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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Table of contents

Budget System Reform in Transition Economies: The Case of the Former Yugoslav Republics By Jack Diamond and Duncan Last.	7
Budgeting in Denmark By Jón R. Blöndal and Michael Ruffner.	49
Twenty-five Years of Budgeting Reform By Allen Schick	81
Issues in Accrual Budgeting By Jón R. Blöndal	103
Off-budget and Tax Expenditures By Dirk-Jan Kraan	121

Budget System Reform in Transition Economies: The Case of the Former Yugoslav Republics

by

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1. Introduction

The 1990s witnessed the unprecedented restructuring of a large number of formerly interconnected centrally planned economies into market-based systems. These reforms were fundamental, affecting all sectors of the economy and all segments of the population. An important component of this structural reform was the restructuring of the country's budget system to function in a more market-oriented economy.

It is apparent that the breadth and pace of these reforms have varied greatly, from those countries, such as the Czech Republic, Hungary, and Poland, that more readily adopted Western-oriented public institutions, to others, such as some of the former Soviet Union republics, that have been slower to reform their government institutions. The republics of the former Socialist Federal Republic of Yugoslavia (SFRY) represent an interesting case study in this transformation process. They emerged from the 1989 collapse of the SFRY with common institutions that they adapted to more market-oriented institutions with varying degrees of success throughout the 1990s.

Since the early 1990s, the Fiscal Affairs Department of the IMF has been providing technical assistance to these republics. As part of its regular process of evaluating its technical assistance, this paper summarises the internal review of technical assistance materials and, as such, represents a stocktaking exercise of what was needed, what was accomplished, and what remains to be done in this important area of reform. The study documents and evaluates the process of budget system reform during this transition period, analyses the various critical elements to successful transition, and – based on this – suggests an agenda for future reforms.

2. The heritage of the SFRY budget system

Prior to 1989/90, the SFRY budget system reflected the broader system of socialist self-management that determined the discharge of responsibilities for various government functions and the provision of public services in a highly socialised state. In the SFRY, this evolved into a very sophisticated system, with many features running counter to current practices in market-based economies. By the 1980s, however, the system was already under considerable strain due to a severe and prolonged fiscal crisis.

2.1. The budget system was very decentralised and lacked cohesion

There were three levels of government: **federal**, consisting of the military complex, the central bank, foreign affairs, and the social accounting service (SDK); **republic** (state), consisting of central policy formulation organisations and small ministries supervising and co-ordinating the policies in different sectors; and **local**, which supervised some local functions and services. To this government superstructure must be added a large number of extrabudgetary funds,¹ each of which received some share of earmarked taxes to carry out well-defined areas in the provision of public services (schools, hospitals, social welfare, and so on). The local institutions (*zavods*), which actually carried out government policy in delivering services to the population, were established as independent legal entities financed from one (or potentially more) of these extrabudgetary funds (EBFs). The EBFs were supervised by a governing board (with representatives from the public, the *zavods*, and the state ministry or local government representatives) and reported directly to the state parliament or the local government council, which approved their operations. *Zavods* also had their own supervisory boards with local representation, and they reported to the relevant EBFs. Even with the substantial move to a market system, the *zavods* still continue to occupy a problematic position.²

2.2. The state budget was limited and non-transparent

There was no real centralised budget. The EBFs and local government and state administrative operations were funded by a multitude of compulsory deductions at source (adjusted by geographical area). Although the state government effectively determined the tax rates for a major part of the aggregate tax base, it had no effective control over at least a third of the total revenues collected.

The budget in the SFRY consisted of a limited number of very aggregate budget lines (or “positions”) which provided only very broad level information to parliamentarians who reviewed and approved it every year.³ This level of aggregation provided very little opportunity to discuss, on the one hand, the input costs (and, therefore, an open examination of their efficiency and the possibility of alternative use) and, on the other hand, the policy objectives and programmes for each ministry (and, therefore, the basis to assess performance). In reality, the budget was a means of setting limits for budget users, within which they had a relative free hand in execution (of course, initially the limits were often so constraining that even this relative freedom was insignificant).

2.3. Budgets were prepared in a bottom-up manner, based on “norms”

The typical process of preparing estimates in the ministry of finance (MOF) consisted of sending a circular to the spending agencies requesting

their proposals for the following year's budget very late in the current year, after the present year's fiscal estimates had been revised. The discussions with agencies, therefore, were cut short, although the very tight controls on fund allocation during the year meant that there were almost daily discussions of agency spending requirements. The important aspect of this process was that there was little long-term focus, and, although the MOF might well have a good idea of a target spending limit (usually the expected level of revenue), it did not make proposals to the government in this regard as part of a planning process, nor did it communicate any target to other relevant agencies. The result was that the detailed examination of the budget, and the determination of the global level of resources available, took place virtually simultaneously – and very late in the budget preparation process.

Rather than the budget circular offering top-down guidance to discourage overbidding by budget institutions and to reinforce the government's intentions to maintain a tight fiscal stance, the bottom-up approach that was adopted put the MOF in the position of having to make deep cuts to the bids, often on an arbitrary basis. At the same time, a problem was posed for budget formulation by the fact that a large section of the budget was guided by legislated, or well-established, formulae or norms. Although such practices may have appeared to simplify the process, or even indicate accuracy or fairness in the allocation of resources, in practice they acted to reduce considerably the degree of flexibility available to the budget decision makers. Such formula approaches to budget preparation may also have tended to encourage spending agencies to overstate client numbers (e.g. pupil or patient numbers) in order to secure more resources. Unfortunately, many of these norms were established in a much different, more stable, economic environment. By the late 1980s the economic and political situation in the SFRY was under considerable strain, and hence these norms became unrealistic.

2.4. Budgets lacked a medium-term perspective

Although the successor of the state planning agency – the ministry of economy (MOE) – (and, in some cases, also the National Bank and other institutions) carried out some macroeconomic forecasting, it was not at all clear that it was an established part of the process of budget formulation. Typically, monthly forecasts of revenue flows and trade balances, for example, provided by the MOE were used within a budget year to support some very short-term resource allocation decisions. These data were usually supplied to the MOF along with regular data (daily, in the case of revenue) from the payments bureau (SDK), whose role is described below.

A major impediment to the MOF advising the cabinet on broad strategy was that the budgets were, at best, prepared for only one year. As the management of the current budget year progressed, there was no means by

which comprehensive estimates for the following year(s) could be built up until this information was requested from the agencies, usually around October. If the cabinet decided to become involved earlier in the budget formulation process, this would have been extremely difficult, given the lack of forward estimates.

2.5. The decentralised system was given cohesiveness through the SDK system

In this highly decentralised system, the SDK was the essential “glue” to keep the system together, to enforce fiscal policy, to provide the central bank with monetary oversight, and to provide the information on which to base financial decisions.

The *Sluba društvenog knjigovodstva* (SDK)⁴ or Social Accounting Service was a rather unique institution, created in 1963 by hiving off payments operations from the National Bank of Yugoslavia. The SDK grew to exert widespread functions in the fields of payments execution, tax collection, auditing and control of enterprises and government agencies, and the provision of statistical data. The SDK operated independently from government and financed its activity out of fees charged for its services, with a nation-wide network of regional offices and branch offices accessible even to remote areas of the country. It was a large employer of skilled staff (with better pay conditions than the ordinary public service), employing not only large numbers of economists, accountants and auditors, but also lawyers and electronic engineers who performed various functions.

The importance of the SDK within the SFRY went well beyond the servicing of government operations and affected all sectors of the economy, especially the financial sector, as shown in the wide range of functions it had accumulated by the 1980s, detailed in Annex A.

2.6. The MOF had limited functions and capacity

The role of the state level MOF in this decentralised system was extremely limited. Tax collection was largely in the hands of the SDK, which automatically deducted from enterprise accounts and distributed according to the ownership of funds established by law. The state did make some transfers to local governments, as well as to support federal level operations, but again these were limited. Even with respect to its own level ministries, in budget preparation the budget department was largely a consolidator of others' budgets, large sections of which in any case were determined by other laws. In terms of executing those budgets, the state MOF's role was limited to authorising monthly transfers to the ministries' accounts; the execution of this authorised spending was accounted for, reported, and even controlled to a

certain extent through the SDK system, which also provided the information for the government's annual accounts. Of course, in times of cash shortage, the MOF could decrease the flow of funding to match available resources, which often led to the buildup of arrears over which the MOF had little control and even less knowledge. The SDK, on the other hand, was uniquely placed to know these arrears, which it periodically cleared through elaborate multilateral "compensation" deals.

3. The reform challenge posed at independence

3.1. Immediate changes on independence

Apart from Serbia, which still had federal structures after the former SFRY broke up, the newly independent states were immediately faced with the need to create new functions that were previously federal functions, such as defense, foreign affairs, and customs. In addition, each new state inherited that part of the SDK operations which was physically within its territory, as well as the state branch of the Federal Central Bank. Given the conditions under which independence occurred, all of the new states were faced with particularly difficult financial conditions, with their share of federal assets denied them until much later.

Faced with these challenges, compounded in some cases by war, the new states had to take immediate steps to avoid chaos. The SDK was restructured to a state level operation and initially continued to perform most of its original functions. The state branch of the Federal Central Bank became the central bank of the new state. The role of the state MOF became more important as it took over federal MOF functions, including fiscal policy and debt. Among the early policy initiatives was the reorganisation of taxes, which introduced a more rational and manageable income tax to replace the multiple deductions, each earmarked for specific public services funded through EBFs. This led to the abolition of most of these EBFs soon after independence, with revenue instead being channeled through the state budget. In the climate immediately after independence, therefore, there was little choice but to hold on to those essential institutions which functioned, in particular the SDK which was renamed the "payments bureau" (PB) but otherwise remained essentially unchanged. It has been argued that this move delayed fundamental reforms, in the financial sector and the management of public finances, although it is questionable whether adequate and appropriate capacity was available in the MOFs and the central banks (and even the commercial banks) to take over these functions immediately after independence.

The increased responsibility placed on the MOF raised its profile within government. However, it would take a number of years before it revised the legal budget framework, acquired the relevant institutional structure, and developed

an appropriate internal capacity, essential elements to ensure sound financial management by other ministries. The immediate aftermath of independence was, to say the least, difficult for all the republics, and in some of them disastrous, as war broke out. Their economies contracted sharply, partly due to hostilities, partly due to the loss of internal markets as well as exports and tourism, and the uncertainties surrounding the division of assets. All of which led to significant declines in government revenues, hyperinflation, and loss of faith in the currency. As a result, the MOFs were faced with constant crisis management, and not surprisingly it would take some time before more deep-rooted reforms could be undertaken. In addition, independence did not bring about immediate change in political leadership; in many cases it simply became nationalistic, which meant that old habits and attitudes dominated government operations.

The fiscal crises of the early 1990s led the MOFs to introduce cash rationing as a main budgetary instrument, especially as they realised that the revenue targets set in the approved budget would not be met. In the absence of financial management reforms to improve oversight of ministry operations, and particularly for those countries engaged in war, it is not surprising therefore that significant arrears built up during this period. Key among the unpaid creditors were public enterprises, pensioners, public workers (salaries), and recipients of social welfare payments. Concurrently taxes were also not being paid by public enterprises. In the countries affected by war, in addition, substantial promissory notes were issued, to be paid after the war. Given these problems, the gap between budget and actual outturns progressively widened. This fiscal crunch led many spending units to understate (or even not report) revenues that they collected, in order to make ends meet. Unfortunately, the lack of ability to pay also had a “knock-on” effect on the banking system, creating a banking crisis, which was compounded by the lack of internal control within the banks due to the still dominant position of the PBs, in which secretive and old attitudes remained strong.

3.2. The challenge of budget system reform

Perhaps the biggest challenge to reform created by the SFRY heritage was the issue of what to do with the SDK system that survived independence under the recast “payment bureaus” (PBs). In this regard, reforming the budget system posed something of a dilemma. On the one hand, it was increasingly recognised that to develop the financial sector and the budget system on market-based lines would require dismantling the SDK system. On the other hand, it was also recognised that the SDK system was so central to the functioning of the financial sector and to government operations that these institutions would have to be restructured and their capacities developed before the dismantling of the PBs could safely take place. This resulted in an initial period where an attempt was made to develop viable capabilities in other institutions, not the

least in the MOF, though these were often handicapped by the continued existence of the unreformed PB system. Box 1 describes the various functions of the PBs and the reforms needed.

3.2.1. Limitations of the SDK system for budget management

The development of MOF treasury and budget management functions were those most obviously held back by the existence of the PBs. Using the PB's giro accounts management system, the MOF transferred funds from its main budget account to direct spending unit accounts of the main budget users' accounts, which in turn distributed these funds to the indirect spending units, or its subordinate agencies that also maintained giro accounts in the PB system. There were obvious problems, however, with the fiscal information available to the MOF. The PB maintained information of the balances and movements in the giro accounts of all the government agencies, as a counterpart to deposits with banks. The PB reported back this information separately to each spending unit. The MOF received information from the PB about the movements in the main budget giro account, but not, in general, about the transactions on giro accounts of the spending agencies (except its own as a spending agency). Information on the general budget giro account was the basis for the final accounts of government. Government expenditure was recorded, as a result, on the basis of transfers from the general budget account to the budget institutions' accounts, and not on the basis of real expenditure by each spending unit. Consequently, the MOF had only limited information on the outstanding balances of spending agencies, that is, on the government's available cash resources.

