, Report on the Long-term Sustainability of Public Finances, April 2015, p. 35; Korean National Assembly Budget Office, Long-term Economic Outlook and Fiscal Analysis, 2012-2060.

The four concepts – solvency, growth, stable taxes and fairness – when taken together, provide a considerably diverse perspective for which IFIs can assess fiscal sustainability. The four dimensions reflect that governments may have accumulated long-term liabilities that do not appear in current budgets or balance sheets but may nonetheless affect future generations and the fiscal position of future governments.

A.13 *Cover the full range of fiscal activity and risk, including tax expenditures, extra-budgetary funds, and contingent liabilities. The analysis should show the full financial costs and benefits of budget decisions and comprehensively cover future public liabilities.*

Source: IMF Fiscal Transparency Manual, 2007; OECD Recommendation of the Council on Budgetary Governance, 2015 and Ulla, 2006.

The notion that the budget should be a comprehensive statement of public revenues and expenditures is among the classical principles of budgeting (Schick, 2005).

In accordance with the *IMF Fiscal Transparency Manual* (2007) and the *OECD Recommendation of the Council on Budgetary Governance* (2015), best practice is to publish a full balance sheet showing all liabilities and all financial and nonfinancial assets of the central government. However, the IMF acknowledges that “even a full government balance sheet, prepared in accordance with generally accepted accounting principles, falls well short of providing all relevant information on government resources and obligations”. For example, under GFSM 2001 obligations under accident compensation schemes and environmental liabilities are not required in the balance sheet.

Schick (2014) notes that there are four main approaches to disclose or mitigate the risks that contingent liabilities impose on public finances: i) these liabilities in the budget or in a separate statement, and when feasible, to estimate their probable or potential cost ii) limit the volume of outstanding guarantees or the amount of new commitments that can be issued during the fiscal year iii) reserve funds in the budget for contingent liabilities that may come during the year iv) integrate contingent liabilities into the expenditure budget.

IFIs can enhance fiscal transparency by separately accounting, and when feasible, estimating the probable or potential cost of contingent liabilities in long-term fiscal sustainability reports.

Box 3.6. Coverage of the full range of fiscal activity and risk

Good practice examples from the United Kingdom and the Slovak Republic

The UK OBR estimates the economic value of government's contingent liabilities, in cases where there is a non-zero but less than 50% probability that the government will face some cost in the future, such as making good a loan guarantee.

The Slovak CBR estimates the value of implicit or contingent liabilities in its baseline scenario. The baseline forecast includes instalments paid for a motorway PPP project and a scheme for funding the costs of the decommissioning of nuclear facilities.

Source: UK Office for Budget Responsibility, *Fiscal sustainability report 2015*, p. 25; Slovak Council for Budget Responsibility, p. 21.

B. Assumptions

Good Practice

IFIs *should* include good practice elements and *could* include leading practice elements with respect to the assumptions used in long-term fiscal sustainability analysis:

B.01 *Make explicit all key assumptions underlying the projections contained in the report.*

Source: OECD *Recommendation of the Council on Principles for Independent Fiscal Institutions* (2014); OECD *Best Practices for Budget Transparency*; Anderson, B. and J. Sheppard (2009), *Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?*

Given that promoting transparency in public finances is a key goal of IFIs, they have a special duty to act as transparently as possible. Full transparency in their work and operations provides the greatest protection of IFI independence and allows them to build credibility with the public. IFI long-term fiscal sustainability analysis and reports

(including a full account of the underlying data and methodology) should be published and made freely available to all.

B.02 *Prepare baseline projections on the basis of current policy assumptions and adjusted for probable policy changes. Forward projections should otherwise be based on “realistic” assumptions of possible policies in the future.*

Source: Ulla (2006); Shick (2005).

Countries differ in how they construct baselines, but most assume that current policies (or laws) will continue through the period covered by the projections. The basic purpose of baselines (including long-term sustainability estimates) is not to predict the future but to project probable future fiscal consequences of continuing the programme and budget policies already in effect.

Medium-term projections, however, are typically based on current law and are often adjusted by stated rules in the yearly budget. Medium-term policies that are possible to carry out in a short period may be difficult to sustain over decades. The UK OBR cites yearly adjustments of the tax brackets with price indexation and wage indexation as an example. These adjustments increase the level of taxation as a share of GDP. If replicated annually over the long-term, these adjustments would imply an unrealistic level of taxation in just a few years.⁶

Hence, long-term projections commonly rely upon long-run relationships between revenues, spending and GDP, in combination with current fiscal policy.

Box 3.7. **Treatment of policy: Current and planned**

Good practice example from the United Kingdom

The Office for Budget Responsibility produces medium-term projections which are most often based on current law and the present rules for adjustments of the yearly budget. However, it alters its assumptions for long-term projections:

“In our medium-term forecasts, unless the Government states otherwise, we assume that it will uprate income tax allowances and thresholds in line with inflation. But because earnings are expected to rise more quickly than prices in the long-term (due to productivity growth), this definition of unchanged policy would result in the average tax rate rising steadily over time as more income moves into higher tax bands. This is known as ‘fiscal drag’. It would not be realistic to assume that this would be allowed to continue indefinitely. Indeed, estimates of the long-run relationship between tax revenues and GDP suggest that in practice other factors have, on average, offset fiscal drag. As in previous reports, we therefore assume that allowances and thresholds rise in line with earnings rather than prices beyond the medium-term horizon, turning off fiscal drag after five years.”

Source: UK Office for Budget Responsibility, Fiscal sustainability report 2015, p. 58.

B. Assumptions

Leading Practice

B.01 *Base all assumptions as the assumptions used in long-term equilibrium models.*

Source: Ulla (2006).

Long-term projections should be based on economic reasoning and economic growth theory. Long-term models differ from medium-term models in one of the main assumptions: In long-term models, all the available resources in the economy will in the long run be fully used. When the economy is in equilibrium in long-term models, there is competition between the public and private sectors for available resources, so changes in public expenditure will change the availability and the use of resources in the private sector. The growth in the economy will be explained to a large extent by technological improvements, capital formation and growth in the labour force.

Box 3.8. Long-term assumptions

Good practice example from Canada

Canada's PBO projects that over the long-term, the Canadian economy is assumed to operate at its productive capacity or potential GDP, which is projected to grow in line with trend labour input (total hours worked) and trend labour productivity (output per hour worked). Consequently, real GDP, labour input and labour productivity are projected to remain at their respective trends.

For example, trend labour input is determined by the working age population, trends in age and gender-specific employment rates and average weekly hours worked. Over the long-term, projected growth in labour input is due entirely to growth in the working-age population.

Source: Canada's Parliamentary Budget Officer, Fiscal Sustainability Report 2015, p. 4.

C. Analysis

Good Practice

IFIs *should* include good practice elements and *could* include leading practice elements with respect to the analysis of long-term fiscal sustainability:

C.01 *Publish regularly enough to make a contribution to public and political discussion on public finances. Forecasts should be prepared, at minimum, every 5 years, ideally specified under law.*

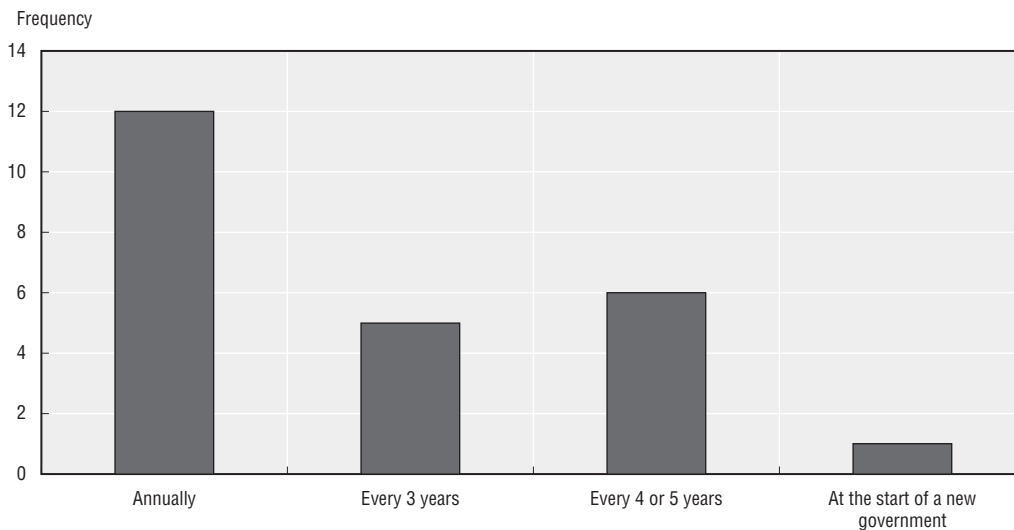
Source: OECD Recommendation of the Council on Budgetary Governance, 2015.

There is not a singular consensus on the optimal frequency of publishing long-term fiscal sustainability analysis, however in OECD countries, governments produce reports with regularity. Half of OECD governments that produce long-term fiscal projections do so on an annual basis. No government publishes less frequently than every 5 years, or at the start of a new government.

The OECD Recommendation of the Council on Budgetary Governance concludes that sustainability reports should be published regularly enough to contribute to public and political discussion on budgetary issues.

Anderson and Sheppard (2009) go further, to suggest that “fiscal projections should be prepared on an annual basis to draw attention to the long-term fiscal consequences of current policies and to eliminate discretion over when projections are produced.”

Figure 3.2. **OECD governments' long-term fiscal sustainability analysis: frequency of publication**



Note: Includes only governments that produce fiscal projections of 11 years or longer (24 of 34).

Source: OECD International Database of Budget Practices and Procedures, 2012.

While there is not an established standard for the frequency of publication, common practice suggests reports should be published in intervals of five years or less, to effectively contribute to public and political discussion on this subject.

In some country examples, IFI long-term fiscal sustainability analysis is required under law, as is the frequency of publication.

Box 3.9. Frequency of publication specified under law

Good practice examples from the United Kingdom and the Slovak Republic

In the United Kingdom, the Budget Responsibility and National Audit Act 2011 requires the Office for Budget Responsibility to produce “an analysis of the sustainability of the public finances” once a year.

In the Slovak Republic, the Report on the Long-term Sustainability of Public Finances is one of the main tasks of the Council for Budget Responsibility laid down in the Fiscal Responsibility Act.

Source: UK Office for Budget Responsibility; Slovak Council for Budget Responsibility.

C.02

Use indicators of fiscal sustainability that send a clear and easily understandable signal if current policy spending moves beyond a defined level of sustainability (e.g. fiscal gap). Indicators and their underlying methodology and assumptions should be sufficiently transparent so as to generate a sound understanding of how conclusions are drawn.

Source: Blanchard et al., 1990 and Anderson, B. and J. Sheppard (2009), Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?

There are a variety of indicators useful for illustrating fiscal sustainability, each with strengths and drawbacks. Anderson and Sheppard propose two main approaches which have emerged both in economic literature and in practice: baseline projections and synthetic indicators.

- **Baseline projections** of budget balance and debt: Unconstrained baseline projections model the effect on major fiscal aggregates (primary spending, operating balance, debt) of the current tax system and current spending programmes projected forward on the basis of demographic and other assumptions without any constraints. Constrained baseline projections begin by imposing a constraint on the major fiscal aggregates and then determine what spending or revenue track would be required to continue to meet these constraints, given likely changes to the population and the economy (Anderson and Sheppard).
- **Synthetic indicators** (e.g. fiscal gap; inter-temporal budget constraint): Are an extension of unconstrained baseline projections. They measure the size of an immediate and permanent increase in tax and/or reduction in noninterest expenditure required to set the present value of all future primary spending surpluses (i.e. revenues less non-interest expenditures) equal to a specific level of debt. They may be calculated against a specific terminal date and/or an infinite time horizon to illustrate the magnitude of the policy response necessary to maintain a specific level of debt in the future.

The International Public Sector Accounting Standards Board prescribes that indicators of long-term sustainability should balance considerations of clarity and relevance; completeness with the risk of information overload and the impairment of clarity (IPSAB, 2013).