3.2.2. Limited capacity in the ministry of finance

At the same time, the PB removed the incentive to develop MOF capacity in budget management. From the government's viewpoint, its control over tax collection, which in any case was easier to enforce in the SDK system, meant that the MOF's capacity in tax administration was extremely limited. At the same time, in executing government payments, and in accounting for and reporting on these transactions, the PB removed the need to develop treasury functions.⁵ The system described was a decidedly decentralised decision-making process, with important resource allocation powers resting within the planning agencies or in the main ministries rather than the MOFs. In effect, the MOF acted merely as a distributor of funds, trying to balance incoming receipts with outlays, but often with real decisions made elsewhere. Information on budget execution resided firmly with the PB, and only some of that information was accessible to the MOF. The secrecy of the PBs also created difficulties for the MOFs. The MOF had no special status to the PB; it was largely treated as equivalent to other ministries that held their accounts in its giro system. Given this status, it was perhaps not surprising to find at the time of independence

Box 1. **Social Accounting Service (SDK) functions and their restructuring**

Payments clearing

- Each legal entity required an SDK giro account usually matched by deposits in a commercial bank.
- Banks, including the national bank, also had a giro account with the SDK.
- SDK's monopoly on all domestic payments meant it was in charge of all clearing, including bank clearing.

Reform: A real-time gross settlement (RTGS) under the central bank; and a small-scale clearing house, usually by a restructured successor to the SDK; banks in charge of executing payment requests from clients.

Cash distribution

- Legal entities, including banks, had limit on cash holdings, with excess deposited in the SDK giro account.
- SDK acted as intermediary between the central bank and the rest of the economy in distributing cash.

Reform: Commercial banks took over this function, maintaining system of secure depositories.

Tax collection

- Enterprises presented their tax payment orders to the SDK, specific to each tax.
- SDK credited transfers to the general budget giro account.
- Checked the accuracy of the assessment, and in charge of procedures for sanctioning tax default.

Reform: Creation of new tax administration authority to assess and audit tax liabilities, with taxes collected through the banking system.

Treasury operations

- Executed government payment orders.
- Accounted for and reported on all government inflows and outflows.

Reform: Creation of a treasury system in the MOF.

Control functions

- All legal entities, including government entities, made regular financial reports to the SDK.
- Reports used for general audit function.
- SDK could start bankruptcy proceedings for all entities facing payment difficulties.

Reform: Creation of external audit body reporting to parliament, and development of internal audit in budget institutions.

Box 1. **Social Accounting Service (SDK) functions and their restructuring** (cont.)

Information functions

- SDK produced large number of statistical reports.
- Major source for official statistical yearbook.

Reform: Creation of a modern statistical agency.

that the republic MOFs were not too well-staffed both in terms of numbers and quality and existed under the shadow of a more powerful federal MOF. With independence, the republic MOFs had to assume some functions previously undertaken at a federal level and also had to develop the capacity to take over other functions residing in the PB or other government institutions. It was evident that initially they were rather unprepared for this role.

4. The reform strategy in public expenditure management: Phase one

4.1. Balancing short-run crisis management with capacity building

The first phase of PEM reforms can be depicted as having advanced on two main tracks. First and foremost, reforms were aimed to **support crisis management**, often under difficult post-independence conditions of macroeconomic, social, and political instability. This focused on improving the system of fiscal reporting to provide fiscal managers with more information on which to act. Four main elements were discernable: increasing coverage of budget institutions under direct MOF control; developing better reporting through the PB system; improving budget classifications; and improving the coding of transactions. Second, with the break-up of the PB system there was the need for **capacity building in the MOF** as it acquired former PB functions. In particular, this effort focused on centralising accounting functions in a new treasury department and, based on this, rationalising cash management and improving other government financial management functions. Both tracks, to a large extent, concentrated on budget execution rather than budget formulation, largely delaying the latter for the next phase of reform. This was perhaps in recognition that, in the earlier days, any budget that was able to be approved politically tended to be unrealistic and not fully executable.

4.2. Short-run crisis management

4.2.1. Centralisation of budget controls

Among the first reforms undertaken by the newly independent republics was the concentration of taxation at the state and local government levels. In

this way, the states and local governments took over the role of transferring funds to their subordinate *zavods*. The majority of the EBFs were removed, except for the very largest – typically, the pension and health funds – as well as a few smaller ones that were directly financing operations to the economy or to households. While this increased the potential for controlling total general government spending, it also placed great strains on the MOFs, which suddenly found themselves with a substantial increase in responsibilities but with limited staff increases and inadequate skills.

This phase, which took place at different times in different republics, was usually accompanied by a system of cash rationing as a response to the highly uncertain times typically faced during the first years of independence. These were often years of rampant inflation and economic and social instability for many of the republics. The effects of war, the virtual halving of the GDP, and the uncertain revenue flows presented major problems. Added to this was the serious corruption and fraud brought about by the effects of war. Only after this initial period of disruption was reform possible. All such factors led to the introduction of strict controls on scarce cash resources and a consequent rise in MOF powers over other government institutions. At the same time, the weaknesses within the MOF were exposed.

Typically, one of the first moves to improve control was the elimination of central ministry giro accounts, and to make all payments (including transfers made to subordinate units) directly from the main budget account, under MOF control.⁶ This, in turn, necessitated creating ledger accounts within the main budget account. However, in order to handle these ledger accounts, it was necessary to develop accounting functions in the MOF. Moreover, it was recognised that to use the information from the accounts, and to make forward projections of cash use to mitigate the disruptions of cash rationing, would require analytical and management skills in short supply in most MOFs. To make the system work would also require stricter controls over the banking arrangements of government institutions. Accordingly, financial regulations governing the opening of bank accounts by budget institutions usually needed to be strengthened, explicitly stating that only the minister of finance had the right to open accounts on behalf of budget institutions.

4.2.2. Increasing coverage by reporting directly on transactions formerly captured by budget user accounts

A first step in delineating the institutional limits of the budget was for the MOF to make a survey of all direct (DSUs) and indirect users (ISUs) of the budget funds. In turn, by examining their functions, the MOF began to effectively reconsider the scope and coverage of budgetary operations. Progressively, it was recognised that fiscal reporting should be extended to include all of the institutions internationally defined as “general government”.⁷

However, it was recognised that organisations of a purely commercial nature, such as co-operatives, enterprises and banks (including the central banks) even if they were exclusively owned by government or any of its public authorities, were to be excluded – largely following international standards. Also to be excluded were organisations established by individuals and interest groups independently of government, such as clubs and associations, nonprofit organisations, and nongovernmental organisations, as well as political parties. All financial transactions (receipts and payments) were progressively included under general government, including budgetary transactions, off-budget transactions, and extrabudgetary transactions. A typically thorny issue revolved around the “own revenue” or retained revenue accounts of budget institutions, some of which supported commercial types of activity, where these institutions typically fought a rear-guard action against having these revenues included in their total available budget resources.

4.2.3. Developing improved reporting from the Payments Bureaus

While it was recognised that achieving complete coverage of general government would be the longer-term aim, in the short run the most that could practically be achieved was to obtain better reporting and control over the central government institutions, namely those covered by the DSU giro accounts. Initially, the MOF relied heavily on reports from the PB on the cash flows and balances in the main budget account. These were relatively timely and adequately tracked the release of budget authorisation once budgetary coding had been introduced in payment orders. However, these reports were of limited use since they did not include the ISU accounts (ISUs provided most of the actual delivery of public services) and hence did not track actual expenditure. On the revenue side, the SDK system had always provided to the MOF detailed reports of tax collections by each tax and place of collection, usually available within three days. Indeed the system of revenue reporting in the SFRY was efficient and timely. In almost all republics, it was recommended that existing reports be enhanced or supplemented/replaced by other reports. In some republics, owing to lack of co-operation of the PB, this improved reporting never became adequately operational.

The only country to fully implement coding of payment orders was FYR Macedonia, having the initial co-operation provided by the PB. Slovenia and Croatia implemented coding for DSUs only, once spending of these units had been centralised through the main budget account. Croatia went one step further with respect to the salaries of education, social welfare and judiciary ISUs, by using the PB to collect payslip calculations from these units and processing their payroll centrally, a major achievement considering that over a thousand units were involved.

4.2.4. Addressing the problem of arrears

The system of expenditure control focused on cash releases. The weaknesses of this system became increasingly evident in the initial post-independence period where most republics faced adverse macroeconomic conditions, lower available financing levels than projected, unrealistic budgeted levels of spending, and pressure from contingent liabilities falling due. The unpredictability of cash transfers to the ministries, and often below their authorised budgetary appropriations, resulted in a continuous process of rebudgeting. This was manifested in increasing reallocations between spending categories within budget institutions, negating the usefulness of the initial budget spending plans, and disrupting the orderly provision of government services. The system was also prone to the generation of arrears – although by very strict application of these cash controls on a daily basis, the MOF often prevented this problem from becoming significant. Arrears existing at the end of the year were usually rolled over into the next fiscal year, without an adequate separate budget provision for this purpose. The result was to make the next year's budget estimates even more unrealistic, so the problem of arrears was not resolved but merely recycled. The extent of the arrears problem was only revealed once the MOF had improved fiscal reporting.

By focusing on cash controls, the existing system had the inherent weakness of not being able to control for past commitments coming due. To exercise real control over spending, it was recognised that this must be applied at the commitment stage, early on in the spending process, as this would ultimately determine the future demand for cash expenditures. The approach is described in Box 2. However, improved control over commitments did not prove easy. When setting up a commitment control system, it is necessary to ensure that comprehensive procedures are put in place and that a robust system of enforcement is established. In brief, such a system is designed to ensure that the MOF is informed of potential obligations (including guarantees) of the government, and also of the signing of any agreement that will establish a future liability. In situations of severe fiscal constraint, as initially encountered in the former SFRY republics, it was recommended that the MOF give approval for every commitment above a certain level. Thus, an important prerequisite for this system of control was that the MOF had the power to cut planned commitments. Experience showed that the MOF seldom had the power to impose such controls, especially on the power ministries such as defence and interior. From a practical viewpoint, there were also capacity constraints within the MOF to be overcome. Even when commitment registering was possible in the MOF, effective commitment control would have to await a higher degree of computerisation and reform in the accounting system – the second stage of reforms (see below). In this second stage, there would be complementary reforms in budget formulation that aimed to construct more realistic budgets

and hence ease the pressures that created arrears. Fortunately, this was supported by increased macroeconomic stability attained by the time the second phase had been reached.

Box 2. The approach to resolving the arrears problem

Generally, an arrears reduction programme needed to be addressed on two fronts by: i) identifying and verifying the present stock of arrears; and ii) putting in place controls to prevent their re-occurrence.

The first aspect (establishing an inventory of arrears) entails:

- a very clear specification of the date at which the stock will be inventoried;
- a clear specification of which internal records of spending agencies should be used to estimate this stock;
- an agreement on how outstanding bills are to be valued;
- specification of all supporting documentation required for verification of their legitimacy;
- a deadline for completing this inventory.

A team in the MOF would be required for this work. It was recognised that this approach of asking the ministries to report their outstanding bills had inherent dangers, since the MOF had no separate check on the veracity of these estimates. Similarly, it is likely that the ministry would have to obtain this information by requests to its subordinate local units and ISUs, and may also experience difficulty in checking the accuracy of their accounts. Thus, there is a strong case for having the final inventory of arrears audited by an independent auditor.

The second aspect (enforcement) requires:

- that the MOF make it mandatory for the budget institutions to record purchase orders, invoices received, invoices due for payment, and invoices verified and sent for payment for all purchases;
- that the budget institutions report on the amount of invoices due for payment categorised by an agreed breakdown of the delay in payment; (This would make the definition of arrears at least consistent across all budget institutions and would give some opportunity for the MOF to check these totals against records kept in the budget institutions.)
- that penalties for non-compliance be enforced.

The MOF's role was viewed strictly to ensure that obligations entered into were within the budget, that the resulting cash flow was sustainable, and that documentation was complete.

4.3. Capacity building in the ministry of finance

4.3.1. Creating a stronger central accounting capability in the MOF

In some republics, such as Serbia and Bosnia, much of the accounting operations of DSUs were handled, at least for some ministries, by a government-wide state agency, the joint services administration (JSA). In these cases, bringing the accounting part of the JSA closer to the core operations of the MOF was one immediate measure to develop accounting in the MOF.⁸ In other republics, it would be necessary to create a new centralised accounting division (CAD), sometimes recruited from the PB, as well as some of the accounting staff from DSUs themselves (since they also performed some accounting operations). With this centralisation came some immediate benefits: first, improved control and supervision over accounting standards and procedures; second, a more focused development of accounting capacity, aimed at raising the standards and professional status of public accountants; third, timely and detailed reporting on actual expenditures and arrears, reported according to budget and accounting classification. In this way, the MOF would acquire the information to more adequately control budget execution and its overall cash resources. In retrospect, in the initial phase of reform these improvements often failed to materialise.

4.3.2. Strengthening financial management in government

The establishment of greater accounting capacity was an essential first stage in the development of an integrated financial management system for the government. With information more readily available in a timely and accurate form, governments could move away from their extremely short-term crisis mode of operations to a system where budget execution and cash management decisions could be made ahead of time, more proactively, and with less disruption to government operations. At the same time as strengthening the centre, it was also seen necessary to ensure the retention of an adequate financial management function inside each DSU, since ultimately they were responsible for the planning of their budgets as well as the utilisation of budget funds appropriated to them in the budget. In the typically cash-constrained early days of reform, this objective often fell by the wayside.

4.3.3. Improving government cash management

The establishment of ledger-based accounting for DSUs in the MOF, as opposed to the previous practice of giro account PB-based accounting, was an essential change in approach that enabled the much needed reform of introducing a treasury single account (TSA). This move would be based on the elimination of DSU accounts, with payments, including transfers to ISUs, being made directly from the main budget account, thus moving the control of

these accounts from the budget department to the CAD. In the first stage of reform, the bank/giro accounts of ISUs were usually left untouched. Due to their large numbers, they posed a severe problem for consolidation in a TSA.