The European Union has a number of long-term sustainability indicators⁷:

- The long-term fiscal sustainability indicator (S2) shows the upfront adjustment to the current structural primary balance (kept then constant at the adjusted value forever) required to stabilise the debt-to GDP ratio over the infinite horizon, including paying for any additional expenditure arising from an ageing population. The S2 indicator does not put any restrictions on the level of debt; rather, it imposes that debt does not grow faster than output.
- The inter-temporal net worth (INW) indicator can be interpreted as a measure of government's net financial wealth, assuming unchanged policies and including projected/implicit future liabilities due to ageing. It reflects the total of the discounted sum of future primary balances under current policies and current net worth (the difference between assets and liabilities, i.e. the negative of net debt).
- The required structural primary balance (RSPB) represents the structural primary balance that would be necessary at the beginning of the long-term projections to ensure long-term sustainability once all other spending has been covered. The RSPB is calculated by summing the structural primary balance at the end of forecast with the additional effort measured by S2.

C.03 *Highlight the long-term fiscal costs of past and possible future policy changes.*

Source: Tarschys, D. (2002), Time Horizons in Budgeting; UK Office for Budget Responsibility, Fiscal sustainability report 2015 and Congressional Budget Office 2015 Long-Term Budget Outlook.

Highlighting the “cost of delay” for policy choices supplements a single indicator of fiscal sustainability. The OBR rightly states that, “even if policymakers have chosen where they want the debt ratio to end up, there are further choices to be made about the desirable

path to get there.” By highlighting various “paths” to sustainable finances, IFIs can illustrate to legislators and stakeholders the opportunity costs of delayed fiscal policy action.

Box 3.10. Policy options

Good practice example from the United States, the United Kingdom and Korea

The UK OBR illustrates the difference that the choice between a one-off permanent adjustment and (an initially smaller, but ultimately larger) cumulative decade-by-decade adjustment makes to the path of net debt en route to the target date.

Both the Congressional Budget Office and Korean National Assembly Budget Office estimate scenarios to highlight policy options to obtain a hypothetical fiscal objective along various fiscal paths and scenarios. In Korea, NABO presents a menu of revenue and spending options disaggregated by functional area and time horizon.

Source: UK Office for Budget Responsibility, Fiscal sustainability report 2015, p. 120; Congressional Budget Office, the 2015 Long-Term Budget Outlook Appendix; Korean National Assembly Budget Office.

C.04 *Separate projections for revenues and expenditures, and their functional classifications should be made wherever long-term cost drivers may differ.*

Source: Anderson, B. and J. Sheppard (2009), Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?; Office for Budget Responsibility, Fiscal sustainability report 2015; Ulla (2006).

Expenditure types with demographic cost drivers (health, education, pensions) should be forecast separate from expenditure types without (environment, contingent liabilities). A similar forecast decomposition should be made for tax revenues with different tax bases. For all IFIs examined in this report, the long-term fiscal sustainability reports include expenditure forecasts delineated by major functional category, forecast independently based on major cost drivers. In many cases, gross domestic product is the primary (or sole) dependent variable in the forecast equation, but other cost factors (demographic and economic changes) are frequently incorporated.

Box 3.11. Decomposition of revenues

Good practice example from the United Kingdom

Receipts from natural resource production are one of the most volatile streams of UK government revenue and one of the most difficult areas of the public finances to forecast. The Office for Budget Responsibility devotes a chapter of its Fiscal sustainability report 2015 to a detailed medium-and long-term forecast of oil and gas revenues in the North Sea. The OBR models long-term declines in oil and gas revenues due to gradual exhaustion of the natural resources remaining within the UK continental shelf; and new resources, such as shale gas, as potential new sources of revenue. It supplements a central forecast with alternative price and production scenarios.

Source: UK Office for Budget Responsibility, Fiscal sustainability report 2015, Chapter 4.

C.05 *Highlight changes to methods, assumptions and key findings relative to past reports.*

Source: Anderson, B. and J. Sheppard (2009), *Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?*; Ulla 2006.

The *Recommendation of the Council on Principles for Independent Fiscal Institutions* state that IFI reports and analysis (including a full account of the underlying data and methodology) should be published and made freely available to all. IFIs broadly disclose and discuss the rationale supporting changes to methods, assumptions and key findings relative to past long-term fiscal sustainability analysis to enhance reader usability.

Box 3.12. Disclosure of changes to methods, assumptions and key findings relative to past reports

Good practice example from the United States and the United Kingdom

The US Congressional Budget Office includes an appendix in its Long-Term Budget Outlook to highlight changes in methods and assumptions underlying the baseline projection. It also discusses the estimated economic effects of changes to fiscal policies and changes to methods for analysing uncertainty.

The UK Office for Budget Responsibility makes explicit policy announcements relevant to long-term projections, including budget announcements since the prior report

Source: Congressional Budget Office, the 2015 Long-Term Budget Outlook; Office for Budget Responsibility.

C.06 *Include sensitivity or scenario analysis for key variables.*

Source: Anderson, B. and J. Sheppard (2009), *Fiscal Futures, Institutional Budget Reforms, and Their Effects: What Can Be Learned?*

To deal with uncertainty in the projections, scenario building is a helpful tool for decision makers to understand how different the future will be if the main assumptions for the projections do not materialise. Sensitivity analysis provides a means of illustrating the impact of changes in the assumptions upon the fiscal indicators. Sensitivity analysis also serves to illustrate the relationship between fiscal indicators and their underlying assumptions. Scenarios can portray distinctions between demographic and non-demographic revenue and spending pressures, helping to illustrate possible courses for policy action. Scenario and sensitivity analysis is widely practiced by IFIs in long-term fiscal sustainability reporting.

C. Analysis

Leading Practice

C.11 *Illustrate the distributional impacts of alternative policies, where applicable.*

Source: Congressional Budget Office, the 2015 Long-Term Budget Outlook; Anderson, B. The Changing Role of Parliament in the Budget Process (2009).

In addition to budgetary and economic analyses long-term sustainability analysis can further support the legislature with analyses of the distributional impacts of various long-term fiscal scenarios. While these analyses can be time consuming, and require detailed data inputs, they can help illustrate the allocative trade-offs legislators may be faced with in pursuit of sustainable public finances.⁸

Box 3.13. Disclosure of changes to methods, assumptions and key findings relative to past reports

Good practice example from the United States

The Congressional Budget Office includes analysis on the long-term income effects of certain policies on representative households at different points in the income distribution. For example, the CBO provides analysis of Individual Income and Payroll Taxes as a Share of Total Income Under CBO's Extended Baseline for households at half, at twice and at four times the median total income in 2015 and in 2040. The analysis highlights how, without legislative changes, the relative share of households eligible for certain tax and spending benefits changes over time.

Source: Congressional Budget Office, The 2015 Long-Term Budget Outlook, pp. 70-71.

C.12 *Feature international comparison, where applicable.*

Source: Office for Budget Responsibility, Fiscal Sustainability Report 2015.

International comparisons provide helpful context for readers to interpret forecast inputs and the reasonableness of the sensitivity and scenarios included in long-term fiscal sustainability reports.

Box 3.14. Disclosure of changes to methods, assumptions and key findings relative to past reports

Good practice example from the United Kingdom

Office for Budget Responsibility reports include analytical sidebars to highlight the international context for selected topics. For example, in 2015, the OBR discussed cost drivers for health expenditure, complete with statistics on the growth of real health spending and GDP per capita across OECD countries. The report also featured international comparisons for age-related expenditures.

Source: UK Office for Budget Responsibility, Fiscal sustainability report 2015, p. 74 and p. 95.

C.13 *Illustrate feedback mechanisms between macroeconomic and fiscal variables*

Source: Slovak Council for Budget Responsibility, Fiscal Sustainability Reports (2012-2015).

IFIs can illustrate feedback effects that fiscal policy scenarios have on real economic variables, for example the effects of the rising government debt on economic growth or how government savings rates could affect the economic behaviour of households and companies over the long-term. This type of analysis can supplement baseline projections, without feedbacks, to illustrate simplified interdependencies between fiscal policy and economic outcomes. This analysis should be based on relationships identified in long-term economic models.

Box 3.15. Fiscal feedback effects

Good practice example from the Slovak Republic

The Slovak Council for Budget Responsibility highlights the economic growth effects of various fiscal policy scenarios, including alternative risk premium on public debt, alternative national public and private savings rates and the relative size of the public sector as a share of the national economy. These scenarios help illustrate on the long-term growth dimension of sustainable fiscal policies, as discussed in benchmark A.01.

Source: Slovak Council for Budget Responsibility.

4. Crosswalk of proposed practices for IFI long-term fiscal sustainability analysis and current practices at peer review group institutions

Note to readers: This section of the report is a work-in-progress, current to January 2017. Gaps in data may reflect data omission and may not reflect current practices. This table is intended to test the reasonableness of the benchmarks rather than an assessment of the long-term fiscal sustainability functions of each IFI.

A Scope of analysis											
Good practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US
A.01	Sustainability dimensions										
	Solvency	Schick 2005									
	Growth	Schick 2005									
	Stability of taxes	Schick 2005									
A.02	Coverage levels of government										
	General government an aggregation of central, state/regional and local government expenditures	Anderson 2009									
	A full national overview of the public finances – encompassing central and subnational levels of government	OECD Rec. on Bud. Gov 2015									
A.03	Time horizon										
	The report should assess the budgetary implications of demographic change, such as population ageing and other potential developments over the long-term (10–40 years).	OECD Best Practices for Bud Trans 2002									
	Balance verifiability, faithful representation and relevance	IFAC 2013									
	The time horizon for the projections will partly depend on the nature of the problems to be analysed. Balance coverage of important policy issues with the risks of making projections more and more uncertain further into the future	Ulla 2006									
A.04	Coverage beyond demographic changes										
	Focus of the projections should be more than just on demographic changes	Anderson 2009									
	Other long-term effects should be considered and included in the projections: natural resource depletion, trade or technology changes t or climate change.	IMF Fiscal Trans. Manual 2007									
Leading practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US
A.11	Sustainability dimension										
	Fairness	Schick 2005									
A.12	Coverage all fiscal risks and pressures										
	Cover all the future liabilities that the government cannot avoid	Ulla 2006									
	Long-term projections should cover the full range of fiscal activity, including tax expenditures, extrabudgetary funds, and contingent liabilities.	IMF Fiscal Trans. Manual 2007									
	A full balance sheet showing all liabilities and all financial and nonfinancial assets of the central government.	IMF Fiscal Trans. Manual 2007									

Shaded areas indicate that recent work broadly adheres to the benchmark.

Note: See Appendix for detailed list of key references.

B	Assumptions											
Good practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US	
B.01	Disclose assumptions											
	All key assumptions underlying the projections contained in the report should be made explicit and a range of plausible scenarios presented.	OECD Best Practices for Bud Trans	2002									
	Explicit disclosures of underlying assumptions and methods	Anderson	2009									
	ID changes to methods, assumptions	Anderson	2009									
	Highlight year-to-year changes in assumptions (policy, demographics, economic)	OBR	2015									
B.02	Realistic assumptions											
	Based on “realistic” assumptions of possible policies in the future.	Ulla	2006									
	The projections should be prepared on the basis of current policy assumptions, and assumptions about future economic and other conditions	IFAC	2013									
	Baseline projections must be adjusted for policy changes that are certain to happen.	Ulla	2006									
Leading practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US	
B.11	Long term assumptions											
	Based on the same assumptions as in long-term equilibrium models.	Ulla	2006									

Shaded areas indicate that recent work broadly adheres to the benchmark.

Note: See Appendix for detailed list of key references.

C	Analysis										
Good practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US
C.01	Frequency										
	Publishing a report regularly enough to make an effective contribution to public and political discussion on this subject	OECD Rec. on Bud. Gov	2015								
	Annual	Anderson	2009								
	Required under law	OECD IFI principles	2013								
C.02	Indicators										
	Clear fiscal indicator(s)	Anderson	2009								
	A good fiscal indicator is one that sends a clear and easily understandable signal should current policy spending move beyond a defined level of sustainability	Anderson	2009								
	Indicator options:										
	Unconstrained baseline projections of budget balance and debt	Anderson	2009								
	Synthetic indicators (e.g. fiscal gap, Intertemporal Budget Constraint)	Anderson	2009								
	Generational accounting: net individual tax benefits by demographic cohort	Anderson	2009								
	What types of fiscal indicators are used and are these compared against previous projections?	Tarschys	2002								
C.03	Fiscal costs of past and possible future policy change										
	Do projections highlight the long-term fiscal costs of past and possible future policy change?	Tarschys	2002								
	Indicators of required policy changes and cost of delay	OBR	2015								
C.04	Separate projections for revenues and expenditures, and their functional classifications										
	Decomposition of revenues and expenditures	Anderson	2009								
	Decomposition of expenditure types: Demographic (Health and old age; Education; Public pension) Non demographic (Climate/environment; Contingent liabilities)	Anderson	2009								
	Decomposition of revenue types: Income Tax (personal, business); Value-Added Taxes; Excise/Duties; Resource Revenues	OBR	2015								
	Projecting expenditures by functional classification may give greater flexibility to build in the need to change the level of public services due to changes in demographics and other changes in the economy	Ulla	2006								
	Treatment of mandatory vs discretionary spending are statutory spending programs separated from similar non-statutory items?	CBO	2015								
C.05	Compare to prior year										
	Compare to prior year	Anderson	2009								
C.06	Sensitivity and scenarios										
	Sensitivity analysis	Anderson	2009								
	illustrate a range of possible projected scenarios	Anderson	2009								
	Range estimates	Bos and Teulings	2013								
	There are two main ways to present uncertainties in the projections: scenarios or probability distributions	Ulla	2006								

Shaded areas indicate that recent work broadly adheres to the benchmark.

Note: See Appendix for detailed list of key references.

C	Analysis											
Leading practice		Reference	Australia	Can	Denmark	Korea	Neth	Slovak	Spain	UK	US	
C.11	Distributional impacts											
	Distributional impacts of alternative policies	CBO	2015									
C.12	International comparisons											
	International comparisons	OBR	2015									
C.13	Economic-fiscal feedback											
	Fiscal feedback effects	OBR	2015									

Shaded areas indicate that recent work broadly adheres to the benchmark.

Note: See Appendix for detailed list of key references.

Notes

1. The matrix of case examples is a trial and work in-progress. Hence, it currently omits many country case examples. These omissions will be improved upon as the project develops and with essential input from network delegates.
2. International Public Sector Accounting Standards Board, Reporting on the Long-Term Sustainability of a Public Sector Entity's Finances, 2013, www.ifac.org/system/files/publications/files/IPSASB_RepLong-Term_Sustainability_of_Public_Finances.pdf.
3. OECD (2015), *Fiscal Sustainability of Health Systems: Bridging Health and Finance Perspectives*, OECD Publishing, Paris.
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5. IMF Fiscal Transparency Manual, 2007, p. 93.
6. UK Office for Budget Responsibility, *Fiscal sustainability report 2015*, p. 50.
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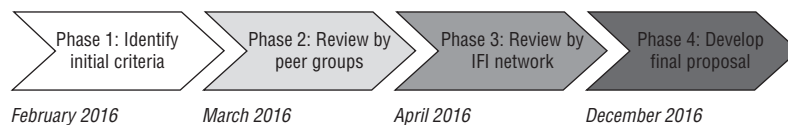
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APPENDIX A

Project methodology

The benchmark practices identified in this report draw upon general literature on guidelines for long-term fiscal sustainability analyses and budget practices, the recent long-term fiscal sustainability publications of OECD Networks of Senior Budget Officials and Parliamentary Budget Officials and Independent Fiscal Institutions (PBO) and input from a network peer group for long-term fiscal sustainability analysis.

Figure A.1. **Developing criteria for Independent Fiscal Institutions' long-term fiscal sustainability analysis***



*Australia, Canada, Denmark, Finland, Korea, Slovak Republic, Spain, United Kingdom, United States

Phase 1: The OECD identifies and classifies a comprehensive set of potential benchmarks for IFI long-term fiscal sustainability analysis practices

- Step 1.1: Literature review of guidelines for long-term sustainability analysis (see Bibliography)
- Step 1.2: Review of the recent long-term fiscal sustainability analyses and working papers of OECD IFI peer group for long-term sustainability analysis?
- Step 1.3: Create a composite list of long-term fiscal sustainability analysis benchmarks based on literature, from step 1.1, and recent work of the IFI network, from step 1.2, (see Sections 2 and 3)
- Step 1.4: A preliminary examination of IFI long-term fiscal sustainability analysis vis-a-vis the composite list of benchmarks (see Section 4)

Phase 2: Initial review of preliminary benchmarks by OECD IFI peer group for long-term sustainability analysis

- Step 2.1: Query IFI peer group members, who possess considerable expertise regarding the important criteria for long-term fiscal sustainability analysis, the following core questions:
 - Do you believe that this type of framework can help your organisation undertake evaluation, peer review, benchmarking or the exchange of good practices?
 - What are the essential benchmarks already identified that should be kept?

- What benchmarks should be revised?
- What important benchmarks have been omitted?
- Do these benchmarks strike the right level of detail? That is, are the benchmarks too specific? Or not specific enough?
- Has important existing literature in this area been omitted when crafting the benchmarks?
- Step 2.2: Query IFI peer group members on whether the most important aspects of their long-term fiscal sustainability work is properly reflected in the draft concept note.
- Step 2.3: Incorporate the feedback of peer group members into a revised set of benchmarks. These were shared with the OECD network of IFIs as a draft working paper and presentation as part of the April 2016 OECD IFI network meeting.

Phase 3: Review of preliminary long-term sustainability analysis benchmarks by OECD IFI network

- Step 3.1: Pilot this work as a general approach, asking all OECD IFI network members:
 - Do you believe that this type of framework can help your organisation undertake evaluation, peer review, benchmarking or the exchange of good practices?
 - Is the approach used to formulate these benchmarks replicable for other lines of work among IFIs?
 - Do these benchmarks strike the right level of detail? That is, are the benchmarks too specific? Or not specific enough?
 - How can the benchmark criteria be improved?
- Step 3.2: Query IFI peer group members on whether the most important aspects of their IFIs long-term fiscal sustainability work properly reflected in the draft benchmarks.
- Step 3.3: Secondary collection of good practice examples from OECD IFIs aligned with each preliminary benchmark.

Phase 4: Refinement of IFI benchmarks among peer group for long-term fiscal sustainability analysis, other IFI network members and external reviewers

- Step 4.1: External review
- Step 4.2: Incorporate feedback
- Step 4.3: Pilot the criteria in an internally-oriented test review of an IFIs long-term fiscal sustainability functions.

Public sector productivity: Measurement challenges, performance information and prospects for improvement

by
Patrick Dunleavy*

Improving productivity at the organisational level offers the greatest immediate dividends and could successfully cover the largest departments and agencies at the central or national level. For many decades the measurement of government outputs in national statistics and economic accounts used inputs, which assumes that government productivity neither grows nor falls. Modern solutions exist however, that can generate empirically useful metrics of total outputs from which stakeholders could learn key lessons about the productivity of their agencies over time.

This article outlines the tools needed to apply these modern solutions and offers recommendations for improving cross-national productivity data for government.

JEL Codes: H10, H11, H30

Keywords: Productivity measurement, core inputs, quality weighting, labour, regression analysis

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Executive summary

A convention has persisted for some eight decades now of measuring government outputs in national statistics and economic accounts using inputs. This is equivalent to assuming that government productivity neither grows nor falls over time. However, modern solutions now exist for cost-weighting outputs so as to generate empirically useful metrics of total outputs at an organisational level. From this kind of information public sector leaders, managers, and stakeholders can learn key lessons about how the productivity path of their agency develops over time, and also compares with other agencies in the same policy field – either cross-nationally for central government bodies, or within the same country for decentralised agencies. Solutions also now exist for handling quality issues, and for going beyond individually delivered transactional, regulatory or delivery services to also tackle government productivity in agencies with complex outcomes.

Improving productivity measurement at the organisational level offers the greatest immediate dividends and could successfully cover the largest departments and agencies at national or central government level across OECD countries. There is great scope too for looking at other large central departments cross-nationally, and for developing organisational-level productivity paths for large N decentralised agencies in fields like healthcare, education, policy, transport etc. Finally, national statistical agencies have made useful progress in estimating national government productivity at sectoral levels. This can contribute to the macro-economic understanding of economic growth – although aggregate productivity data may not be helpful for improving government sector performance.

Introduction: Government productivity in the modern era

Directly delivered government services (and a few goods also) make up a substantial part of the GDP of advanced industrial nations. The levels involved vary across OECD countries. But something around a 1/5 to a 1/4 of final economic output can be safely considered as governmentally produced. Yet because of past difficulties in measuring public sector outputs, they have primarily been accommodated in national statistics by relying on a conventional assumption – that they are the same value as the inputs used in producing them.

Productivity can (and should) be thought of in quite simple terms as

“the total value of outputs produced (or sometimes activities undertaken) by an organisation”
“the amount of inputs used in producing them”

The conventional representation of government/public sector outputs by means of inputs of course replaces this with just Total inputs/Total inputs. This is equivalent to assuming that the productivity of all government sector organisations is always 1, and never changes over time. In particular, government productivity growth is inherently zero (Statistics Denmark, 2013, p. 13).

This mainstream pattern of recording has endured for many decades now, although its deficiencies in statistical and economic terms are obvious. Traditionally all or many public

sector organisations were widely seen as “immortal” or long-lived organisations (Kaufman 1976), machine bureaucracies delivering administrative and personal services in labour-intensive and relatively unchanging ways. The conventional wisdom became that measuring public sector productivity was “an impossible task” (Boyle, 2007, and see his 2006). In many ways very fuzzy concepts like “value for money” (OECD, 2010; OECD, 2015b) distracted officials and analysts from productivity measurement. Support for a static view of government productivity was also not hard to find. Some decentralised and professionalised public services continue to depend largely on in-person interactions between staff and clients (as in most healthcare). In many essential healthcare tasks, modern labour requirements may be pretty much the same as have always applied (e.g. think of safely lifting a sick person of a certain weight into or out of bed).

Yet in the modern, digital era, many other public agencies have greatly changed. For instance, regulatory and transaction-handling departments (perhaps especially at national or central government level) have become a great deal more capital intensive (Dunleavy et al., 2006). In little more than 15 years they have changed from labour-intensive organisations to place a heavy reliance on IT-based investments, with rapidly shrinking workforces (Dunleavy and Carrera, 2013a, Chapters 2-6; Dunleavy, 2015). Many IT changes have appeared as “disruptive innovations” (Christiansen et al., 2000; Christiansen et al., 2004) for established bureaucracies (Margetts and Dunleavy, 2013). The advent of “big data” has great potential for making analytic improvements in how services are organised and delivered (Dunleavy, 2016; Margetts, 2013), especially in shifting from volumetric patterns of intervention to risk-based management. Recent 2016 research undertaken with top officials across all departments in the Australian Commonwealth government has shown that digital changes already in process there will affect the full range of government regulatory and service-delivery activities, like policing (Perry et al., 2013; Police UK, 2016). This effect goes far beyond current efforts at the “digital transformation” of citizen-facing agencies (Evans et al., 2016) as new technologies like distributed ledgers and machine learning may greatly affect previous public sector information monopolies (Government Office for Science, 2016; Armstrong, 2015). Across large areas of the public services it is now possible to realistically foresee a transition to a “robotic state” (Dunleavy and Carrera, 2013b) where a new wave of automation advances are certain to be made.