One cannot underestimate the effort involved in establishing a TSA. The SFRY system of government banking arrangements was based on a proliferation of bank accounts all managed through the SDK. As an example, in FY2000 it was found that there were 14 082 legal entities of general government in the residual FRY,⁹ of which 12 922 were situated in Serbia and the rest in Montenegro.¹⁰ These legal entities had between them 94 943 giro accounts (86 918 belonging to legal entities in Serbia), of which 64 792 were revenue collection accounts (58 269 belonging to legal entities in Serbia). In addition, there were 93 legal entities (73 in Serbia, the rest in Montenegro) classified as unused funds, whose functions were indeterminate. These undetermined funds and other giro accounts had between them 9 742 giro accounts (7 937 for Serbia). Among these giro accounts were court and other deposits (some 9 215, of which 7 477 were in Serbia) which may have been funds held in escrow-pending court decisions.

This number of giro accounts, and associated banking arrangements, was not dissimilar to the situation in other ex-SFRY republics which inherited the same system.¹¹ Such proliferation of giro accounts, many with sight deposits in banks other than the central bank, presented a very complex problem for efficient cash management – just how complex was indicated by the excessive level of idle cash balances usually found in the banking system which were supported by these giro accounts.

4.3.4. Modifying the system of budget execution

With the accounting function centralised in the MOF, the new central accounts division could also establish centralised computerised operations, such as payroll, to ensure better control and accounting of this important item of spending. Since salaries usually were already disbursed through the banking system, such systems could be established relatively quickly. The aim of the new arrangements was to give the MOF better control over budget execution and, at the same time, to enable it to develop modern systems for all stages of expenditure management.

The new accounting arrangements implied that budget execution flows would also change as the MOF developed its treasury function. A usual first step was to require financial management units in DSUs to channel all payment requests through the CAD, which would code and record them by budget position and by accounts code, conduct pre-audit checks, and generate payment orders on the main budget account. These new arrangements provided the MOF with the opportunity for both a more direct and simplified

control over cash utilisation, and a more detailed and timely reporting system for budget execution. With all payment orders being made either directly to suppliers or to ISUs, the MOF could establish a system of payment order coding which could be the basis of a more sophisticated daily report from the PB system. Coding of each payment order would identify the budget position number, the institutional code of the ISU if it was the beneficiary, and the accounting code.

At this preliminary stage of the treasury system development, the CAD handled all payments made by DSUs, including individual payments to the accounts of ISUs. Financial management units in DSUs would send their payment requests directly to the CAD, which would check if they were within the available budget appropriation, as well as the periodic cash limits set by the treasury. Where a payment request was for a transfer to ISUs, the DSU would submit one payment request with an attached list of ISUs to receive transfers, indicating the amount for each. The CAD would then process these into individual electronic payment orders. Varying in coverage and timing, most republics in their reform process have tried to adopt some variant of this system of budget execution.

It was also recognised that the new system could include commitment recording. For example, the DSUs could submit commitment forms to the CAD's front-end operations, which would check and approve them if they were within budgetary and cash limits, after the budget department had given its approval, if this was required. Such a system was successfully introduced in Slovenia, which by then had constructed a computerised information system that could handle the extra work implied. FYR Macedonia is also introducing this system on a pilot basis. Information on these commitments was thus available, alongside accounting information, to all relevant departments in the MOF, particularly for budget and cash management purposes. As indicated, initially this was only judged feasible for large contracts. With this commitment recording in place, the process of establishing more reliable cash-flow projections, at least on the expenditure side, could be achieved, and early warning given to DSUs if the revenue situation did not meet expectations. Most other republics, however, decided to delay such a reform until their level of computerisation had been more fully developed.

4.3.5. Creating a supporting legal and institutional framework

Building capacity in the MOF, as outlined above, was typically facilitated by its institutional reorganisation. One of the most fundamental changes was to create a new treasury department, usually by redeploying sections responsible for budget execution from the budget department, but also generally requiring the recruitment of new skills. The CAD typically formed the core function in the treasury. Another change was to build up a macro

fiscal analysis and policy capability within the ministry, to replace the old-style central planning methodology typically located in the former state planning agency which mostly disappeared after independence. To empower the MOF in assuming its new role as the government financial manager also required giving it the required legal authority. This was generally done through a new budget system law that redefined the MOF's responsibilities much more comprehensively in the area of budget procedures, treasury operations, and the control and supervision of public resources. Such laws were modeled on other OECD countries, although in this initial phase of reform with the existing administrative capacity they were often not capable of being implemented fully, or else were amended regularly.

5. The reform strategy in public expenditure management: Phase two

The first phase of PEM reforms tended to focus on budget execution issues and putting in place a basic legal and institutional framework that would allow better control over government resources at the same time as giving the MOF some flexibility to make in-year adjustments if required by macroeconomic developments. The second phase of reforms, although taking the development of treasury operations a little further, can be seen as placing greater emphasis on budget preparation and management issues and tackling the fundamental weaknesses in the former SFRY budget system which were identified in Section 2 above.

5.1. Improving budget preparation and management

A reorientation in techniques of budget preparation and management is visibly under way in the former SFRY republics. In most of the republics the first steps have been taken to move away from the compliance-dominated traditional input-based system to one that stresses greater operational efficiency, greater examination of cost alternatives, the use of market mechanisms and cost recovery, and, above all, a focus on productivity and performance. In some cases this is at a very rudimentary stage, but once initiated it is expected that the pace of these reforms will increase. In most OECD countries, the budget office is not merely an assembler and consolidator of budgets prepared by others, but is more deeply involved in policy aspects of budget formulation and in the work of policy analysis and co-ordination. In the former SFRY republics, it was recognised as necessary to reorient budget preparation activities in this way towards policy and operational analysis, rather than merely remaining focused on the calculation of the cost of operations. In order to fulfill this role, the budget departments would be required to develop the capacity and authority to collect specific, detailed, and accurate information, both financial and qualitative, about government programmes and policies, and to compile and present the information to decision makers in the government and the legislature. This meant overcoming the dearth

of skills in analysis, planning, and monitoring to assist in defining the budget framework, to provide sound financial policy advice to the government, and to track the budget's performance during the year. The experience in the republics is that it is taking considerable time to build up this expertise.

One of the most important reforms for budget preparation has been the introduction of a programme classification to the budget. In principle, a programme is a collection of government activities and projects that share a common set of objectives. Conceptually, it is distinct from either an administrative or a broad functional classification based on policy. It represents a more specific operational and management orientation than a functional classification, and a more strategic policy orientation than an administrative classification. With a move to OECD budget standards, the focus was required to be progressively shifted from inputs and costs to the outputs to be achieved from budget programmes, thus enabling performance objectives or targets to be set. Such an approach highlights the underlying purpose for which public expenditure is being incurred (e.g. raising educational standards in schools) rather than the inputs used toward that purpose (e.g. per pupil expenditure on education). It is an important element in improving transparency and accountability in the budget, by enabling government to present to the legislature and the electorate the objectives and goals of its programmes and the measurable results it seeks to achieve from them. It also allows the possibility to improve overall effectiveness of expenditure, and forms the basis of an approach focusing on outputs and objectives used to force personal responsibility on programme managers in spending units for meeting output targets, while at the same time opening up the possibility of greater flexibility in deploying resources. For those countries aiming for early EU accession, such as Slovenia, an important impetus for them to review the effectiveness of government operations was the need to conform to Maastricht deficit limits and to find room for financing required EU budget contributions. Other republics may not have perceived the same urgency as Slovenia in developing their budget management system, although that attitude is now changing, especially in view of their likely eventual accession to the EU.

5.2. Providing a macroeconomic and medium-term perspective

The unsettled macroeconomic conditions encountered after independence made most republics quickly appreciate the need to develop a macroeconomic framework for fiscal policy and to set the overall annual fiscal targets for the budget to guide the ministries and lower-level governments in the preparation of their budgets.

Initially, the work of macroeconomic and fiscal analysis was severely handicapped by the very limited reporting information available. This improved with the development of the treasury system and the introduction of more meaningful budget classifications. The next stage of reform was to provide a

medium-term budget framework, consistent with the medium-term prospective developments in the economy, which is standard practice in most OECD countries. An important aspect of this exercise is to act as a consistency check on competing views of the evolution of the public finances relative to macroeconomic developments, and on this basis establish targets that can be translated into a ceiling for aggregate spending. These projections also enhance the transparency of the budget process, by forcing discussion on budget priorities and promoting a consensus on medium-term fiscal objectives. While a full medium-term budget framework (MTBF) requires forecasting a large number of different types of expenditures, often there are a few key variables (“cost drivers”) which are useful to subject different assumptions and provide a sensitivity analysis on overall aggregate expenditure ceilings.

5.3. Making the budget process more transparent

One of the fundamental principles underlying the recent process of public expenditure reforms around the world has been the promotion of greater transparency and accountability at all levels of government. This involves not only the government’s interaction with the legislature and with the public, but also the internal processes and procedures for assembling fiscal information and its review. Apart from introducing an MTBF, efforts to make the budget coverage more comprehensive – to include formerly retained revenue into budget totals; to scale down the number and size of extrabudgetary funds; to phase out such operations as tax concessions, tax offsets, concessional lending through state banks, directed social spending through state-owned enterprises; and so on – all increased the transparency of a formerly opaque budget system. Such reforms are being increasingly implemented in the former SFRY republics. The more reformed of the economies, which ceased to rely on multilateral financing and thus required market financing, have begun to appreciate that transparency in government operations was also an essential aspect of sustaining confidence in government and, through this, access to financial markets at more favourable terms. Accordingly, the more reformed countries have been interested in participating in the IMF initiative on fiscal reporting on standards and codes (ROSC). Slovenia was the first to complete a fiscal ROSC in 2001, and Croatia is likely to follow.

5.4. Developing accounting and information systems

The work in developing a treasury system that would not only replace the PB accounting and information functions but also improve upon them continued in the next phase of reform. With the closing of the PBs, there was an immediate incentive for MOFs to press ahead with improved government accounting systems, increased computerisation, and the establishment of government-wide financial management information systems.

There have been two distinct approaches to improving government accounting. The first has been to capture all stages of the spending process in the accounts. Using the PB-based accounting system, the MOF could only recognise in its records an institution's appropriation (in very aggregate form), and the PB recorded the funds released to them from the main budget account and the final cash debit from a spending unit's account – the final stages of spending, which often could only be fully reconciled with the appropriation at year's end. This system, which had the drawback of not allowing fast disclosure or monitoring of arrears, raised an interest in monitoring prior stages of spending, and, in particular, the commitment stage. By following all stages of the expenditure process in the accounts – appropriation, authorisation, commitment, obligation, obligation liquidated, and cash payment – it is possible to identify the sources and extent of the arrears problem and to get a better indication of the total resources used by the government and its future cash requirements. A second major reform, usually introduced partially in the republics, is to move the basis of accounting from cash toward accruals.

Parallel to, and in support of, the reform of the accounting system, there has been an increase in computerisation. To track the evolution of the budget with more complex classification systems and in its different stages of spending was not possible without enhanced computerisation. In addition, improved and more detailed budgetary classification systems based on a programme approach, so that costs can be allocated to individual activities to be compared with the outputs of these activities, had obvious management relevance. Similarly, moving to an accrual-based accounting system was often promoted by the existence of accounting software packages derived from commercial accounting which are generally accrual-based. Tailoring different reports to meet different management needs through a computerised accounting system has been a general public expenditure management reform attempted in the last few years by nearly all former SFRY countries. This has met with greater success in some republics; for others a considerable amount of work remains before such systems can be considered fully operational.

Simultaneously, there was need for capacity building, not just within government but within the economy as a whole, to develop the accounting function and establish accounting standards. Various elements are discernable: qualifications of accountants, particularly those occupying senior positions, to be prescribed by law; a professional certification process for public sector accountants; standardising accounting procedures; and establishing training programmes. These issues have now begun to be addressed in most of the republics.

5.5. Deepening financial management in government

The closing of the PB system removed a number of important controls in the budget process. As described previously, the PB did not merely process transactions but checked the veracity of these transactions and performed the role of external auditor. Accordingly, as part of the PB restructuring, it was important to replace these financial controls. This necessitated creating an independent supreme audit institution, again on OECD lines, as well as strengthening internal audit in government agencies. Moreover, as the republics develop a more modern devolved type of budget management model, where agencies will have wide responsibilities in resource allocation, it is essential to ensure that they operate within an effective internal financial management framework. There remains much to be done in this area.

6. Progress in reform

The progress attained in moving from these short-run reforms to more sustainable medium-term reforms has differed between republics. Usually, this has been dictated by the speed at which political and economic stability could be restored. The two republics which moved quickly ahead were essentially outside the war zone. These were Slovenia, which made rapid progress in the second half of the 1990s, and FYR Macedonia, whose problems were protracted by internal ethnic divisions and the political dispute with Greece, yet in recent years still made notable progress. In the last few years, but more noticeable after the change in government in 2000, Croatia has also begun to progress on the medium-term reforms. Serbia has only recently started to plan its reform strategy to catch up, but starting from a position where it can learn from the successes and failures of the other republics. For the most part, reform in Bosnia has been externally driven, if not forced, leading to the question of the longer-term sustainability of some of its reform efforts. To a lesser extent, reforms in Montenegro have also been externally driven. While nearly all republics still suffer fiscal strains, the second phase of reforms is underway in all republics to some degree, although they all have different starting points. Even in those that are more advanced, there remain unresolved issues (such as the status of the indirect budget users, the *zavods*) and the coverage of general government in their fiscal reporting.

6.1. The reform strategy with regard to the Payment Bureaus

The PB, as it was structured, could not be conceived as a treasury-to-be, where government agencies would hold their accounts as a substitute for bank deposits. However, the PB system was recognised as containing the basic elements out of which such a treasury system could be established. Initially, it was regarded as prudent that the reform of the PB would not destroy this

potential – at least until a treasury system could be developed in the MOF and the banking system could be strengthened. It was recommended that any reform relative to the payments system should, therefore, exclude any idea that government agencies and spending units could perform their payments without the intermediation of the PB.

As indicated, initially basic government accounting, while admittedly limited, was largely carried out by the PB. This was the general short-run approach before a more satisfactory medium-term solution was found by developing a treasury system. Improvements were made to the coding of payment orders in some republics, in conformity with reformed budget classifications, to give more economically meaningful reports. As to the medium-term solution, one option considered (*e.g.* in FYR Macedonia) was to modify the PB system to act more as a treasury and eventually transfer this to the MOF. It was argued that all the record keeping and consolidation could be carried out much more efficiently by the PB itself, using its computer facilities. The segment of the activity allocated to the PB – payment execution, accounting, and consolidation – would not differ in principle from the core paying and receiving functions assigned to computerised treasury systems under the control of the MOF. These operations, therefore, needed to be clearly identified and separated from its other functions (even if the same computer network had to be used for ordinary payments and for government payments) after which it was argued this segment of its activity could be put under MOF supervision. Movements of funds among government spending units would belong in this system, while payments from government spending units to and from other legal persons would build the link between this system and the general payments system.

While this strategy is presently being pursued in Serbia, for some republics it was very difficult to get the PB management to relinquish this important component of their operations, nor were there incentives for them to downscale their operations or plan for the PB's ultimate partition and disappearance. The case of FYR Macedonia was, in retrospect, one of delaying tactics on the part of the PB, and eventual loss of patience by the minister of finance that eventually forced the issue of the closure of the PB and the reform of the payments system in 2001. This approach was also tried in Slovenia, but the development of the treasury functions had to wait until the broader reform of the PB was implemented in 2002. Slovenia had a five-year plan for the eventual transfer of all non-government legal entities accounts from the PB to banks, with a conservative prequalification of banks. Once this had happened, a core element of the old system was retained and restructured to perform paying and receiving operations of the general government sector. In Bosnia-Herzegovina, the PB system emerged much weakened from war. Not only was it physically damaged and depleted of human resources, but the PB was partitioned along ethnic lines and used accordingly for financing political objectives, rendering its

basic clearing functions suspect. Largely at the insistence of external donors, the payments bureaus in Bosnia were forcibly closed in December 2000. This “big-bang” approach to PB reform only caused temporary disruptions to public finances particularly on the revenue side, but the experience there gave encouragement to adopt a faster track approach to closing the payments bureaus in other republics, such as Serbia and Montenegro. In yet other republics a more cautious stage approach was adopted. In Croatia, the payments bureau was recast into a commercial operation called the Financial Agency (FINA) and given a clearing house function for the banks, but otherwise left very much intact with much the same functions as before. The situation in Croatia is however evolving, as the MOF is engaged in an extensive computerisation project that will allow it to rely less and less on the PB. All countries have taken their own reform path, but, at the same time, by end-2002, all had reformed their payments systems or were implementing such reform plans. Annex A summarises this reform effort.

6.2. Progress from first- to second-phase reforms

As summarised in Table 1, the majority of the countries of the former SFRY have undertaken and accomplished most of the reforms in phase one. In Serbia, however, which began the process with the greatest lag, this has yet to be accomplished. Even for those implementing second-phase reforms, some elements of phase one still seem not to have been fully attained – in Bosnia for example, the resolution of the arrears problem in both the Bosnia-Herzegovina Federation and the Republika Srpska has yet to be fully achieved. Moreover, many countries still have to successfully resolve the internal capacity problems in their MOFs, which has not allowed the complete fulfillment of accounting and financial management reforms. With these qualifications, it is evident that between 2000 and 2002, these countries have significantly shifted into the second-phase reforms described previously.

In this movement, Slovenia has been the first to lead the way. Budget preparation and in-year management have been considerably improved by extensive training and capacity building. Slovenia introduced a programme classification in 2000 on a pilot basis which was fully implemented in the 2001 budget; FYR Macedonia began introducing programme budgeting in pilot ministries in 2001; Montenegro’s new budget classification of 2001 has functions from the Government Finance Statistics (GFS) and a basic programme structure; and it is apparent that Croatia also is seriously considering piloting the programme approach. The latter’s new chart of accounts allows detailed specification of activities and projects that would facilitate identification of the programme structure;¹² however, this may hold the danger that the programme structure is only seen as a way of retabulating budgetary data and not for decision-making purposes.

Table 1. Progress in First-Phase Reforms
Assessment made as of December 2002

	FBIH	Srpska	Croatia	Serbia	Montenegro	FYR Macedonia	Slovenia
1. Clear delineation of institutional limits of the budget							
a. Complete inventory/classification of government units	No	No	Yes	Yes	Yes	Yes	Yes
b. Regulations on opening/closing bank accounts	Yes	Yes	Yes	Yes	Yes	Yes	Yes
c. Own revenues now included in regular budget	Partial	Partial	Yes	Partial	No	Yes	Yes
2. Improved reporting							
a. From the payments bureau	Partial	Partial	No	Yes	Yes	Partial	Yes
b. From treasury	Partial	Partial	Yes	No	Partial	Yes	Yes
c. Using internationally accepted classifications	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3. Arrears problem addressed							
a. Full arrears situation known	No	No	Yes	No	No	Partial	Yes
b. Commitment monitoring	No	No	Partial	No	No	Partial	Yes
c. Adequate commitment control	No	No	No	No	No	No	Partial
4. Accounting function established in the MOF	Yes	Yes	Partial	No	No	Yes	Yes
5. Cash management improved							
a. Financial planning strengthened	Partial	Partial	Partial	Partial	Partial	Partial	Yes
b. TSA substantially established	Partial	Partial	Partial	Partial	Partial	Partial	Yes
6. Budget execution controlled by the MOF							
a. Moved from budget department to treasury	Yes	Yes	Yes	Partial	Yes	Yes	Yes
b. ISUs payment orders also processed	No	No	No	No	No	No	No
7. Budget system law revised along international lines	Yes	Yes	Yes	Yes	Yes	Yes	Yes
8. MOF reorganised							
a. Treasury department established and functioning	Yes	Yes	Yes	Partial	Partial	Yes	Yes
b. MOF strengthened in human resources	Partial	Partial	Partial	Partial	Partial	Partial	Yes

Source: Diamond and Last.

Most of the republics have moved to provide a **macroeconomic and medium-term perspective to their budgets**. For many, this evolved from the economic adjustment programmes they have had with the IMF, which stressed the need for local counterparts to develop macroeconomic forecasting, policy, and analysis capabilities. Some have progressed beyond this stage. Slovenia, with the assistance from an EU-funded Swedish twinning project, introduced in 2000 a two-stage top-down approach to budget formulation. Macroeconomic decisions on the economy's evolution determined the future deficit/surplus, with implied ceilings, for discussion with line ministries at a high level before final negotiations on the detailed budgets. This process was further refined in 2001 by the introduction of a two-year detailed budget, aimed mainly at avoiding temporary financing and at providing a more secure horizon for the government's investment programmes. The FYR Macedonia budget circular also is increasingly based on a top-down process, with ongoing work to develop a medium-term macroeconomic framework, with explicit medium-term government priorities that can provide expenditure ceilings. Croatia is also at the early stages of developing a medium-term approach to its budget with a view to meeting EU monitoring and reporting requirements, following closely in the footsteps of Slovenia.¹³

All republics have succeeded in **making the budget process more transparent**, through improved budget procedures, usually required by new legislation. Slovenia, with improved economic and programme classifications, has provided a better link between priorities and the budget, and consequently political discussion in parliament on policy issues is more informed (amendments are allowed on the sub-programme level). Also introduced were new supporting documents and reporting requirements (to support performance auditing) making for a much more transparent budget document. The new Public Finance Act, passed in 1999, had as one of its requirements a listing of all the institutions of general government (some 3 200 entities).¹⁴ The entities in Bosnia-Herzegovina have been pushed by external donors to improve transparency. Budget laws have been adopted by the entities that improve the transparency of the budget procedures, limit the borrowing by sub-national governments, and incorporate own revenues of ministries and budget institutions into the entity budgets. Unfortunately, owing to the highly decentralised government structure, fiscal reporting continues to be generally weak and fragmented. FYR Macedonia has continuously improved its organic budget law, as it also has taken major steps in better defining the role of government and redefining state functions and activities and, since 2001, has introduced legal changes to divest non-core activities to the private sector. Montenegro's new budget system law, passed in August 2001, similarly helped make budget procedures more transparent. Serbia has recently introduced significant legislation in 2002: an organic budget law, an accounting law, and a law on government administration, which together aim to

reform its budget system to catch up with the other republics. The budget law provides a comprehensive cycle for the preparation, adoption, execution, control, and accounting of the budget. It sets out a clear timetable for the adoption of the budget before the start of the financial year. Considerable effort has been made to improve the coverage of the budget to include own or retained revenues, by identifying and allocating these revenues alongside budgetary resources in the 2002 budget documents.

Transparency has also been served by other major reforms. For example, the audit function has generally been redefined and considerably strengthened. In 2000, auditors general were appointed for the Bosnian entities, and this was followed by audits of budget execution for 2001 in Republika Srpska, and external audits of military operations have also occurred in Bosnia-Herzegovina Federation. The Montenegrin Budget Law of 2001 specified not only a treasury department and its functions, but also a department of internal audit. FYR Macedonia has strengthened its internal audit with a new department being created in the MOF in 2000, as well as establishing the State Audit Office as the external auditor of the government. Unfortunately, both institutions have found it difficult to recruit staff. Slovenia recently strengthened its Court of Audit to meet EU standards. All republics have introduced new public procurement laws to meet international standards, and they are all addressing the need to strengthen and modernise internal control and audit. Transparency has also benefited from the move to a TSA, closing the accounts of spending units and subunits, recording payments between government entities, and ensuring prompt accounting records and more timely and meaningful fiscal reports. In 2001, Slovenia undertook and published a fiscal ROSC (reporting on standards and codes), and Croatia is considering following suit.

There has been a general recognition of the need to **develop accounting and information systems**. Slovenia has established centralised financial management and reporting standards to be applied by all general government units through its Law on Public Finance. Based on the Accounting Law, which came into effect in 2000, cash-based accounting was prescribed for all general government units, but with additional requirements for accrual accounting by around 1 500 general government institutions classified as indirect budget users. The Bosnia-Herzegovina Organic Budget Law in 1998 spelled out the role of the treasury, but only with the regulations regarding treasury operations in 2000 (amended in 2001) were the TSA and general treasury ledger established. This, in turn, required introducing regulations on budget accounting the same year that were supported in the subsequent year with financial regulations regarding the chart of accounts, financial reporting, and annual accounts. Generally, as these countries changed their budget classifications to international standards, so too were amendments made to the government chart of accounts (e.g. Croatia in 2002).

All countries have turned to computerised information systems as a means to fulfill their new accounting and reporting requirements. In Slovenia, budget execution and accounting are supported by a locally developed software package for all central government units provided by the MOF (MFERAC). In addition, in the last five years, considerable effort has been directed to computerising the budget preparation process. The budget department now has a fully operational government-wide budget submission system that allows subsequent modifications and provides the electronic budget documents data that are transmitted to parliament in the first week of October. The changes made in parliamentary deliberations are also recorded, and then the final appropriation data are transferred to the government's MFERAC information system. Most other countries have concentrated their efforts on budget execution, partly to cope with the closing of their payments bureaus. In FYR Macedonia – following the creation of a treasury department in the MOF in 2000 – with the reconstruction of the payments bureau, the control of expenditures passed to a treasury system. The system operated a domestically operated software application, an “interim system”, to allow the treasury to operate with a TSA in the National Bank. The system uses a relational database and includes complete budget control, payment request approval and a payment order generator, revenue recording, reconciliation with accounting, and the facility to export data to Excel. The software was expanded to allow communication between the treasury and the National Bank's real-time gross settlement (RTGS). It is planned to replace this with a more modern integrated accounting system in the near future. In Croatia, a financial management information system (FMIS) has been developed, based on the SAP software within the MOF, that allows the MOF to communicate with other central government DSUs, but not used by them. As previously indicated, the Bosnian entities have benefited from an externally financed computerisation project by the United States Agency for International Development (USAID), which provided Oracle Financial software to support the various treasuries. Similarly, Montenegro has benefited from a less extensive EU-funded FUMES but recently has moved to adopt an integrated FMIS, with SAP software, and Serbia is planning to follow the same route.

Generally, the republics of the former SFRY have not done so well in **deepening government financial management capacity**. Slovenia, which has been developing its treasury system for the longest period, is perhaps an exception. In 1996, it reorganised its treasury department into two departments, one for cash management and the other for public debt. This allowed specialisation and skill development: the former specialising in liquidity management and the money market use of funds in overnight deposits; the latter in establishing the capacity to issue bonds in the European market, as well as in developing the domestic market in longer-term government debt,

including development of a repossession facility with government securities. Some republics, however, have not introduced a full TSA. In Croatia, although budget institutions still maintain foreign exchange accounts, many of the payments are made directly to suppliers via the TSA. Other republics are in the process of recruiting and training their staffs in new skills required for an increasing range of treasury functions. For example, FYR Macedonia has introduced a central register of public servants and other employees in the public administration, on which basis it has new software for updating monthly and monitoring public employee expenditure. There are also plans to begin a treasury bill auction, to replace that of the National Bank and to take over debt management functions from it. However, taking on new functions such as this has demonstrated a potential constraint – most MOFs are generally weak in financial management skills, and this is even more true of the other government agencies.