These important variations and contemporary advances now place a premium on actively and accurately measuring the productivity of government sector organisations at a range of levels:

- in national statistics, for government as a whole
- across large services sectors within a country involving multiple central and local government or public service organisations, such as public healthcare, education or law-and-order functions
- for individual central government departments and agencies
- for decentralised networks of local provider organisations within the public sector and for “parastate” organisations (whether companies or NGOs) working with them in the contracted delivery of services on the ground.

At each of these levels the greatest value of productivity measures lies in:

- creating reliable empirical data on *productivity paths*, that is, the over-time development of indices of productivity

- allowing *meaningful and insightful comparisons* to be made between different government organisations or sets of organisations

so as to allow service controllers and providers to make practical improvements in what is being done.

Recent methodological developments pioneered in the Atkinson Report (2005) have been implemented in some countries and in a few studies (e.g. Dunleavy and Carrera, 2013a) – see next section. It should now be feasible to avoid many past problems of measurement, and to exploit the current potential of improved government information systems, so as to move decisively away from the conventional assumption of static government productivity. OECD countries collectively could now make major improvements both in how government productivity is understood within each country, and in developing cross-national comparisons and policy-learning.

The challenges here are considerable, as the past history of weak progress in the field over decades attests. Yet the gains that could now be made in helping to improve public sector efficiency and knowledge of “what works” are also substantial.

1. Five essential steps in measuring productivity in the public sector

The long-run inability to develop widely used measures of government productivity reflects a considerable failure of imagination and focused effort in economics and public management studies on the one hand; and some very sustained resistance by civil servants, public sector professionals and some politicians to the application of “crude” and “limited” measures to government activities on the other hand. Many of these barriers hinge on the issue of “quality” in public services, discussed in Section 2, and others concern some widespread mis-uses of the “productivity” concept, discussed in Section 3. But here I focus on showing that we now know very well how to complete the essential operations involved in computing useful productivity indices for government organisations.

1.1. Identify the “core” outputs or activities of the agency

Like firms, government organisations do myriads of things. But firms’ activities all culminate in a clearly defined list of products or services that are sold to customers, so we can clearly distinguish as “intermediate production” all the stages that lead up to this marketing of an output. By contrast it is not so straightforward for departments and agencies to define which few of their outputs or activities are fundamental to or trigger the remainder. A *core output* or activity is one that gives rise to other activities, which are created as a result of it. For example, in a school, teachers running a parent’s evening or marking homework are not core outputs, because they follow on from a more fundamental output or activity – such as, admitting a child to the school, or teachers delivering a set of lessons. Similarly, in a taxing agency having staff members in call centres answer queries from income tax payers would not be a core activity, but counting the number of existing taxpayers and of new taxpayers (because they are more costly to handle) would be core.

Core outputs or activities for any agency need to be restricted to complete “activity packages” (not parts of operations) or to finally-delivered services (akin to end-products in firms). Different core activities should have different origins, rules and practices governing them. For example, in a taxation agency each kind of tax will need to be treated as a separate “product”; and in a welfare agency each type of benefit similarly. Core outputs may also be distinguished where parts of the same activity have distinctive cost profiles.

For example, in many tax and welfare contexts adding new clients is far more costly than just maintaining a service to ongoing clients, so it is useful to distinguish these two types of cases separately.

The number of core outputs we distinguish per agency needs to be limited to a few outputs, perhaps only one or two for small or single-purpose agencies. For very large agencies with diverse activity streams (such as national tax or social security organisations) there might be 10 or 15 main outputs, with some of these also showing new clients and existing clients as having different cost profiles.

Counting output levels means being clearly able to denominate units or cases. This is easiest in transactional agencies (e.g. each taxpayer or recipient of one benefit is a case), and we can treat each case as having the same weight. Where organisations deliver more complex outputs this may affect both how we distinguish core activities, and require a weighted-count of the levels of outputs in each category.

1.2. Develop unit costs or activity accounting for core outputs

We next need to attribute administrative costs to each core output or main activity stream that an agency operates. This is not necessarily as easy as it sounds, unless the core outputs or activities schema has already been in use within the agency. Difficulties commonly arise because:

- Costs are historically monitored only on an inputs basis, and the agency or units within it does not know how to attribute costs to different outputs. For instance, a fire service might have two core activities, fire prevention and inspection work, and emergency response to fires. It might allocate (some of) the same staff to work flexibly between the two roles. Partitioning costs across the two core activities may not have previously been undertaken
- Units of outputs or activities have not been previously counted in the same way as needed for unit costing. For instance, detailed costs data may be available for a wide range of micro-activities that a police force undertakes (such as running a crime prevention meeting or briefing neighbourhood watch committees), but these costs may have been aggregated up previously only as “central”, “corporate” or generic activities that were untagged to specific core outputs.

1.3. Develop a cost-weighted total output metric for each agency

When we measure total outputs for a given firm, we add up an amount for (sales * price) across each of its products. For instance, suppose a firm has two products, the first X priced at USD 5 and selling 20 000 units and the other Y priced at USD 10 and selling 5 000 units. Its total output is thus: $(\text{USD } 5 * 20\,000) + (\text{USD } 10 * 5\,000) = \text{USD } 150\,000$. Price is important here in two ways. First, it allows us to easily price-weight across completely dissimilar products. Second, in competitive markets with consumer sovereignty, we can make welfare implications about the sales patterns observed – in this case that consumers would not freely pay USD10 for product Y compared with USD 5 for product X unless they were getting commensurate benefits from it. This is very valuable information – so if the firm progressively shifts from X to Y sales, we can infer that this is creating a good for (consumers in) society more widely as well as for the firm itself.

In government sector organisations, price-weighting is not feasible (except for a very few special cases), because outputs are not marketed, and many outputs must be consumed

whether citizens or enterprises wish to do so or not. Some outputs are directly coercive, as in arresting criminals or enforcing regulations.

The alternative way of getting to total outputs for a government organisation was proposed and developed by the Atkinson report (2005), namely to weight different outputs by their administrative costs. So if a government organisation has three core outputs (or activities) F, G, and H, its total output can be defined as

$$(\text{units of F} * \text{unit costs for F}) + (\text{units of G} * \text{unit costs for G}) + (\text{units of H} * \text{unit costs for H})$$

With total outputs defined in this way we can now begin to make meaningful comparisons of how an agency's outputs compares with other agencies at the same time, which is immediately useful in cases where we have large N datasets. However, it is also very helpful to know how even a single agency's total outputs are changing over time, and here direct comparison entails adjusting for varying cost levels from year to year. To put the costs in different years onto a comparable basis we deflate them to a common, base-year level. We can then compute a total outputs index number over time that responds to the changing levels of outputs, and the changing mix of outputs, but strips out the otherwise misleading inflation of (and perhaps, in future, deflation of) cost levels.

There are a number of technical issues about how to handle costs when generating total outputs index numbers (for more details see Robano, 2016; Office for National Statistics; Statistics Denmark, 2013). Key points include:*

- whether to use general costs levels in the economy or for government as a whole as the deflator; or
- whether to use a sector-specific or even agency-specific cost deflator, normally because the agency's costs have a significantly different dynamic from those in the economy or government as a whole – as may be true for say defence equipment, or for health-care costs; and
- how to link across years in computing the index numbers, using more sophisticated “chaining” methods that allow for mid-year or more continuous shifts in costs levels, as opposed to unsmoothed changes of cost levels from a one year period to the next.

One main argument for using general GDP deflators across multiple sectors and agencies, or alternatively whole-of-government cost deflators, is that it facilitates easier comparison between different parts of the public sector in the same country. In comparing productivity levels across countries, using more general costs deflators may also have advantages.

1.4. Develop an accurate total inputs cost number for the agency

Most government organisations in OECD countries have well-developed information on most of their input costs for a given year's outputs or activities. The total salary bill will normally be very well known, plus the costs of intermediate products supplied by contractors (e.g. private call centres), and the agency's annual running costs on property, equipment maintenance, materials, routine small procurements and so on.

However, difficulties often arise in respect of

- accurately measuring the total capital costs for buildings or major equipments, like IT systems, or in defence the acquisition of complex equipments likes planes or weapons systems;

* See also DCLG Department of Communities and Local Government (2015); Lee (2008); OECD (2007); OECD (2009); OECD (2010).

- attributing these costs across the multiple years that the capital investment is being used; and
- costing in depreciation, usage and wear and tear.

Buildings, IT systems, equipments and other resources may also be planned to be used for one period of years, but then either remain in use for longer than planned (e.g. because output mixes have been adjusted to allow this) or are deployed for less time than planned (e.g. because equipment, IT or buildings prove inappropriate for the evolving patterns of service delivery).

In addition, governments often confront difficulties in accurately costing apparently “free” resources that are inherited from earlier periods without charge, or have been requisitioned in non-market ways, or both. For example, an army might own large tracts of land as military training grounds that have been in their current use for many years and perhaps were acquired at non-market prices initially. Generally the measurement of “public sector equity” remains a highly problematic field. Both in their own internal accounting and in national statistics many governments continue to use conventional solutions for valuing public sector equity that are palpably inadequate – for instance, valuing a land registry simply as the costs of the IT capital equipment used to store the database.

Exactly as with total outputs, there are a number of technical alternatives in computing index numbers for total inputs, again including using general economic deflators for costs, or sector-specific costs, and how to “chain” or link costs levels across years or periods (Robano, 2016; Office for National Statistics; Statistics Denmark, 2013).

1.5. Divide total outputs by total inputs to give a total factor productivity number for the organisation

In the modern era, by far the most useful productivity measure in any given year or period is total factor productivity (TFP)

$$TFP = \frac{\text{cost-weighted total outputs}}{\text{inclusive total inputs cost}}$$

The key advantages of the TFP measure are:

- it includes both directly-produced outputs from the agency’s own staff, and intermediate outputs supplied by other government agencies, or “para-state” firms, or NGOs under contract; so
- changes in the balance of internal production and contracting-out do not affect the comparability of the TFP numbers before and after the change.

Where capital costs cannot be accurately determined, both the cost-weighting of outputs and the estimate of total input costs are impaired. However, it is still most helpful in such conditions to compute:

$$\text{“near TFP”} = \frac{\text{cost-weighted total outputs (lacking capital costs)}}{\text{total inputs cost (lacking capital costs)}}$$

In conditions where an agency produces all its outputs internally, and uses only minor or routine amounts of contracted or intermediate outputs services, it may be useful to compute

$$\text{labour productivity} = \frac{\text{cost-weighted total outputs}}{\text{inclusive labour inputs cost}}$$

Labour productivity might also be a useful sub-measure of total productivity to calculate in particular circumstances, where analysis focuses below the core outputs level and below an agency's total outputs and costs. For instance, in defence equipment planning it is useful to know how an older naval ship with a large crew compares in running costs per day at sea with a newer ship with more automated capital equipment and a smaller crew.

Bear in mind, however, that changes in an agency's labour productivity measure over time will be acutely sensitive to any alterations of the scope of external contracting or commissioning in producing outputs. Over-time series will not be comparable across such changes, and comparisons between agencies using different levels of commissioning and outsourcing will not be feasible.

1.6. Decide on a strategy for controlling quality issues

In public services it is important develop an approach to incorporating quality in one of two ways. A first approach treats quality as stable over time unless and until there is clear evidence of a decline or quality lapse, which may affect only one or two years in a quality path. A second approach reweighs all the "total cost-weighted output" numbers derived in Section 1.5 above for variable quality levels across years. These options are discussed in detail in Section 2.

2. Is measuring services quality needed for government productivity metrics? Two main approaches

One reason why the public sector employs far more graduates and highly educated staff than many private firms is that the delivery of government services on the ground is professionalised and often involves very personal issues and needs. We do not have a "big book" manual or a giant expert system that can tell us how to treat people who show up in an emergency room with symptoms that might suggest a heart attack. Instead we invest resources in establishing an ER operation, employing qualified and (hopefully) dedicated professional staff, who are empowered to treat every case in a "best practice" way.

The Economist famously defined a service as "any product sold in trade that cannot be dropped on your foot". So services are already far less tangible, far more relational and far "fuzzier" in character than goods. Public services often add extra, highly salient dimensions of urgency (e.g. ambulance arrival times), strong need (e.g. acute healthcare), sensitivity (e.g. mental health treatment), compulsion (e.g. disease or HIV notification), recognition of rights (e.g. immigration appeals), equality of treatment (e.g. fairness across taxpayers) and an appropriate service relationship (in the absence of a payments nexus between consumer and service supplier). All these factors mean that *how* public services are delivered and *when* they are received are highly salient issues. An influential line of argument in public management for two decades has argued that the essential task of administrators is exceptionally complex because their key mission is to maximise the "public value" of services, which can be shaped by many different factors (Moore, 1997).

Yet it is important not to exaggerate the differences between public and private sector organisations. Services quality is also a key issue across many professionalised private sector services. And not all public sector services are fully professionalised – some indeed are delivered by massive bureaucracies in highly systematised ways. Accordingly quality issues may be handled in two ways:

2.1. Treat services' core outputs as being of uniform quality over time or across agencies, unless strong evidence suggests quality lapses or variations

Where service delivery is highly bureaucratised, as in taxation, social security and most regulatory functions (e.g. passports issuing, immigration control or vehicle licensing) there are good grounds for believing that service quality is fairly uniform in the normal course of operations. The activities implied by any core output type are constant – for instance, when citizens deal with a tax agency they can find information about what to do by looking at its website or by ringing up a call centre with an enquiry. Perhaps not all calls to tax contact centres get through (especially close to deadline submission dates), but the percentage of successful calls expected and delivered as part of the service remains fairly constant from year to year.

However, if the usual fail rate for phone calls connecting is (say) 15%, but in one year that suddenly jumps to 44% (as has happened to the UK's HMRC department on two occasions in the last decade) then in the exceptional year this is clear evidence of a serious quality slump. When this happens we must inevitably conditionalise the total factor productivity number recorded for that year. (For example, in the tax case, perhaps staff in the call centre service were cut back too much, reducing total input costs but also changing the character of the service. Clearly an income tax system operating with and without a generally accessible phone enquiry service are non-comparable outputs). Note that we do not have any measure of quality and so cannot replace the index number for the problematic year. The relevant data point stays in the time series or in the comparative data set, but we pay special attention to it, lest any changes it reflects are simply the effects of the quality lapse.

This approach is useful in a second simplifying way. Suppose that an income tax agency has introduced online tax forms to replace previous paper forms. Should we count this as a quality improvement? The approach to identifying core outputs and activities above shows that this is not needed. Tax agencies generally transition to using online forms only when the society as a whole is making an equivalent set of transitions to digital ways of working. We do not need to separately identify a “quality” improvement by the tax agency – its online provision just means that it is operating a modern tax system (and not an anachronistic one, out of touch with societal norms and expectations). In other words it is using an appropriate “tool of government” for its time and environment (Hood and Margetts, 2007). In this case, as the transition from paper to online tax forms rolls out, we would expect to see savings in total inputs accruing, and hence TFP improving.

Similarly, if a social security agency modernises its websites or offices for the public so as to more closely approximate those found in the private sector, then even though the change may be a costly one, we should still treat service quality as unchanged. No separate provision is needed for registering a service quality improvement where a change in a government service simply keeps pace with point of service standards elsewhere in the economy.

2.2. Apply an additional quality-weighting to the “total outputs weighted by unit costs” metric

Across most professionalised services, especially those delivered personally to clients and run by decentralised local or sometimes regional agencies, quality variations may be more important in judging all service outputs. And output numbers that are not quality-adjusted or standardised may especially create the capacity for misleading productivity

signals. Suppose hospital J admits and treats patients with a given condition over four days on average, taking time to check their recovery before sending them home. Meanwhile hospital K admits patients and treats them more speedily, sending them home after two days, but with a high proportion of patients encountering problems from inadequate care and later needing another admission to rectify things that have gone awry. If readmissions are separately counted it is perfectly feasible that conscientious hospital J has worse output or activity data than the skimping hospital K.

Bad policies may also create an apparent “need” for more of the most expensive services. For instance, fire service M has invested heavily in fire prevention, and in consequence has fewer fires and less demand for its emergency fire outputs. Meanwhile, another fire service N does little preventative work, has more local fires, so creating more “demand” for its costly emergency teams.

Measuring service quality was previously very hard to do, since this is an intangible variable, which may seem to require close and labour-intensive investigation before it can be established in a single case, let alone assessed across many different decentralised services. However, in the modern era a number of developments have made available regular flows of information that have a bearing upon service quality, including:

- Complaints about services are a useful metric, Many OECD countries now require that all complaints about public services are systematically recorded in publicly available ways, and the range of complaints has expanded. (See Dunleavy et al (2010) for the UK case).
- Response times in dealing with complaints are also good indicators of the quality of agencies’ provision.
- Official “star ratings” of services and report are often now provided by central government regulators who oversee decentralised agencies and outsourced service providers in areas like social care, health care and education. Ratings may not be updated every year, however, although most are regularly revisited.
- Similarly it might be feasible to operationalise indicators of quality for a wide range of other outputs – for instance, the conditions of roads in terms of numbers of potholes or graded assessments, or the condition of pavements in terms of compensation payments made for pedestrian trips and falls.
- Surveys of users’ experiences may provide additional useful indicators of clients’ experiences and level of satisfaction with services. Key difficulties here are that most people’s views tend to be general recollections or judgements, which may be vague, subject to recall defects, or coloured by respondents’ overall views of government and politics.
- Some governments make an effort to systematically attract targeted online feedback from service users on the quality of their immediate experiences – for instance, the UK’s NHS Choices website includes large numbers of patients’ comments in “Trip Advisor” mode, some praising the care they received and others criticizing the care given or facilities. These valuable “real time” indicators can be linked to “Sentiment Analysis”.
- “Sentiment Analysis” amongst local populations about their local services which might be tapped using Automatic Processing Interfaces (APIs) provided by some companies like Facebook, Twitter or other forums. Paying attention to press or media criticisms may also be useful in assessing quality across very large or national providers, and can often serve as a leading indicator of upcoming crises. But normally for local agencies the incidence of public criticism will be too small to permit detection or analysis.

- Finally, internal agency surveys of staff opinion and morale offer important insights into the likely service quality being achieved by providers. Many public services and NGOs attract “mission committed” staff, whose commitment to doing a decent and professional job (often for relatively low pay) is a key source of quality (Besley and Ghatak, 2005). If staff are disillusioned with how their agency is operating, they may be some of those in the best positions to detect poor service quality. For instance, in a social work agency where staff survey responses show that they are demoralised and distrust their leadership and managers, it will be difficult for good caring and protection work to get done (Munroe, 2011).

In most service contexts within most individual OECD countries, it should be practical to operationalise some quality weightings for core outputs or activities based on a basket of some of these or similar indicators. However, it is likely to be far more difficult to secure any international agreement on relevant quality weights. Nonetheless, quite apart from their use in productivity calculations, having good indicators of real time public service quality can be very helpful for national, regional and local political leaders and top officials – in providing lead indicators of upcoming problems that could develop later on into major issues or even policy crises.

Once a quality weight metric has been agreed, it is a relatively simple matter to apply the weighting to the cost-weighted total outputs metrics recommended above (in Section 1.4). Adding an appropriate quality weight will increase the total outputs of high quality service providers and reduce the total outputs of poor quality providers (Dunleavy and Carrera, 2013a, Chapter 7). The salience of the quality weights to be applied will need to be carefully judged in each service area. The end result should be a quality-adjusted as well as cost-weighted total outputs index that can be applied to large N settings, where multiple service providers are delivering services to citizens, such as local authorities or local hospitals or healthcare providers.

3. Measuring productivity in national/central government departments and agencies

Across OECD governments there are some common patterns in the structure of ministerial or cabinet-level departments. Most countries have around 14 or 15 major national departments, covering broadly analogous fields like taxation, social security, defence, interior, justice and prisons, homeland security and immigration, foreign affairs, overseas development, environment, local government/housing/planning, education, and health and social care. The mission briefs of departments in different countries varies somewhat, but especially within Europe and the EU there is a substantial measure of administrative convergence. And cabinets also include 5 to 8 other ministers heading up smaller or more technical (such as legal) departments. The invaluable OECD data collation series, *Government at a Glance* (OECD, 2015a) already documents some substantial continuities (but also some important differences) in how liberal democratic governments operate. And there are a few other valuable comparative treatments (e.g. Goderis, 2015). Yet there are at present no comparative productivity data covering even some (let alone all) major departments at central level in OECD countries.

This huge gap in our knowledge is far more important than it may seem at first sight. Each national government typically contains only one example of any given type of department – e.g. one taxing agency, one social security administration, one defence ministry and armed forces. Within that country there are no other agencies doing substantially the same function with which comparisons can be made, nor lessons drawn.

Each central department in an OECD country can justifiably claim to be unique in some sense, the sole representative of department type X within its national government. Departments with the same broad mission in other countries may be situated in completely different political and policy environments from X, and will often operate at quite different scales. Differences in experiences and trajectories are hard to usefully compare when so many potentially conflating variations must be taken into account.

Yet, despite this there are some departments for which productivity paths over time can be more easily calculated – and comparisons between productivity paths can much more fruitfully be drawn. I consider these in Section 3.1 below. In Section 3.2 I look at the somewhat more intractable problems arising with large agencies delivering complex collective outputs. Lastly Section 3.3 discusses tracking the performance of smaller policy and regulatory departments with “intangible” outputs.

3.1. Citizen-facing ministries/agencies with large transactional loads

Typically the biggest departments within any national government in terms of staff levels and running costs will be concentrated in some traditional core state functions that are heavily transactional, involving the agencies in millions of interactions with citizens, enterprises and other individual organisations in civil society. This transaction-heavy category also includes many service delivery activities and covers:

- Paying social security benefits, in the UK accounting for a quarter of civil servants for instance.
- Raising taxation, increasingly dominated by income taxes and social security contributions and by VAT/GST general consumer taxes. Again, in the UK this has historically accounted for a quarter of civil servants, although this proportion is falling.
- Supervising and running most law and order functions, plus part-running homeland security, and border force/ immigration functions
- Supervising the law courts, directly administering (national) prisons, other justice functions.

There may also be a few other central government regulatory agencies running discrete functions that require substantial transactions with citizens and enterprises, such as registering land and property, and administering passports or vehicle and driver registration, although in some OECD countries these functions are handled at sub-national level.

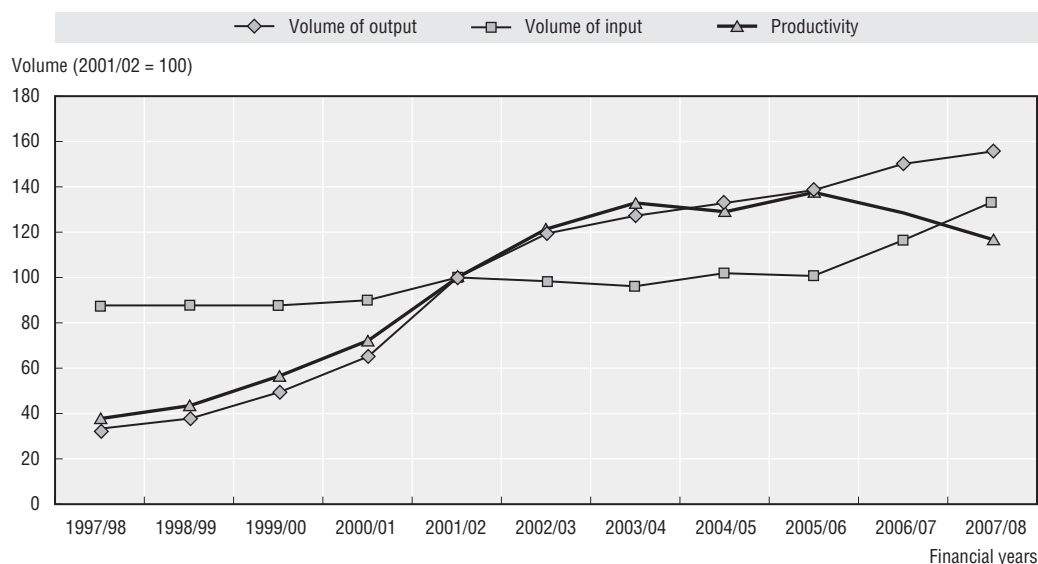
The huge advantage that these organisations have is in identifying core outputs – e.g. each type of tax, or benefit, or prison – and in having straightforward unit counting to scale these different activities. Although small sections of these organisations do handle complex high-order projects, the vast bulk of outputs are denominated by individual cases, which makes scaling demand and supply far easier.