Recognising this constraint has occasioned a new regional initiative. All republics of the former SFRY have major ongoing reform agendas, and all are keenly aware of the need to train/retain their staff to ensure that these reforms stay on course. However, local public service training has, on the whole, not kept pace with the changing environment, and the universities have also been slow to modernise their curricula. In 2001, the Center of Excellence in Finance (CEF) was created to meet these needs. Slovenia, whose reforms are probably the most advanced in the region, has made both financial and technical commitments to supporting the new center that was established in Ljubljana. The CEF has benefited from significant lecturer resource assistance from a wide range of bilateral and multilateral donors and institutions, including the IMF. The CEF is currently developing a PEM training programme for newly recruited public finance staff in both central and local governments, and expects that this programme will eventually be situated in local training institutions. A second area of focus is the development of a training and certification programme for public accountants to meet a critical shortage faced by the region.

7. The lessons learned

The first lesson learned is that some degree of economic and political stability was required before reform initiatives could really get under way. The significance of the specific republic's history and starting point significantly influenced the reform process. While some republics emerged to independence in a situation of war, some even in civil war, and others with significant internal tensions, the speed of reform was significantly affected by the speed with which peace was restored. Added to the conflict was the significant economic disruption which created further problems. Sometimes it is argued that disruption to the status quo is essential to foster change. At the same time, it

can be argued that too much disruption can overwhelm reformers, since they are too preoccupied with short-run issues and find it difficult to gain widespread support for changes that bring benefits in the longer term. The experience of the former SFRY republics seems to support the latter view.

The second lesson is that inadequate administrative capacity can constrain reform. The budget systems created, either in law or by change of policies, evidently suffered because of the inability to administer them. Experience shows that it takes time to develop adequate capacity in the MOF to be able to operate the new systems. In part, this was a reflection of the lack of initial power by the MOF *vis-à-vis* other ministries and the inherited SDK institutions, but was also in part a question of the human resource base that eventually had to be replenished with outside recruits or with a younger generation more open to market ideas.

Third, budget system reform was constrained by the pace of reforms in other parallel areas. In particular, the financial sectors of the republics needed to be restructured by reforming the PB clearing system and allowing the banking sector to develop under the control of the central bank. All such changes required capacity building and innovation in these parallel sectors before the budget system could itself be moved onto a more market-based footing. Even now, most republics exhibit basic weaknesses in areas complementary to budget system reform, such as banking, accounting systems, procurement, and auditing.

Fourth, and most notably, most republics lacked a strategic plan for reform. Much of the initial reform was prompted by outside advice and often by external conditionality, rather than by the result of an internalised reform plan, with the notable exception of Slovenia. Republics moved toward such a strategic plan at different speeds. Slovenia, which started from the best initial conditions, was perhaps the first to arrive at a reform strategy; Serbia, owing to prolonged hostilities, was perhaps the last.

If one is to interpret the reform experience of the former SFRY republics in terms of change-management methodology, then it is possible to identify other key components that were often missing. Successful institutional change is thought to involve at least the following elements: recognition of a sense of urgency to make a change; development of a powerful enough coalition to support the change; identification of a champion of change, who creates a common vision and communicates and “sells” it; empowering others and giving them resources to act; and building the reform process stepwise on early successes and progressively institutionalising the changes.

Applying the change-management paradigm, the first element (the sense of urgency) was common to all republics. However, in some republics which were more homogeneous, such as Slovenia, it was easier to form a coalition

for change. When this was coupled with a long-standing champion of change, as in Slovenia, the combination soon produced a strategic vision and a medium-term plan for reform that was implementable. Other republics had to await the appearance of a champion before reforms could be energised (e.g. FYR Macedonia after 1999 and Serbia after 2001). For some countries, such as Croatia, the reform agenda was never clearly defined, without which the strategic vision reforms have been piecemeal and have been slow. The initial lack of an agreed reform strategy and work plan also often meant that the technical assistance was delivered ineffectively and sometimes inappropriately, sometimes supporting the agenda of the donor country rather than that of the recipient (for example, initially in Bosnia).

Finally, the case of former SFRY countries clearly shows the influence of peer pressure and best practice within the region. The presence within the group of a model for others to follow, in this case mainly Slovenia, has helped shorten the reform timeframe. The success of reforms in Slovenia provided the others, who all shared the same institutions inherited from the SFRY, with working solutions as well as highlighted mistakes to avoid. In this context, the establishment of the CEF regional centre provided a unique and important forum in which to exchange and disseminate reform ideas and experiences.

Notes

1. For example, Slovenia, the second smallest republic, had over 600 of these.
2. Many *zavods* could be excluded from the definition of general government, sometimes straddling the grey area between public policy and enterprise functions, and between public policy and local interest groups. In this context, it is important to note that, even today, in these republics the notion of “nonprofit” is almost universally used interchangeably with the function of the *zavod*.
3. On independence, typically the budget formulation process still bore the imprint of the system inherited from the SFRY. In the Republic of Serbia, for example, in the 2001 budget, there were only 250 budget lines, divided among some 40 main titles, most of which represented ministries or major government institutions. Each ministry would have on average six or seven positions, of which two were salaries and material costs.
4. This is in Serbo Croatian; or *Sluba drubenega knjigovodstva* in Slovenian; and *Sluzhbata na Opshestvenoto Knigovodstvo* in Macedonian.
5. Since the word “treasury” refers to different concepts in different countries, it should be noted that in the former SFRY this was defined quite broadly in functional terms: to make payments in and out of the government account, to manage this through a consolidated government bank account, to account for and report on all these transactions in a common ledger, and to act as the financial planner and manager of the government. Of course, in all countries the institutional arrangements to perform these functions differ, and it is not surprising that the treasury systems that emerged during the 1990s reflected individual country characteristics.

6. Rationalisation of accounts was often hampered by certain power ministries and institutions, and where there were complications arising from the geographical distribution of their direct and indirect users (*e.g.* courts and the ministry of the interior).
7. General government in the Yugoslav context typically included: the federal and republic governments, their ministries and dependent agencies, funds and public authorities and institutions; all local and regional governments, parliaments, assemblies and councils, their dependent departments, local administrative units, funds and public authorities and institutions; and all independent public authorities and institutions, including those of constitutional, parliamentary, and legal nature, attached to central or local governments.
8. Albeit this was found to be difficult in Serbia initially because the JSA was under the President's Office.
9. By 2000 only Serbia and Montenegro remained within the Federal Republic of Yugoslavia, which was officially dissolved in 2002 with the creation of a looser association called Serbia and Montenegro.
10. It was recognised that the number of Montenegrin entities may be incomplete, given the independence of their payments bureau operations.
11. At the time of independence, it was found that many government institutions also had foreign exchange accounts. Accordingly, it was usually recommended that these foreign exchange deposits be converted as soon as possible into domestic currency and integrated into existing domestic giro accounts.
12. The 2002 budget was tabled at the level of activities/projects.
13. It should also be noted that recently both the Federation of Bosnia-Herzegovina (FBiH) and the Republic Srpska (RS) undertook a medium-term expenditure review.
14. In the process, many inconsistencies were resolved. This cleared the way for common treasury management rules to be prescribed for all in 2001/02.

ANNEX A

SDK Reform in the Move to a Market System

Functions of the SDK

To understand the key role of the SDK system is to understand why the reform of this system was a precondition for fundamental budget system reforms. As indicated above, the former SFRY's financial system revolved round social accounting service (SDK) functions.

Payments clearing

The *raison d'être* of the SDK centred on its payments functions. Once legally established, all organisations had to register with the SDK and open a single so-called "giro account" maintained at the SDK office where the legal entity was located. All payments had to go through these special accounts. When the giro account was opened, its holder designated one or more sight deposits (with special code numbers under the banking accounting plan) with a commercial bank of its choice. These were the accounts where the money would be held, and where in- and out-payments were made. The single giro accounts held with the SDK were mere duplicates of the matching deposits held with banks. Through the giro accounts, the SDK, instead of the banks, was the manager and record keeper of the matching bank deposits. The SDK giro accounts functioned as mirror images of the bank accounts, and the SDK itself did not perform any deposit-taking or lending operations. Legal entities could hold time bank deposits not linked to SDK accounts. However, debits and credits to these accounts would have as a counterpart a credit or debit to the sight deposit controlled by the SDK, as any other financial or non-financial transaction.

Each government agency or spending unit also had one (occasionally more than one) SDK giro account (typically a Number 603 account), which mirrored a deposit with a commercial bank rather than with the national bank – although main ministries and other first-level budget institutions (direct

spending units, DSUs) usually had their accounts in the national bank (designated Number 637). In addition, there were numerous transient giro accounts where tax receipts were credited before being transferred to a general “budget giro account” (account Number 630). The latter typically had a matching deposit with the national bank that was under the control of the MOF and was debited with budget payments (actually transfers to the giro accounts of the spending units). Thus, expenditure took place by electronic transfer, debiting the main budget account Number 630, and crediting the Number 637 accounts of main budget users, the DSUs. The latter distributed these funds to their subsidiary units, ISUs, to Number 603 accounts.

Banks also had a single giro account with the SDK, which mirrored their ordinary deposit account (or giro account) with the national bank, which in turn also had an SDK account. The SDK knew the balances held by banks in separate required reserve accounts with the NBM, as it could exceptionally draw on them. The SDK had a monopoly on payments – legal entities were obliged to carry all domestic payments through the SDK; this included all government agencies, banks, and even the national bank. It also included payments that were a counterpart to credits or other financial operations, as in the case of banks or the national bank. By contrast, foreign exchange payments (both abroad and domestic) were performed by the banking system without the intermediation of the SDK. As the SDK covered only legal entities, households interacted directly with banks, where they held their accounts. They could deposit cash, get reimbursements in cash, or issue payment orders which were executed directly by banks through the SDK system. Payments were executed through the SDK on the basis of payment orders, whereby money was transferred from the payer’s account to the payee’s account.

Using its extensive computer facilities and regional branch network, the SDK was able to execute almost all payment orders within 24 hours across the whole country, as legally prescribed. The system was highly efficient from this point of view, though highly inefficient if account is taken of the effort required to deliver payment orders to SDK offices and to retrieve information on payments inflows and final deposit balances from the SDK. The inability of banks and the national bank to directly credit or debit their clients on account of other financial operations, as well as to carry out payments among clients of the same institution, involved additional inefficiencies.

Bank clearing

For the net result of payment orders issued by the banks’ clients, plus orders issued by banks themselves, the SDK had to enter a net debit or credit in the bank’s own giro accounts (deposits with the national bank). As a result, the SDK performed the functions that clearing houses and other netting

arrangements perform in other countries. New payment orders would not be processed if, according to the results of the last clearing, there was not a sufficient balance in the payer's account. As a result, no overdrafts could appear on the accounts of the bank's clients. By contrast, a cash deficiency could result on any settlement in some bank's giro account. Therefore payments may be considered final for clients, though not for banks. Usually from 10:00 a.m. onward, banks could know the position of their giro accounts after the provisional clearings, and could undertake measures to cover any deficiency of liquidity. Even if they did not do so, the SDK was entitled to automatically cover any deficiency with the required reserves of the banks held with the national bank, which was consequently the institution incurring the credit risk.

Cash distribution

Legal entities had a limit, assigned by the SDK or agreed with it, on the volume of their cash holdings. Any excess had to be deposited in the giro account (transfers through the post office were also available for this purpose). Legal entities in need also had to obtain cash from the SDK. This was only possible within limits, and only for certain declared purposes, subject to SDK scrutiny. Banks' cash needs (related to transactions with households) were subject to similar rules. As a result, the SDK was the only possible intermediary between the national bank and the rest of the economy concerning the distribution of coins and banknotes, necessitating that it maintain a nation-wide system of strong rooms. This implied that the SDK needed to maintain a correspondent account with the national bank, through which cash deliveries between the national bank and the SDK were registered. The cash delivery function implied that there had to be some permanent financial relation between the SDK and the national bank.

Tax collection functions

The collection of taxes was also made through the SDK. On tax collection dates, enterprises had to present to the SDK a payment order, together with a form specific for each tax. Tax proceeds were credited in some transient giro accounts in the SDK, according to the type of tax. These were subsequently debited, and the total revenue was credited to the general budget giro account Number 630, controlled by the MOF.

Since the most important taxes (sales, wages) were based on payments which must have been carried out through the SDK, it was in a position to immediately check the accuracy of the assessment. In case of failure in presenting the payment order when due, or of disagreement with the tax assessment, the SDK would stop the execution of any payment order of the defaulting entity, and would charge penalty interest rates on delayed tax payments. Eventually, the SDK was in charge of procedures for sanctioning tax

default. This was in the past a very expedient system of tax collection; however, with the introduction of new taxes, this became a large source of tax evasion. Enterprises, particularly in the case of the new private enterprises, turned to cash payments, avoiding SDK mediation partly or altogether, and so avoided the payment of taxes assessed or controlled through gross payments.

Control functions

Apart from the information stemming from payment orders, the SDK was obligated to receive different reports submitted by all legal entities, including government agencies, concerning their activity. Enterprises had to submit quarterly reports on taxes paid and other legal obligations, and half-yearly reports with income statements and a balance sheet. Other legal persons were obliged to submit yearly reports. This information was the basis for the general audit functions assigned to the SDK. These functions centred on the legality aspects rather than on performance criteria. A special role was typically assigned to the SDK in starting bankruptcy procedures of legal entities facing payment difficulties.