Here the focus is on whether or not each department or agency shows a pattern of improvements in productivity (total outputs/ total inputs) across relatively long periods, at least five years, and ideally looking across a decade. We should not expect to see a pattern of continuous year-on-year improvements for several reasons. Like firms, departments may show heightened productivity levels in periods of sharply rising demand, as more clients are processed (for a short while) by pre-existing staff levels and installed systems are worked more heavily. Similarly, department’s productivity levels may decline if the demand for outputs falls off unexpectedly, before staffing levels or facilities can be adjusted downwards. But over a five to ten year period these wobbles should wash out and it should be feasible to see if departments are improving productivity or not.

For example, Figures 3.1 to 3.3 show some contrasting patterns from a recent study of productivity paths in UK central government, where the approach of assuming pretty standardised service quality over time was adopted (Dunleavy and Carrera, 2013a, Chapters 3-6):

- The function of controlling import and exports regulation is shown in Figure 3.1 for the UK. The chart shows dramatic improvements in productivity across a decade, reflecting an early and large investment in new IT and in risk-based management approaches.
- The UK's main tax agency shows a lagged improvement at the end of a decade following a major reorganisation and the maturing of online services after a previous rather static period (Figure 3.2).
- The social security function in the UK shows twenty years of non-progress in improving productivity (Figure 3.3). This pattern reflected the absence of any modernising investments in the 1990s, and then a major merger and reorganisation and heavy investment in new services during the early 2000s. The latter changes at first severely depressed organisational productivity levels, but later years' numbers did show some promise of the modernisation making sustainable if lagged savings.

Figure 3.1. **Total factor productivity in the UK Customs regulation on trade, 1997-2008**

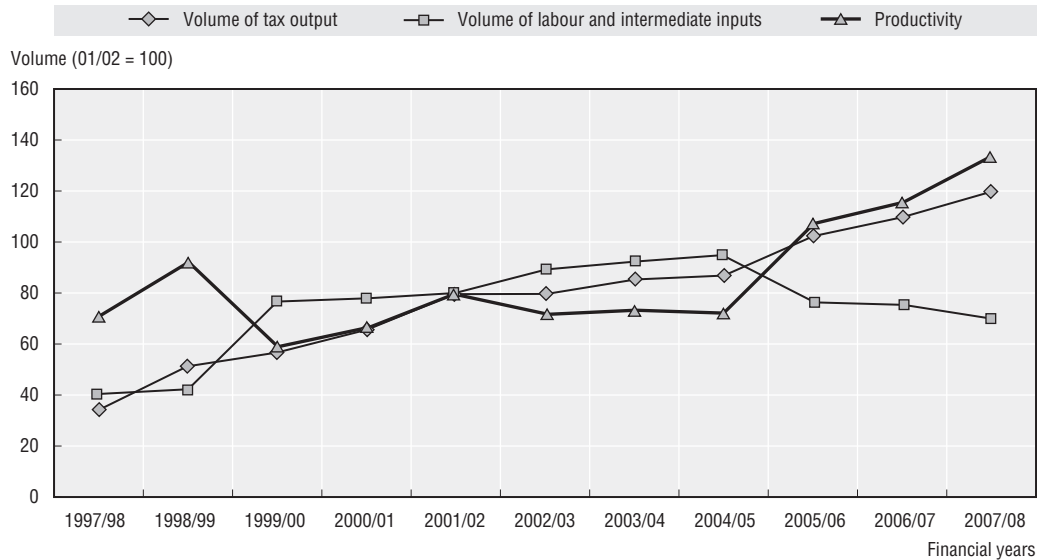


Source: Dunleavy and Carrera, 2013a, p. 70.

Dunleavy and Carrera (2013a; 2011) explain how these three productivity paths were established. They look in detail at some of the key influences shaping them, of which IT and digital investment changes were dominant, along with administrative reorganisations and investments in new buildings and reorganised work processes. This source also shows how the productivity pathways approach was also applied to another three, smaller regulatory agencies with heavy transactional loads.

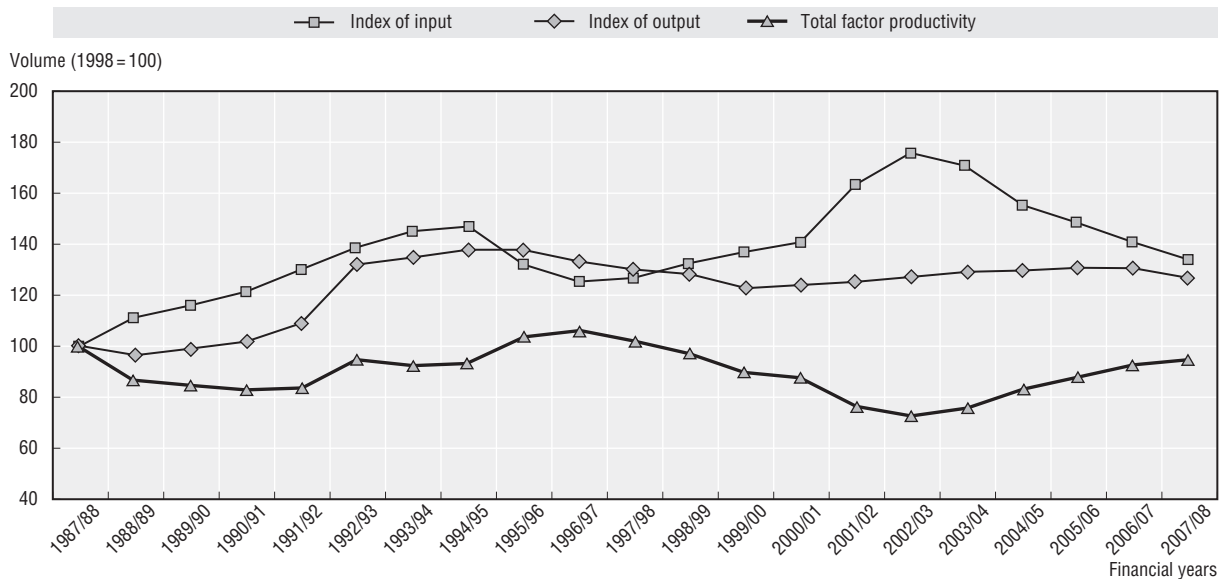
For the leaders and managers of all these large central agencies over-time comparisons are important sources of information. Given relatively stable organisational functions, and structures that evolve but normally bear close family resemblances to each other over

Figure 3.2. **Labour and intermediate inputs productivity, UK taxation, 1997 to 2008, using tax collection activity data**



Source: Dunleavy and Carrera, 2013a, p. 106.

Figure 3.3. **Longer-term estimates of changes in total factor productivity for UK “social protection” services, from 1987 to 2008**



Note: Authors' calculations based on data from National Statistics and DWP/DSS departmental reports.

Source: Dunleavy and Carrera, 2013a, p. 149.

successive years, tracing and explaining the productivity path for one's own department provides key information that cannot be gained from any other source. Of course, productivity paths do not say anything about whether organisations are focusing successfully on the right *outcomes*, or about a department's *overall effectiveness* in delivering on government objectives. But they do speak to the technical efficacy of the organisation in converting inputs into outputs and activities, and they do so in an unblinking, objective

manner that cannot be swayed by the “hype” that often surrounds ministerial or civil service self-presentation of their activities.

Major departments have close analogues in other national executives. So *comparing productivity paths* for the same functional department across countries can generate very potent additional learning for public management. The US Social Security Administration, the British Department of Work and Pensions and Swedish *Försäkringskassan* (National Agency for Social Insurance) operate on radically different population scales (and somewhat different spatial scales). But given commonalities of IT and technologies, similarities in functions, and relatively similar liberal democratic political contexts, we might nonetheless expect to see broadly analogous changes in their productivity paths over time. If instead we find that some social security or taxing agencies have static or declining productivity paths, while others are growing productivity appreciably, questions should clearly arise about the variations.

3.2. Large central departments delivering complex outputs

A second category of large central agencies directly produce substantial collective and non-marketed services including especially:

- Organising national defence, and administering the armed forces. National defence ministries are smaller bodies now, while armed forces are far smaller than in the past but remain substantial organisations in staff numbers
- Foreign affairs, and overseas trade
- Intelligence activities bearing on homeland or national security – especially agencies for internal security, overseas spying and electronic surveillance, whose staffing has considerably expanded in most countries (e.g. see Brill, 2016)

For all these agencies enumerating units or cases may seem to be possible only at the most basic level, but not for the kinds of output that “really matter”. For instance, we can record new cases started by a police force or an intelligence agency, but some may be routine and less salient, whereas others can develop into very large-scale and top-salience operations. In order to make *productivity path* comparisons over time, taking advantage of the generally stable functional responsibilities in these core areas, the organisations involved will have to be able to rank their outputs into categories, ideally in ways that do not use inputs data (like personnel costs) to denote salience (which reintroduces circularity into productivity measurement).

Some half-way steps towards measuring productivity can normally draw on and inform analytic work that is already ongoing, by focusing on scaling the most fundamental end-activities and attributing costs to them. For instance, for an air force the key metric might be the number of hours that aircraft operated, or were available fit to operate, or operated on active service in the field perhaps overseas. For a police force, the core activities might be a salience-weighted case mix. Getting organisations to make more explicit the ways in which they rank or grade different cases or levels of complex services being delivered is difficult. But by definition all these organisations are already using some implicit (“judgemental”) way of doing this. The key trick is to bring out these categories in ways independent of the allocation of inputs.

We do not yet have any worked-up examples of productivity path analyses for national (or top-level) police forces, defence ministries, the armed forces, or foreign affairs or intelligence departments. A lot of work would need to be done on specifying core outputs

and prototyping productivity measures in each case. Some observers have argued for the regular use of particular metrics – e.g. the National Commission of Audit (2014 in Australia) argued that: “A simpler and leaner structure is a priority ... [So] a particular focus should be the ratio of the combat force to other personnel (the so called “teeth to tail” ratio, TTR). Defence should develop a programme to improve this over time” (p. 131). However, evidence from the USA over a long period shows that with mechanisation and automation, in fact the TTR number has been falling (as it should do). In addition, the ratio also falls during extended periods of operations as an effective supply chain grows to support deployed forces. A recent Australia review recommended discontinuing its use of TTR (Defence Department, Australia, 2015, p. 64). The ratio is also vulnerable to shifts when levels of outsourcing change, as are all labour productivity numbers excluding labour in suppliers of intermediate outputs.

So perhaps attention should focus instead on more disaggregated productivity path analyses – e.g. measuring the labour productivity of sailors on naval ships to see if capital intensification is yielding the over-time gains that it should be. Some progress might also be made with activity data that relates to outputs, such as the numbers of “flying hours” achieved by pilots in different services recorded (for the last year only) in Australia’s Defence Portfolio budget documents (Defence Department, 2016, Tables 18, 20 and 22). A somewhat similar measure is Unit Availability Days (UADs), defined as “a day when a unit is materially ready and its personnel state and level of competence enables the unit to safely perform tasks in the unit’s normal operating environment, immediately” (Defence Department, 2016, Tables 16). Data Envelopment Analysis (DEA) methods (explained in the next section) might also be usefully applied to the operational units of the armed forces (Hanson, 2016). Productivity path analyses using actual achieved readiness or operational metrics over time could be insightful. In principle the techniques applied in Figures 3.1 to 3.3 should also be fully applicable to large central delivery agencies when appropriately worked up, and when used in combination with perhaps larger baskets of indices that can take account of the greater complexity of outputs.