Information functions

In addition to providing each account holder with all the relevant payments information, the SDK produced a large number of reports, some yearly, some quarterly or monthly. For example, the monthly reports on budget revenues made to the MOF were critical for cash planning purposes. There were some annual and semi-annual reports on government expenditure which, however, were not based on information collected through the payments mechanism but on the reports submitted to the SDK by the spending agencies. Except in the case of government agencies, the SDK charged fees for these reports. The SDK was a major source of data for the official statistical yearbook.

Quite clearly, the SDK was a very powerful organ of the socialist state. The concentration of power to move funds, and the consequent information it possessed, were viewed suspiciously even before the collapse of the SFRY. Clearly, it carried out many of the control and supervisory functions of a central bank and hence stood in the way of the more modern conception of an independent and powerful central bank. Moreover, its monopoly on payments transactions was a barrier to allowing the commercial banking system to develop on market-based lines.

Reform of the SDK system

The progress in reforming the SDK system is summarised below.

Bosnia and Herzegovina – Federation of BiH (FBiH) and Republic Srpska (RS)

The closure of the three BiH payments bureaus¹ by 31st December 2000 was agreed by all parties at the Madrid conference following the Dayton accords, and follow-up pressure from the international community ensured that this decision was implemented on that date. While the closure of the PBs was abrupt, with immediate and wholesale movement to the banks for all customers, the implementation of new treasury systems to replace transaction processing previously managed by the PBs was considerably complicated by the number of levels of government involved – the State of Bosnia and Herzegovina (BiH), the Federation of Bosnia and Herzegovina (FBiH), the Republic of Srpska (RS), and the FBiH cantons, not to mention lower-level local governments and municipalities. On the revenue side in particular, the transition was difficult and problematic, as tax payment transactions through the banking system failed to identify both the taxpayer and the nature of the payment, making the accounting (and sharing of revenues) impossible. The government banking arrangements were further complicated by the unwillingness of the RS and the FBiH to use the “common” central bank for their main operating account. Instead they used commercial banks that were individually favoured by each government for political reasons (which resulted in two banks for the FBiH).

The changeover was assisted by external involvement in the process, in particular in the provision of computerised systems for the new treasury operations. USAID provided the bulk of this assistance, through the provision and customisation of the Oracle Financial software to support the various treasuries (locally known as the SUFI system) whose deployment started in 2001 but was only completed in 2002. USAID also provided last-minute support for the development of a special software application for revenue recording and sharing which was ready in January 2001. Both these systems went a long way towards replacing the functions previously performed by the PBs. These systems allowed the maintenance of treasury general ledgers, so that with the closing of the budget institutions’ bank accounts, new ledger accounts could be opened instead, thus allowing a TSA to be established in each entity (FBiH and RS). In the RS the treasury management and banking arrangements went further, with the establishment of branch treasury offices operating zero balanced transit accounts in commercial banks to look after regional revenue collection and to service the transactions of budget users based within their region. In contrast, the FBiH has only two branches (Sarajevo and Mostar) to cover, given that most service delivery operations are carried out in the cantons. To simplify the move, both entities limited the need for cash transactions for the launch of the new system.

The Bosnia State Treasury's conversion to a TSA was delayed to mid-2002, owing to delays in the software implementation and the special problems of putting in place arrangements for making payments to field locations (*e.g.* state border services).

In Republika Srpska, the successor to the SDK, the SPP, was closed and its activities passed to the APIF as an independent but publicly owned entity in charge of payments clearing. The Central Bank of BiH (Banja Luka Branch) took over the bank clearing, and the institutions transferred their accounts from the SPP to the commercial banks. The APIF took control of former payments bureau functions such as registration of legal entities and statistical returns, and maintained a residual IT capacity, which in theory allowed it to supply services to anyone but in practice mainly to government bodies. Tax administration received some staff from the SPP, with tax collection made through the banks, and other staff joined the treasury.

In retrospect, the "big-bang" approach to the payments bureau reform was not as disruptive as would have first been expected, largely due to significant levels of external technical assistance, but also because in the BiH the SDK system had already broken down. At the same time, there were losses of information (*e.g.* company statistics collection from end-of-year accounts had a two-year gap in their completion) and the lack of preparation in the treasury initially resulted in a significant loss of control over public finances, particularly in the FBiH.

Croatia

The Croatian payments bureau (called *Zavod za platni promet*, ZAP) was transformed into the Financial Agency on 1st January 2002, based on the Financial Agency and National Payments System Acts. Under these new arrangements, the responsibility for payments systems operations that were performed by ZAP were transferred to the Croatian National Bank, and the commercial banks were put in charge of processing and clearing their own payments. The National Bank had previously established an RTGS system in April 1999. The National Clearing System was established in 2002 as an independent operation managed by a branch of the Financial Agency. The Financial Agency also continued to provide agency services to the banking sector to handle payments operations, as many of the commercial banks had not made the required investment in systems and resources by the time the new law came into force. ZAP employees continued working as employees of the Financial Agency.

In Croatia, the migration of accounts from the ZAP to the banks was completed in one step, including the accounts of the DSU and ISUs. However all DSU and ISU accounts are to be reported to the Financial Agency, and the

banks are to provide regular balances on them. According to the Croatian National Bank Law, the accounts of the republic are managed through the National Bank, but the SU accounts are opened and managed through the commercial banks. The banks also receive and process payment orders for revenues and other budgetary receipts that must be filled in according to a 2000 Order of the MOF, and banks must have IT applications that assure compliance with this Order.

Banks that maintain the accounts of local government and municipal accounts are obliged to report daily on payments made and disbursements from those accounts. Information is sent to the Financial Agency on magnetic media in a form prescribed by the MOF Order. Since the Financial Agency also provides services to the banks in processing revenue payment orders, there was little change in the flow of information. For those banks not using this service, there were some initial problems in information that appear to have been resolved. On a contractual basis, the Financial Agency also performs tax sharing between central and local governments. In the treasury, the MOF has the capacity to process a significant part of the wage bill. Salary slips from ISUs in the education, social welfare, and judiciary branches are collected and processed by the Financial Agency and settled centrally from the various transfer budgets. Cash management is now a treasury function.

Serbia

Serbia only began a transformation of its payments bureau (called ZOP) beginning in October 2001, although it had taken a first step in the early 1990s by placing it under the supervision of the Federal Central Bank. The Law on Payments Transactions was adopted on January 2002, to take effect on 1st January 2003. This prescribed that all accounts of legal entities and physical persons would be moved to the banks and only denominated in dinars. The National Bank of Yugoslavia (NBY) will maintain clearing house settlement accounts and the giro accounts of the federal government and the Republic of Serbia. As in Slovenia, a part of the ZOP was employed as an agent for government payments transacting. And as in Croatia, the ZOP can provide agency services to the banking sector. The federal and state governments had until 31st December 2003 to establish a TSA. The payment system is based on an RTGS run by the NBY and a clearing house for small-scale transactions. To participate in the RTGS, a bank must be licensed by the NBY. The transition period for migration was very short, but it appears that, despite some minor disruptions in tax collections, the changeover on 1st January 2003 went rather smoothly, probably owing to lessons learned from the experience of Bosnia. It is envisaged that the NBY will maintain accounts for collection of public funds and allocate funds from such accounts up until December 2003.

Montenegro

The approach to payments bureau reform in Montenegro was to divest all non payments functions from the ZOP and reallocate them to successor institutions. The retained central processing and communications network was then taken over by the central bank, and the ZOP branch network was transferred to the commercial banks, still connected to the central processing hub. This meant that the payments service, its role as fiscal agent, and the giro and wide area network (WAN) services were integrated under the Central Bank of Montenegro (CBOM) management. In this way, Montenegro shied away from major changes, opting for modifications of present systems. There was no major investment in new IT systems (RTGS, a clearing house, or even commercial banking systems), providing a breathing space for the development of more modern and market-oriented systems. At this time, it is unclear if this deregulated giro system and WAN communications service for the banks are sustainable in the long term. Much will depend on the extent to which they are willing to subscribe to these services and how much they will opt for other solutions. At the moment, the inter-bank RTGS operating within the modified system appears to be functioning reasonably well.

FYR Macedonia

In the 1990s, the ZPP worked closely with the MOF to develop more effective reporting systems for government transactions, particularly on the expenditure side. This close collaboration began to wane, however, when it became evident that the government wished to reform the payments system in line with market economy practices. FYR Macedonia passed the ZPP Reconstruction Law in 2001, and in December 2001 it dismantled its payments bureau. The law provided for the accounts of budget users to be transferred to the treasury from the ZPP. An RTGS system managed by the National Bank of Macedonia (NBM) and the Agency for Inter-Bank Clearing System (KIBS) were the successor institutions to handle payments. A new revenue payment order was established, requiring the taxpayer to enter the correct tax code when making payment, and thereafter the Public Revenue Office (PRO) took over ZPP branch offices as local tax offices. A Skopje Treasury Office was formed (with staff and associated software transferred from the ZPP) to handle payment requests in the capital area. The other payments covered by a small treasury presence in the regional branch offices were taken over by the PRO. This was preceded by intense activity in 2001 in completing the alternative treasury system, based on the operation of a TSA. This was accomplished in two phases. The first phase, before the closure of the ZPP at end-2001, required the treasury to create software for the treasury general ledger (TGL) and the NBM to create a new payment system based on a clearinghouse for small-scale

transactions and the RTGS for large-scale transactions. The system required budget users to submit monthly spending plans to the treasury department, which approves and records them using specifically tailored software. The treasury then gives the budget user authority for its monthly expenditures. The budget users submit their requests centrally to the treasury, which electronically submits a payment order to the central bank, recording the transactions in a TGL. The central bank, via the new clearing RTGS, credits the accounts of the suppliers, giving online electronic reports of the inflows, outflows, and balance of the TSA to the treasury.

The second phase of the reform process under way involves budget units having increasing electronic access to the system, so that they can view their accounts and obtain online reports through a combination of prepared reports and download capability. At first, only the main budget units, the major DSUs, would be online to the treasury, and the ISUs would communicate electronically through their supervising ministries (DSUs). Beginning in 2003, the plan is to extend online connection to the smaller DSUs and larger ISUs, as well as to improve the methods for ISUs to directly communicate with their supervising DSU.

Slovenia

Work on the payments system reform started in the early 1990s, although institutional difficulties prevented the reform from being concluded at that time. However, in the mid-1990s, the Central Bank established the RTGS and small values clearing systems, imposed in-day reporting on the position of the banks at the payments bureau, and developed its own retail account management system for government users. During this period, the payments bureau shed some of its tasks, namely tax functions to the Tax Administration (along with 600-800 staff), banknote distribution to the Central Bank, and auditing to the Court of Audit. With this background, and with mounting pressure to implement a payments system reform, a renewed and concerted effort started in 1999, this time with MOF involvement as both referee and interested party. The Law on the Reform of the Payments System was drafted, with sections added to deal with the dismantling of the payments bureau, including the creation of two new entities, the Office of Public Payments (UJP), and the Office of Public Financial Records. The work on treasury reforms strongly influenced the drafting of the law, particularly with regards to the UJP, which was assigned the specific task of handling all general government transactions.

The Law on the Reform of the Payments System was adopted in March 2002 and implemented on 1st July 2002, determining the closure of the payments bureau at end-2002. Migration of business legal entities started in

batches from late 1999, under provisions in the old legislation. The gradual migration gave the banks time to adapt their operations to suit the needs of corporate clients, and the payments bureau time to downsize its operations and shed its staff gradually, with full union involvement and agreement. The 2003 budget received a windfall from the accumulated reserves of the payments bureau, part of which was earmarked for the development of a TGL system to be installed in the UJP, with the staff complement of around 250. By July 2002, 193 TSA accounts were established at the Central Bank (one central government and 192 local governments), and all accounts of central government, EBFs, and local governments, as well as those of the 1 500 third-level institutions (*zavods*), were established as sub-accounts of one of these TSAs. All general government budget users have therefore *de facto* become part of the TSA system and do not have their own bank accounts. All transactions (including own-source receipts and payments, and tax receipts) are processed through TSA sub-accounts maintained by the UJP. For the moment, ISUs continue to deposit their surpluses in the commercial banks independently, although the central treasury has begun to offer its own short-term deposit facilities aimed at attracting these surpluses.

Note

1. In the FBiH, there were two PBs: ZAP in the Croatian-dominated part, and ZPP in the rest. In the RS, the PB was known as the SPP. All three PBs had become heavily involved in financial transactions in support of the ethnic conflict, and were perceived to be highly politicised and factional after the Dayton accords.

Budgeting in Denmark

by

Jón R. Blöndal and Michael Ruffner*

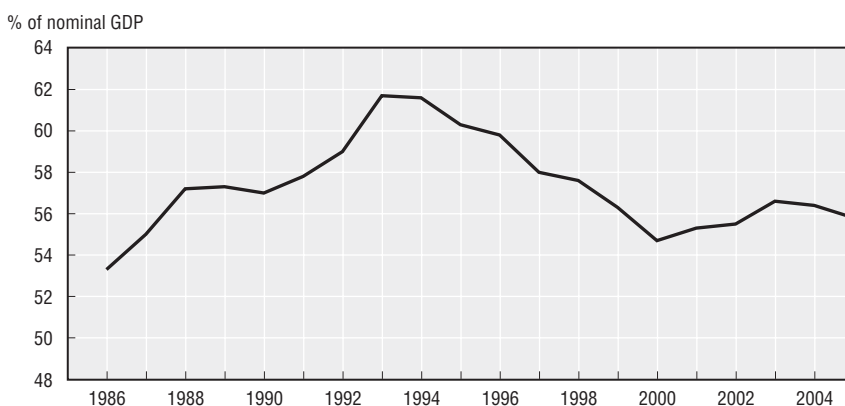
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1. Budget formulation

1.1. Introduction

Denmark has a very large public sector and this has historically been the case. Currently at over 56% of GDP, the size of the public sector in Denmark is larger than that of any other OECD member country except Sweden.