Service quality factors may also be less standardised than in the 3.1 category organisations above. However, it should be feasible to construct a basket of measures that can be used for quality checking (against major lapses in quality), or even to do quality weighting of more disaggregated outputs. Looking at stakeholder ratings, internal staff morale, “sentiment analysis” of press and social media for “close to the department” groups, and perhaps expert and audit office assessments can all be helpful here.

3.3. Smaller central government organisations, especially policy-making or regulatory ones

Most national governments include “control agencies” (Dunleavy, 1991, Ch. 7) whose main business is to do national policy-making and to channel funding via grants to regional or local governments who actually do all the delivery. Control agencies are typically small organisations (spending perhaps 2% of the total budget they supervise on their own operations). Good examples are education ministries in Anglo-American democracies, transport ministries, and often departments supervising healthcare or environmental planning systems. Other relatively small ministries provide Treasury/Ministry of Finance budgeting, legal services or other corporate services, and their “customers” are only other departments.

The core problem here may be to get to any meaningful activity counts that are not just inputs-based. But some things are countable – like responding to consultation memos sent

around by other departments, handling other correspondence and questions from the legislature, the numbers of ministerial or public events undertaken, and the numbers of routine checks or authorizations carried out. The aim here is to get to some kind of “base load” measures for the department’s work, to which might be added more complex or less regular activities such as piloting new legislation through Parliament or Congress, consulting with stakeholders on new legislation, or undertaking unusually intensive activities (such as an austerity spending round in a finance ministry). To estimate final “loads” on departments, it is also useful to look at how a department’s “customers” elsewhere in central government rated its services, plus stakeholder ratings, internal staff morale, “sentiment analysis” of press and social media for “close to the department” groups, and perhaps expert and audit office assessments. These may help fix both levels of outputs delivered and give clues to service quality levels.

4. Measuring productivity in decentralised public sector organisations

Most regionally or locally delivered services require contact with or delivery to clients in person, especially professional services (as with most welfare state services provision), or carrying out operations on the ground (as with building flood defences or repairing roads). Some of these areas may raise in an acute form, the issues of measuring service quality discussed above in Section 2. As a result the general level of development of productivity measures here is less advanced than for the central agencies discussed in Section 3.1 above. In addition, activity accounting may not be so well developed as a universal practice in smaller regional or local departments and agencies as it is in a few OECD central governments

However, assessing productivity for regional and local agencies, and for contracted service providers, has one key advantage. With a large number of relatively comparable service providers like local governments or outsourced contractors we can compare productivity levels amongst them. We can also often link performance with explanatory data, and so use multi-variate analysis to statistically assess “what works” and why. Such analysis can then generate information for service-providers on how they compare with other agencies, and can provide valuable guidance for policy-makers in seeking to improve productivity.

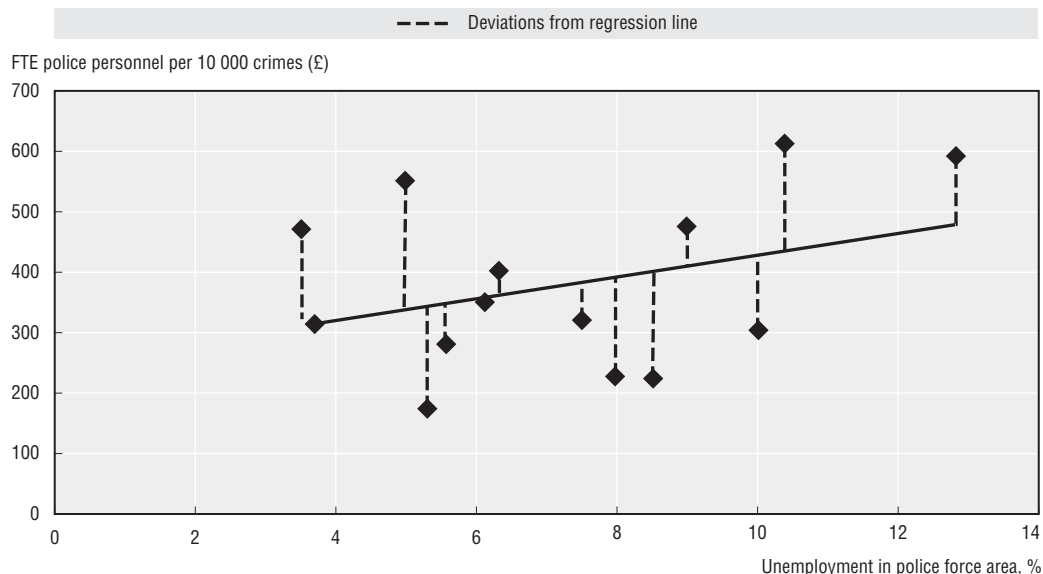
The two main approaches are:

- *Regression analysis*, where the aim is to fit an overall regression line to a whole data set, identifying “under-performers” as those below the line (see Figure 4.1). Regression analyses make it easier to use quality-weighting of outputs, and some examples show that taking account of quality at the whole-organisation level can be operationalised (Dunleavy and Carerra, 2013a, Chapters 7-8); and
- *Data envelopment analysis (DEA)* where the aim is identify “under-performers” as those on the interior of the DEA “production frontier”. These are units that have a capacity to move towards the frontier while keeping the same service mix (see Figure 4.2).

We do not yet have any examples of large N studies focusing on productivity paths over time for whole organisations. But the insights here would be even greater, since the number of data points increases, and over-time regression analysis can use “fixed effects” to separate out the effects of factors distinctive to individual agencies from more generally operating explanatory variables.

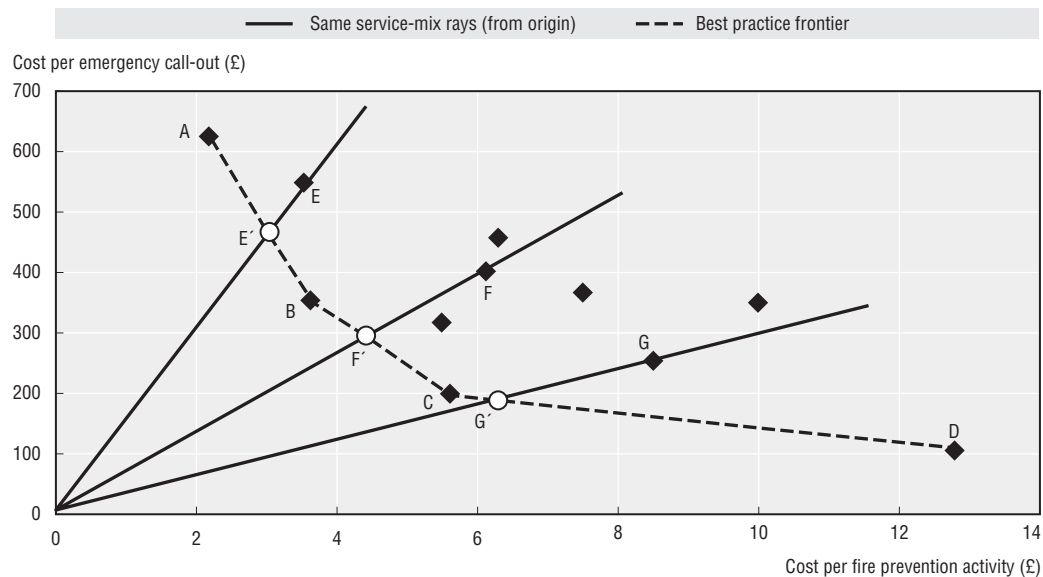
There have been some studies by economists of influences on organisational performance across local authorities. But even in sophisticated cases they fall well short of

Figure 4.1. Regression analysis of decentralised agencies' data
(In this hypothetical example, the dependent variable is "police personnel per 10 000 crimes" and the explanatory variable is % local unemployment)



Source: Dunleavy and Carrera, 2013a, p. 206.

Figure 4.2. A data envelopment analysis of decentralised agencies productivity
(In this hypothetical example, local fire services are compared for two core activities, emergency responses and fire prevention work. The production frontier is defined by the lowest cost local services closest to the origin. The rays from the origin show selected comparisons of fire services with the same outputs mix)



Source: Dunleavy and Carrera, 2013a, p. 212.

operationalising productivity effectively as total outputs/total inputs. Some accounts are suggestive of the wider potential – for instance, analyses of the influence of management practices on performance in UK hospitals and schools (Bloom et al., 2011 and 2014). However, such studies are few. “[I]n economics it is not common to specify management as an input at all” (Førsund, 2013, p. 18).

This picture may seem surprising because there is a great deal of activity and performance data being used administratively to monitor micro-changes in education, healthcare and social care policies. However, some of this information is very disaggregated. For instance, much medical research has focused on individual treatments or types of disease-handling, and some over-time trajectories here are well established. The challenge is to relate such disaggregated data work to performance at the whole-organisation level within the public sector, so as to try and capture overall productivity lessons. For instance, we may know on a specialism-by-specialism basis how public hospitals compare with each other (and possibly non-public hospitals also) on pregnancy care, handling heart attacks, providing cancer care, and other services. We may even have time series data on this. But we may still not know how whole hospitals (with varying case mixes and functions) compare in overall productivity. For doctors and medical researchers this has not been such a salient research issue previously.

But for public hospital managers it is vital to try to find out the importance for productivity of such factors as equipment spending, development of IT and digital capabilities, financial management to avoid closures or admissions crises, different HR approaches, and good general management and leadership – all of which can only be assessed at the whole-hospital level (see Dunleavy and Carrera, 2013a, Chapters 7 and 8 for one early effort).

5. Improving productivity measures for government as a whole and for large public service sectors in national statistics

In an ideal world perhaps the most accurate way to arrive at productivity numbers for a whole public services sector (like education in schools) would be to aggregate up from the component delivery organisations to the whole-sector level. We are a long way from being able to do this at present. However, some OECD countries have made extended efforts to compute productivity numbers for the whole of government directly, or for large sectors of public services. They seek to replace the conventional inputs measure of government sector outputs in national statistics with more empirically based alternatives.

To do this national statistical agencies (NSAs) must use independently gathered output or activity data, focusing on variables like the number of lesson hours taught in the schools sector. The Atkinson report (2005) methodology can be used to aggregate up outputs of different types so as to reach a total output number, and total inputs numbers are normally already calculable.

However, the scarcity of such data has meant that many NSAs have actually compiled output measures which draw extensively on some input measures, together with some output or activity measures, and also elements of outcomes achieved. This approach risks a certain amount of circularity (since inputs contribute both to the numerator and denominator in computing productivity). But NSAs argue that they help to yield robustly-grounded output numbers, and thus add to the understanding of macro-economic performance and growth over time.

A minority of NSAs have also sought to add in outcomes data as a component of outputs measures, and others have attempted to quality weight outputs using outcome measures. These efforts have the merits of tackling the quality conundrum addressed in Section 2, and can perhaps increase the accuracy of output recording at this aggregated level. However, either approach may have some drawbacks or dangers. Attention may shift

away from outputs data (such as lesson hours delivered, which are relatively easy to reach consensus about) to outcomes data (such as qualifications attained by school students in public exams at 16 or 18). But outcomes are not what productivity is about (see Gonand et al., 2007; OECD, 2009; Schreyer, 201; Schreyer 2012). Such a shift is understandable. But it risks turning a limited metric of *one* aspect of performance into being some kind of omnibus measure of *all* aspects of performance – on which it is likely to be far harder to reach consensus. For instance, in the UK Labour governments from 1997 to 2010 assigned a high salience to school leaver's exam performances, claiming that rising pass rates showed a quality increase in education performance. However, many critics argued that the apparent increases were due to grade inflation, and from 2010 a Conservative-Liberal Democrat government took steps to “restore confidence” in school exam grades.