**Figure 1. Public expenditure as a percentage of GDP 1986–2003 and forecast for 2004–2005:
General government total outlays**

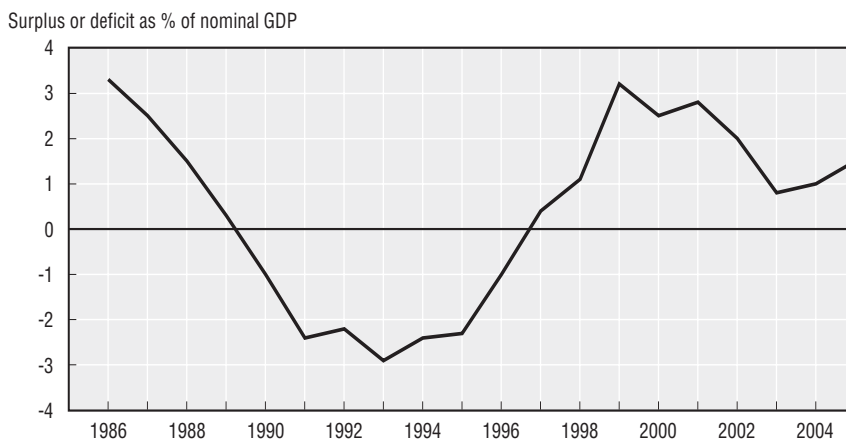


Source: OECD.

At the same time, the public sector is built on solid and stable financial foundations. Surpluses ranging from 0.4% to 3.1% of GDP have been recorded in each of the past seven years, and the government is committed to maintaining surpluses into the future in preparation for the fiscal implications of population ageing.

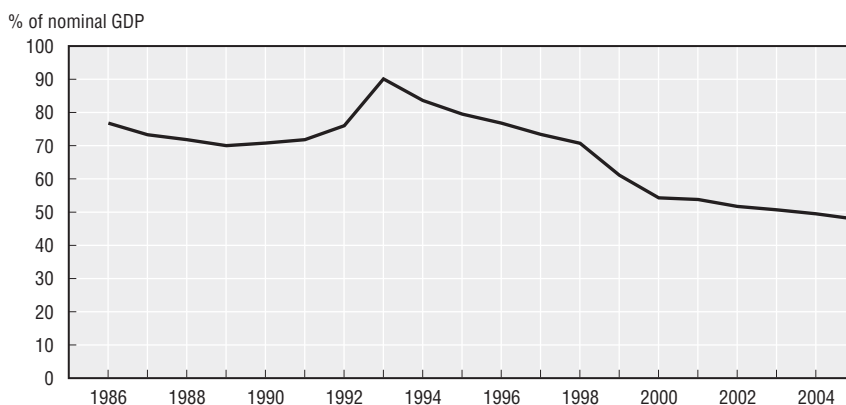
The government's debt has been significantly reduced in recent years as the result of these surpluses and now stands at 50.7% of GDP. Again, the government is committed to reducing this proportion further in preparation for the fiscal implications of population ageing.

**Figure 2. Public expenditure as a percentage of GDP 1986-2003 and forecast for 2004-2005:
General government financial balances**



Source: OECD.

Figure 3. General government gross financial liabilities as a percentage of GDP 1986-2003 and forecast for 2004-2005



Source: OECD.

This part of the paper discusses Denmark's budget formulation practices. It is divided into two sections. The first section highlights several unique characteristics of the Danish budgeting system; this sets the scene for the discussion of the main steps of the annual budget formulation process in the second section.

1.2. Key characteristics of the Danish budgeting system

It is useful to discuss several unique features of the Danish budgeting system – and the environment for budgeting in Denmark – that differentiate it from that of many other OECD member countries:

- First, Denmark has a history of **coalition minority governments**. This has placed a premium on achieving consensus through negotiations between political parties, both in government and outside government. This is especially relevant for budgeting.
- Second, a widely supported **medium-term economic and fiscal programme** – *Denmark 2010* – is in place to foster fiscal prudence in preparation for the onset of major demographic changes. This serves as a useful “anchor” for fiscal policy.
- Third, two-thirds of public expenditure is carried out by **local and regional governments**. This poses challenges for overall fiscal management and co-ordination.

1.2.1. Coalition minority governments

Denmark has a history of coalition minority governments and there is nothing to indicate that this will change in the near future. This has placed a premium on achieving consensus through negotiations between political parties, both among the coalition partners in government and with political parties outside government. The support of political parties outside government is necessary since a minority government – by definition – does not enjoy majority support in parliament for its legislative agenda. The fact that different political parties will provide the majority for different proposals means that the government is engaged in negotiations and consensus building with (most) political parties.

The consensus building in government manifests itself in the coalition agreement set at the beginning of each government's term of office and in the system of cabinet committees where the coalition parties meet to discuss and approve major policy issues.

There is no set formula for how budget policy is treated in the coalition agreements. Sometimes it is a statement of general policy objectives whereas in other cases it is at a much greater level of detail. However, it is accurate to say that most major budget policy initiatives during a government's term of office will emanate from the coalition agreements. For example, the last coalition agreement provided for significant cuts in expenditures in certain programmes (environment, foreign affairs). The exact amounts of the cuts were not specified, but the political decision to make significant cuts was signalled in the coalition agreement.

The objective of the system of cabinet committees is to create a forum for the different coalition parties to be involved in decision making and to have “ownership” of the decisions made. In the case of budget policy, the Cabinet Economic Committee¹ is the most relevant committee. It is chaired by the Minister of Finance and serviced by the Ministry of Finance. In practice, this means that many decisions of the Minister of Finance are made in the name of the Cabinet Economic Committee. It is clear, however, that substantively the power lies with the Minister of Finance as witnessed by the fact that the minister's proposals are generally accepted by the cabinet and its committees. Of course, informal consultations will have taken place prior to the submission of proposals to the committee.

Achieving consensus with political parties outside government takes the form of agreements when the budget proposal is in its parliamentary phase. These can either be one-off “deals” on isolated issues or comprehensive agreements on expenditures in specific sectors typically for three to five years. There are examples where all the political parties in parliament have signed such agreements. The scope and detail of these agreements is extensive. Approximately two-thirds of government operating expenditure in 2004 is covered by such agreements. In addition to expenditure levels, these agreements often cover substantive issues and desired structural reforms in a sector. Recent agreements have ranged from less than five pages to over 30 pages in length. The multi-year agreements relieve much tension from the annual budget process, but they do impose significant rigidities on the annual budget process. A large amount of spending is simply deemed “off-limits”, and it is difficult to revisit the expenditures and objectives of the agreements once they have been finalised. The agreements should, however, very much be seen as political tools to lend stability to budget policy. These agreements are further discussed in part two of this paper, on the role of parliament in the budget process.

1.2.2. Medium-term economic and fiscal framework

The “anchor” for budgetary policy is the *Denmark 2010* programme which applies to all levels of government, not just the central level. This medium-term economic and fiscal strategy enjoys broad political support in Denmark and has been followed by successive governments. The overall objective of the programme is to ensure that fiscal policy is sustainable in the long term. Sustainability is defined so that the level of taxation and standards of public service per user reached in 2010 can be maintained in the future despite large demographic changes.

In essence, this means running budget surpluses until 2010 in order to reduce the amount of the debt and the associated cost of borrowing. According to projections, sustainability requires an average government surplus of close to 2% of GDP from 2003 to 2010. It should be noted that this is

conditional on a substantial improvement in labour market performance as well.² In operational terms, this is translated as a surplus of 1.5-2.5% of GDP until 2010. The actual surplus may fluctuate within this range in individual years as a result of cyclical conditions, thus allowing the automatic stabilisers to contribute to dampening the business cycle fluctuations.

The *Denmark 2010* programme also incorporates specific annual growth targets for real public consumption of only 0.5%. This is a quite challenging target, not least compared with the actual rate of growth over the past decade.

It should be noted that the *Denmark 2010* programme originally had a built-in buffer of approximately 1% of GDP but that the current government reduced the levels of taxation by an equivalent amount. This, together with the government's commitment to a tax freeze, makes achieving the programme's objectives all the more challenging, although the disciplinary effects of the tax freeze cannot be underestimated.

Finally, it needs to be emphasised that the *Denmark 2010* programme does not provide an explicit hard budget constraint in any given year. The surplus goals are explicit as is the government's commitment to the tax freeze, according to which all taxes are fixed whether quoted in percentage or nominal money terms. The tax freeze has added a further disciplining effect on government expenditure, since new spending cannot be financed by new taxes. This makes the level of expenditure a residual item, i.e. an indirect expenditure ceiling.

1.2.3. A large role for local and regional governments

Almost two-thirds of total general government expenditure is carried out by regional and local governments, the highest share of any OECD member country. This is especially noteworthy since Denmark is a unitary country.

Municipalities and regions carry out most of the public service delivery that is targeted directly towards citizens, including elderly care, assistance to disabled persons, hospitals and the primary health services, daycare for children, and primary and secondary education as well as payments of retirement pensions, sickness and maternity benefits, social assistance and individual housing benefits.

The share of own revenue of regional and municipal governments in financing this expenditure is around 80%, with the remaining 20% being financed in block grants from the national government. Regional and municipal governments set their own rates of taxation, subject to the tax freeze.

This high degree of decentralisation poses challenges for overall fiscal management and co-ordination. To alleviate this, agreements are reached each year between the national government and the Association of Regional Governments and the Association of Local Governments. The agreements stipulate aggregate expenditure levels and tax rates for regional and local

governments, and set the amount of the block grants from the national government. These agreements are voluntary and collective, i.e. they are not legally binding for any individual municipality or region. Nonetheless, they establish the general framework for fiscal aggregates in municipalities and regions.

As a general rule, there was always some slippage in the performance of municipalities and regions, i.e. the level of taxation and therefore the level of expenditure were higher than agreed. (Regional and municipal governments must operate a balanced budget.) The central government did not have any effective mechanisms to enforce the original agreements. This has now changed. In accordance with the tax freeze, new legislation allows for a reduction in the amount of the block grant to the regions by the same amount as any extra revenue from tax increases in regions as a whole. Similar legislation has been announced in relation to municipalities, but has so far not been necessary. This is, however, a most contentious issue in constitutional terms in Denmark due to the “sovereignty” of regional and municipal governments.

Denmark has a special system in place to prevent unfunded mandates, i.e. directives from the central government that lower levels of government must implement and finance. Any such initiative will have to be fully costed and the ministry responsible for the mandate will have to provide the financial resources for implementation. Conversely, if a ministry removes a mandate from lower levels of government, the amount saved by lower levels of government will be reflected in increased resources for the ministry. However, if the mandate concerns very large amounts, the compensation to or from the relevant ministry will be subject to negotiation.

The timing of the negotiations is dictated by the legal requirement that individual regional and local governments must be informed about the size of their block grant for the coming year by 1st July at the latest. This is to allow regional and local governments enough time to determine their budgets. Consequently, the agreements are typically reached in early June.

It should be noted that there is great pressure for increased spending by municipal and regional governments due to the nature of the services they provide to citizens. In fact, the negotiations generally allow for most of the increase in public consumption as called for in the *Denmark 2010* programme to be made by municipal and regional governments. The central government has experienced no real increase in its consumption in recent negotiations.

1.3. Annual budget process

This section outlines the major events in the annual budget formulation process in Denmark. Aside from several milestone provisions in the constitution, very few aspects of the annual budget process are enshrined in law. There is, for

example, no organic budget law in place. Provisions normally contained in such an act are specified in the *Budget Guidelines Handbook*, which is issued by the Ministry of Finance. Although the Finance Committee of parliament approves its contents, the *Handbook* is very much viewed as a Ministry of Finance product.

The annual budget process starts in January each year with the Ministry of Finance presenting a draft Budget Priorities Memorandum to the Cabinet Economic Committee. This is a short paper (three to four pages) that discusses the total level of expenditures which is consistent with achieving the goals as set out in the *Denmark 2010* programme. The Memorandum may or may not propose ceilings for total expenditures for each ministry; it varies each year. The Memorandum will describe the major politically sensitive expenditure issues with which the government will have to grapple. It will outline the objectives of the government's negotiations with the local and regional governments. Finally, it will propose specific expenditure programmes for special analysis.

The draft Memorandum is discussed at several meetings of the Cabinet Economic Committee and at a special 1½-day retreat by the full cabinet. The

Box 1. Budget formulation timetable

January	Ministry of Finance prepares draft Budget Priorities Memorandum. Cabinet Economic Committee and the cabinet discuss Budget Priorities Memorandum.
February	Cabinet formally approves Budget Priorities Memorandum. Minister of Finance issues letters to spending ministers highlighting their maximum level of spending and specific expenditure programmes for special analysis.
March-April	Spending ministries work on their budget submissions. Special studies undertaken on specific expenditure programmes.
End April- Early May	Spending ministries submit proposals to the Ministry of Finance.
May-June	Negotiations with spending ministers. Negotiations with local and regional governments on the size of their block grants.
June	Minister of Finance submits draft budget to the Cabinet Economic Committee. Cabinet endorses draft budget.
August	Final adjustments (if any) to economic assumptions used in the budget.
End August	Budget presented to parliament.

final Budget Priorities Memorandum is generally in line with the draft proposed by the Ministry of Finance.

In this context it should be noted that systemic changes in budget policy or major reallocations will normally only take place at the time when a new government is being formed. Nonetheless, political co-ordination among the different coalition parties on budgeting issues is important, as was highlighted earlier.

The full cabinet will formally approve the Budget Priorities Memorandum in February. Two weeks after the cabinet's approval of the Memorandum, the Minister of Finance will send a formal letter to each minister summarising the key aspects of the Budget Priorities Memorandum and outlining the total level of expenditure for each minister.