It might be objected that more objective data, like standardised morbidity rates for hospitals or survival time for key diseases can be helpful here. But many “quality” indicators taken to be vital at an aggregate or national scale can be subject to “gaming”, as with indicators like UK waiting times in hospital emergency rooms (where hospitals established separate “rooms” to move very delayed cases too, perhaps separated from the official ER by no more than a curtain). The fewer the indicators used for sector “quality” measures the more likely they may be to be subject to agency manipulation. Goodhart's law probably applies, that “any regulatory indicator selected to be critical for policy automatically loses meaning”. At the statistical level “diagnosis-related groups” might seem to give a disaggregated grip on hospital outputs, since they originally covered 460+ categories, and progress in their use has been made, especially in the USA. However, during efforts to operationalise “quasi-markets” in health care in the UK and Italy, even more detailed classifications of treatments were deployed – but there was still often scope for agencies to categorise cases in ways that either maximised their revenues or improved their apparent performance (Bevan and Hood, 2006).

The great advantages of statistical efforts to measure overall government productivity at national level, or at the level of large component public services or policy sectors, are twofold. First, they hold out the promise of improving national economic statistics, especially over the long term, as expertise in this still-fledgling field deepens. Second, they are also useful for making cross-national comparisons, so that governments and their top administrators can try to benchmark their country's performance against those of “need neighbour” countries. Especially if a run of five to ten years' statistics can be compiled for several countries, *comparing productivity paths* becomes feasible, and this is far more useful than isolated observations of the kind sometimes generated by academic research studies.

There are some key limitations of measuring government productivity at national level:

- Only *very aggregate numbers* are generated, and they may tend to be far more static over time than single agency numbers, because national numbers include many countervailing trends. For instance, over time the alleged “Baumol effect” (Baumol, 1967) may tend to pull more resources into the most labour intensive parts of the public sector like health care (Baumol et al., 2013) – although this effect is disputed (Bailey et al., 2016). So slower productivity gains here can easily offset and mask faster gains being made elsewhere (for instance, especially in IT-heavy public services). Even within major sectors, advances in some aspects of service delivery are likely to be offset by crises or under-provision elsewhere, perhaps exaggerated by zig-zag policy paths (or even pointless “policy churn”) enforced by changes of the partisan control of government. Highly aggregated numbers

are also resistant to analysis, offering few useful clues about why productivity trends are as they are.

- *Management approaches and issues* may well affect health or education outputs. For instance, suppose a hospital runs out of money before the end of the financial year, so that it has to cancel many elective surgeries. Here its overall productivity may fall for reasons that have nothing to do with doctors' or nurses' productivity or effectiveness. They are primed to do more work, but budget limits mean that they cannot do so. Similarly, running very old IT and implementing austerity programmes may hold back a wide range of health providers, saving money but worsening productivity at the same time by slowing modernisation processes. In education a substantial literature also now suggests that the overall leadership of school principals, or the internal governance culture of schools (or both), can help shape students' attainments and teachers' effectiveness (Bloom et al., 2014). These kinds of whole-organisation influences cannot normally be accessed by data at sectoral or national levels.
- National or sectoral numbers are so widescale that they are typically not "owned" by anyone. If progress is slow or non-existent in a whole policy sector, involving a central department and multiple decentralised local providers or municipal agencies, the national department may exhort providers to greater efforts. And the municipalities or other providers may complain of being starved of modernisation funding. Good providers may know that the national statistics do not apply to them, while bad providers will know that their performance is camouflaged and not identifiable by their stakeholders or supervising national departments. In other words, unlike the measures discussed in Sections 3 and 4 above, national or sectoral data may have very limited practical value (perhaps even no value) in giving public managers meaningful data that they can use to achieve improvements.
- *Standardising productivity data comparably across countries* is likely to be hard and to take a long time. Of course, NSAs are highly skilled and expert in making progress across many different fields with similar difficulties. But the poor historical record of work in the productivity area suggests that achieving broad statistical progress on comparable lines will be difficult. In addition, there is always a lot of resistance to measuring productivity crudely or badly by many key stakeholders (including civil servants, and public sector professions and trade unions). To get to useable information on *productivity paths* the data-collection and methods to be used must also be defined authoritatively at the start of a period, and then kept substantively unchanged, ideally for a long time, if data comparability is to be maintained. In practice, this rarely happens (Hood and Dixon, 2016). When methods are changed or improvements made, productivity path analyses can still be analytically sustained, so long as both the old and new methods of computing data are overlapped for several years (ideally three or more), adding to the analytic workload.
- There are *some continuing barriers* explaining why some governments and NSAs have resisted the Atkinson (2005) suggestions for creating cost-weighted total outputs series, despite Eurostat countries apparently signing up to it in 2010. For instance, using the convention that government outputs = inputs has advantages for governments in recessions. If governments boost public sector spending in a counter-cyclical way, then this part of recorded economic output immediately grows also, perhaps helping to boost confidence in a wider recovery. By contrast, if governments must wait for recorded public sector outputs to pick up, they may see slower, less automatic and less politically helpful effects.

6. Conclusions and recommendations for improving cross-national productivity data for government

Both productivity path and comparative data should ideally be *action prompts* that allow and encourage politicians, the top managers and the staffs of government organisations and public services networks to see how their sector or agency is developing. The point of acquiring this data should not be an academic, analytic or informational one alone, but rather to facilitate an up-to-date and contextualised understanding of performance, one that will allow corrective actions to be taken in real time if things are not progressing. Ideally these data should also help innovative thinking about growing productivity, especially from public sector staff and professionals themselves, who inherently have a great deal of practical knowledge of alternative ways of delivering services. Analysis should allow policy lessons to be derived and absorbed that will maximise the productivity of government in producing, funding and regulating the delivery of a large part of final economic outputs.

The metrics to be used should also be *accurate and legitimate measures* that are used *appropriately* so as to maximise the trust, support, engagement and understanding of staff and stakeholders in the productivity-improvement process. Staff inherently know and control detailed information about what is or is not working (Miller, 1993) – see for instance the impressive results of an “efficiency challenge” asking UK public sector staff for productivity ideas (Gov.UK, 2015). Productivity metrics inherently deliver information only on *one* aspect of public agencies’ performance, that is the ratio of total outputs/total inputs. Using these data constructively so as to strengthen public services and enhance efficiency and effectiveness inherently requires being alert to the limited insights they can offer. And it entails policymakers and stakeholders making some difficult long-term commitments in a forward-looking way, rather than relying on attractive-looking, short-termist (and largely failed) nostrums like “Lean” (Radnor and Osborne, 2013).

However, this is an opportune time for OECD countries to consider advancing measures of government productivity because of a number of supportive trends:

- OECD and other bodies have made considerable progress in developing cross-national analysis of economics, education, and skills training, and some progress in healthcare. These advances have increasingly left the conventional statistical treatment of government productivity in inputs terms as looking anomalous – it becomes harder and harder to defend (or even explain away) this “know-nothing” tactic. Valuable information pooling efforts (such as OECD’s *Government at a Glance* data compilations) have already pioneered insight-drawing from cross-national public administration information (OECD, 2007; OECD 2015a). So there is at present a lot of goodwill to make progress.
- Activity costing has improved now in a fair range of OECD countries. A 2016 OECD “Survey on Measuring Productivity” (with 17 countries responding) found that approximately half were using “activity-based costing” in their government accounting systems. Slightly fewer countries said that they were measuring government productivity, with the most cases being for sectoral data in the education and health care systems (9 cases each), followed by social care (7 cases) and the judicial system, defence and other systems (5 cases each). Applications to ministries were rarer (3 cases) and elsewhere (e.g. 2 cases each for tax administration, procurement or municipalities). So beyond the national statistics level, only a smaller minority of nations have yet made progress in achieving consistent productivity measurement within parts of government over time – but many of the foundations to do so may nonetheless be in place.

- In the past, in a tradition starting with the Nixon administration in the early 1970s in the USA, many politicians and senior civil servants badly misused the concept of productivity, as if it was some sort of omni-performance or efficacy measurement, which of course it is not. This greatly increased the opposition of public sector unions and professions to their governments deploying metrics that they knew to give only a very limited and partial view of performance. There are still echoes of the old fallacy around, such as the UK think tank which in 2015 argued idiotically for a focus on “social productivity”, meaning only “everything good” (RSA, Action and Research Centre, 2014). But now that public managers know that productivity is only one metric (albeit a vital and helpful one), and are accustomed to operating with multiple metrics, they are in a far better position to use productivity information responsibly and to allay stakeholders’ earlier fears.
- We can also now generate productivity data at levels that are useable by public management in guiding and developing their organisations over the longer term. Productivity measures need no longer be just a “vaguely nice to know” set of abstract insights about government at large. Instead they can offer immediately useful information to leaders and top managers in the guidance of their own organisations, especially in the form of productivity paths.
- Rapid advances in digital information across many government functions, and contemporary developments such as “big data” (Dunleavy, 2016; Kitchin, 2014a and 2014b) and machine-learning (Armstrong, 2015), should contribute strongly in the next decade to better measures of outputs, to progressing activity costing, and to expanding our capacity to generate insights into how government agencies perform and use resources.

7. Recommendations

OECD should establish one or a set of working parties to take forward a process of developing an international consensus on improving productivity measurement in government, with this suggested order of priorities:

1. The most promising area involves working up productivity measures for the large central government departments and agencies discussed in Section 3.1, where it is already feasible to complete all five essential steps outlined in section 1, and where it is normally not essential to try to measure services quality directly, but only to guard against major service lapses (as in Section 2.1).

The main agencies involved here are taxation, social security and major regulatory agencies all with large transactional loads. Together they account for a high proportion of central government staff in all OECD countries. The precise missions of such agencies do not need to be completely aligned for useful comparisons to be made. Nor does highly detailed agreement need to be reached on statistical and definitional issues, because the main focus here is on first generating data on *productivity paths* on an annual data basis, and only second on *comparing the paths* of parallel agencies across countries.

Some major national delivery agencies like prisons (see Bastow, 2013) and perhaps routine policing may also fall in this category – since individual cases remain a common denominator there also.

2. The second priority should be to make progress on central government organisations producing more complex outputs (where individual denomination of units is less feasible) discussed in Section 3.2. This category includes big organisations like foreign ministries, defence ministries, the armed forces, and (perhaps in non-public data ways) intelligence and homeland security services.

Both the budgetary scale and the national importance of these departments' and agencies' operations justify investing in achieving productivity paths for large sections (if not all) of their activities. And developing comparative insights about trends in different countries offers, for which productivity paths would be valuable, offers great potential in lesson-drawing. However, it may be that generating annual productivity data here would be a tall order. So more episodic exercises (for instance, conducted every three years or so) might be appropriate here.

3. The third priority should be to develop productivity measures for large N analyses at the delivery organisation level in major sectors like healthcare, social care and education, often the policy fields where most thinking about government sector productivity has already taken place. There are major gains to be made by developing single-country databases, and even more to be made in facilitating comparisons across large N datasets for several or many countries. However, it is probably not feasible at this stage to generate annual data routinely on a comparable basis. So efforts might aim instead for say productivity surveys with data points spaced every three or five years. Since large N data permit more elaborate analysis, this would partly make up for not having annual productivity path information.
4. A fourth priority might be to develop similar comparative data at the delivery organisational level for less salient or high cost services, but for which good data sources exist – sometimes because of a convergence of international technical norms and extensive private industry or contractor involvement. An example might be looking at new road investments and repairs investments against road quality achieved; or comparing local refuse collection productivity, where different kinds of service organisation and capital equipment are in use.
5. Finally a fifth priority should be assigned to making further progress in national statistics and whole service-sector productivity numbers. Here the gains to be made are largely analytic and technical. However, as the options above develop, there should also be scope for developing national statistics to rely more on disaggregated data.

Of course, national statistics agencies (NSAs), and perhaps also supreme audit institutions (SAIs), have key roles to play in helping the wide range of central, regional and local government organisations affected by recommendations 1 to 4 above to make progress in developing better productivity information and data at an organisational level.

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