Box 2. **Expenditure ceilings**

Denmark operates a system of “expenditure ceilings”. This entails the Ministry of Finance establishing the aggregate amounts for expenditures for each spending ministry. Each ministry then has the responsibility for final reallocations of funds within its portfolio. It is believed that higher quality decisions will result – since the respective ministries have better information on which to base their decisions – and that they will have greater ownership of such decisions, having made them themselves.

The expenditure ceiling for each ministry will be divided into two parts: a maximum for operating expenditures and a maximum for transfer (non-mandatory) expenditures. Shifting money from transfers to operating expenditures is not permitted. A sub-ceiling is also set for the expense on salaries within the operating expenditures ceiling. Money may be transferred from salaries to other expenses, but not from other expenses to salaries.

The expenditure ceilings are presented for the next year's budget and the following three years. The expenditure ceilings generally are the same as the ones presented as the year-2 ceilings the previous year, taking into account changes made by parliament in its approval of last year's final budget proposal and any technical adjustments required.

It is important to note that the Ministry of Finance does maintain a capacity for detailed analysis of the expenditure programmes of ministries and will intervene if ministries do not keep within the ceilings set for them.

Transfers that are mandated by law and capital expenditures are not included in the system of expenditure ceilings. Bids for capital expenditure are received from spending ministries at the same time as they submit their other requests. The Ministry of Finance evaluates such requests in view of the government's policy priorities.

The letter from the Minister of Finance will also confirm specific expenditure programmes for **special study**. These studies are an established feature of the Danish budget formulation system, although there are years when they have not taken place. As noted earlier, the programmes for review are decided by the Cabinet Economic Committee and then the full cabinet. Areas for review are proposed by the Ministry of Finance. The special studies are normally associated with specific cuts in expenditure programmes. These programmes will generally be excluded from the total expenditure ceilings sent to spending ministries; they are carried out by teams of civil servants representing the Ministry of Finance and the relevant spending ministry. Depending on their terms of reference, these teams will either present specific proposals or a menu of possible proposals. There is a very short period of time for these teams to operate, as they will generally only have about 1½ months to carry out their studies. This was criticised as too short a period for proper analysis. Despite this, the special studies have produced significant savings.

Spending ministries present their budget submissions at the end of April or early May to the Ministry of Finance, including the conclusions of the special studies. The submissions are to be in line with the expenditure ceilings given to them in February. In reality, the amounts are generally in excess – either due to the ministries claiming that the cost of operating unchanged policies is higher than what was assumed, or because they will be making claims for new initiatives. The principle that the funding of new initiatives or higher costs of existing programmes be achieved by reallocations from other areas in the ministry is well established in Denmark, and the submissions by ministries reflect the fact that they believe that the Ministry of Finance has a “kitty” (reserve) at its disposal. This may or may not be the case in individual years. There are strong procedures in place to justify any bids in excess of the initial expenditure ceilings allocated.

During June, the Ministry of Finance will conduct negotiations with spending ministries based on their submissions and the conclusions of the special studies. Negotiations will take place at all levels with budget analysts, deputy permanent secretaries, permanent secretaries and ministers taking successively higher level decisions.

As noted earlier, the negotiations with regional and local governments over their level of expenditure (taxation) and the block grant from the national government will have been concluded in early June. This places additional constraints on the negotiations with other ministries, since the aggregate of the negotiations with spending ministers and the agreement with lower levels of government will have to be within the confines of the *Denmark 2010* programme.

Box 3. Budgeting within spending ministries

Spending ministries in Denmark consist of a core “ministry” and a number of agencies. (See part three of this paper for further information on organisational structures.) The Ministry of Finance only interacts with the core ministry as representing all components of the ministry. Each spending ministry has its own internal budget process for how it receives submissions from its subsidiary agencies.

In some ministries, the core “ministry” divides the expenditure ceiling received from the Ministry of Finance among its components and asks them to make submissions in line with that ceiling. This process in effect cascades down to agencies the expenditure ceiling system for ministries.

Other ministries prefer a process whereby agencies make submissions with no specific reference level for the total amount. They consider this a more dynamic system, and believe that it promotes reallocation by highlighting new and emerging areas.

In reality, there is a great deal of interaction between ministries and agencies throughout the year, and the actual budgeting system within ministries can be considered as a mixture of the two processes.

This is also the primary stage in the budget formulation process where performance information is used.

Later in June, the Minister of Finance submits the conclusions of these discussions to a meeting of the Cabinet Economic Committee which will typically approve them with very little discussion. The full cabinet will approve the outlines of the budget proposal in late June. Thus, the Cabinet Economic Committee and the full cabinet are primarily involved at the very beginning and the very end of the process. A final check is made in August to ensure that there are no changes in the economic situation which would affect the amounts in the budget.

The government has to negotiate with other political parties in order for the budget to be approved in parliament. As a result, some tactical decisions are taken about what should be in the original budget proposal and what should be included later as subjects for negotiation with other political parties.

The documentation accompanying the government’s budget proposal is prepared by each respective ministry. The Ministry of Finance verifies this information and ensures its consistency and presentation. The government’s budget documentation is very “legalistic” in format. A user-friendly version of the budget is also published.

Box 4. Economic assumptions

The economic assumptions applied in the budget are the same as those used for the *Denmark 2010* medium-term economic and fiscal programme. Their preparation is the responsibility of the Ministry of Finance. There are three separate forecasting rounds each year – May, August, and November/December. The May round coincides with the negotiations with spending ministries on their final budget allocations; the August round takes place just prior to the budget being presented to parliament; and the November/December round coincides with parliament's final approval of the budget and the preparation of the Budget Priorities Memorandum for the subsequent fiscal year. The Ministry of Finance produces comprehensive reports on the prospects for the economy following each round and assesses conformity with the *Denmark 2010* programme. A more research-oriented report is published once a year.

There are no independent panels as such involved in formulating the economic assumptions, but the scrutiny of parliament's Finance Committee involves seeking the opinions of the Central Bank and other research institutes on the appropriate economic assumptions.

1.4. Conclusions

Denmark has managed its fiscal finances on a prudent basis – consistently achieving surpluses and paying down debt for each of the past seven years. There has been widespread support among successive governments in Denmark to continue this policy in order to prepare for the emergence of the impact of population ageing. Although there may be room to formalise more clearly the hard budget constraint embodied in the *Denmark 2010* programme, it would appear to be serving its purpose in a satisfactory manner at present. It should, however, be reiterated that the *Denmark 2010* programme is based on significant improvements in the performance of the labour market.

The pressures for increased spending by regional and local governments coupled with the provisions of the *Denmark 2010* programme will impose great strains on budgeting for the central government in future years. It seems likely that the central government will have to reduce its expenditures in order to create room for increased spending by regional and local governments.

The multi-year expenditure agreements pose challenges for effective reallocation in Denmark, as they place very large portions of the budget off-limits. This is, however, an entrenched part of the Danish political environment and unlikely to change. The challenge is to use the agreements effectively in order to secure required structural changes and streamlining in the individual sectors covered by the agreements. The importance of the

coalition agreements in achieving reallocations from lower to higher priority areas is fundamental, and there may be room for a greater formalisation of this procedure and for reinforced communications between the Ministry of Finance and the parties to the negotiations for the coalition agreements.

The division of responsibility between the Ministry of Finance and sectoral ministries appears to work extremely well, with a concomitant positive impact on budget formulation. The Ministry of Finance concerns itself largely with aggregate expenditure ceilings and general policies, but allows spending ministries wide latitude in deciding their own affairs within that general framework. A key factor for the integrity of this system is that the Ministry of Finance has retained its capacity for analysis of individual programmes and can intervene if necessary. Overall, the budget formulation system performs its task in an effective and efficient manner.

2. Role of parliament

2.1. Introduction

There are no restrictions on parliament's ability to modify the budget. In fact, the Danish parliament plays a greater role in the budget process than in most countries with a parliamentary form of government. However, the role is relative, and the amounts increased (changed) by parliament are modest when compared to the total size of the budget.

As noted previously, this relatively greater role is due to the fact that governments in Denmark are typically minority governments. The political parties that form the government do not have a majority in parliament, but have the conditional consent of other parties in order for the government to

Box 5. **The Folketing**

The Danish parliament – the *Folketing* – is a unicameral body with 179 members, 175 from mainland Denmark and two each from the Faroe Islands and Greenland.

Members are elected every four years through a proportional representation system. The Prime Minister can call an election at shorter intervals; four years is the maximum time allowed between elections. Of the 175 seats from mainland Denmark, 135 are constituency seats which are distributed among the 17 multi-member constituencies, while the remaining 40 seats are compensatory seats which are distributed among the constituencies in order for representation in parliament to best reflect the nationwide distribution of votes among parties.

There are at present eight political parties represented in the *Folketing*.

formally enjoy the confidence of parliament. As a result, the government has to engage in negotiations with other parties in parliament in order to secure a majority for their proposals. This applies to all proposals, but is especially pertinent to the annual budget.

The treatment of the budget during the parliamentary phase can be divided into two components. The first is the formal role played in parliament and its committees, especially the Finance Committee. The second phase consists of the political negotiations that take place at this time, often outside of the formal structures of parliament.

2.2. Parliamentary budget process

Box 6. Parliamentary budget approval timetable

Fiscal year = Calendar year

End August	Budget proposal submitted to parliament.
Start September	Finance Committee undertakes two-day technical review of budget proposal.
Mid-September	“First Reading”.
Start October	Second “First Reading”.
October-November	Political negotiations.
Mid-November	Second Reading.
December	Third (final) Reading. Queen signs the budget act into law.

In accordance with the provisions of the constitution, the budget is presented to parliament during the last week of August, or four months in advance of the start of the fiscal year. However, parliament is not formally in session during this time period (summer recess). As a result, a special provision in the *Standing Orders* allows the budget to be referred to the Finance Committee prior to its first reading in plenary session in parliament. The budget is presented in the form of an act and is debated like any regular bill.

The mandate of the Finance Committee includes scrutiny of the government’s budget proposal and general oversight of the government’s economic policy. It is considered the senior committee of parliament. The Finance Committee is composed of 17 members, proportionally representing the political parties in parliament.³

The Finance Committee commences its work by conducting a two-day technical review of the budget at the beginning of September – about one week

after the budget has been submitted. During this process, each member of the committee is assigned specific components (ministries) of the budget. She or he asks questions to clarify technical aspects of the relevant part of the budget (for example, has the structure of budget accounts been altered from last year's presentation?). During these two days, respective ministers and their staff come to the committee one after another to answer questions. Each minister is normally allotted about 30 minutes with the committee.

The Finance Committee views this review as strictly non-political. Members of the government parties participate in them in the same ways as members of other parties. The committee in fact would prefer for only staff from ministries to appear, but the government views it as a matter of principle to have ministers attend the review. This format of the technical review is recent. Previously, the technical review took longer and was conducted through written questions. The new format is considered a success by all involved.

A week following the conclusion of the two-day technical review, or in mid-September, the "First Reading" of the budget takes place in parliament. This is led by the Minister of Finance on behalf of the government. During this "First Reading", the political parties that are not members of the government announce their views on the budget and highlight their differing priorities.

The Finance Committee does not hold any other specific hearing on the budget until just prior to the approval of the budget in December. Members of the committee do, however, have the possibility to submit written questions to ministers and any minister can be recalled if a member of the committee wishes. Written questions are common; recalling ministers is rare.

The new parliamentary year formally starts on the first Tuesday of October. As a result, a second "First Reading" of the budget proposal is performed in order for the budget to remain officially on the agenda of the new session. This is a procedural issue and normally no discussions take place at this time. It does, however, mark the beginning of the negotiations between the government and other parties to seek parliamentary approval of the budget proposal. These are discussed in the next section.

The Second Reading of the budget takes place in the beginning of November, but this is while the political negotiations are at a critical stage and is generally only a perfunctory event. At this time, the Finance Committee will formally release its report clarifying any technical aspects of the budget and listing all significant changes between this budget proposal and the current budget in effect.

Although not formal actors in the budget approval process, the sectoral committees of parliament play an important role in parliament's scrutiny of the budget. This varies greatly, however, from one committee to another.

Box 7. A parliamentary budget office?

The amount of resources that parliament enjoys in order to effectively scrutinise the budget is a perennial question in Denmark.

At present, the Finance Committee has a professional staff of four analysts. In addition, the political parties receive a discretionary stipend that may be used for budget and policy analysis. Finally, many of the political parties also have think tanks attached to them which provide further resources.

However, there have been specific discussions of establishing an independent parliamentary budget office. The primary mandate of this office would be to cost any amendments proposed during parliament's debate of the budget. At present, only the Ministry of Finance has the ability to conduct such analysis. There is, however, no consensus on doing this.

The largest parties in parliament have all been in government and appear to be satisfied with the non-political nature in which the Ministry of Finance conducts the analysis.

Others, however, note that irrespective of the professionalism of the Ministry of Finance, parliament as a constitutional body should have its own resources in this regard.

In general, each committee will on its own initiative decide to take the relevant part of the budget for discussion. For example, the Education Committee will scrutinise the budget of the Ministry of Education. The minister and relevant staff will be called to the hearing and will answer questions from members. The sectoral committees do not formally give the results of their discussions to the Finance Committee, but members of each sectoral committee will give views and requests to their party's representative on the Finance Committee (their party's "finance spokesperson"). Also, there is no written procedure whereby the Finance Committee requests the views and estimates of the sectoral committee.

The Third (final) Reading of the budget takes place during two days at the middle or end of December. The political negotiations will have finished and this process amends the budget accordingly. During the first day, each and every amendment to the budget is voted separately.

For practical reasons, all proposed amendments are collected and dealt with at once during the Third (final) Reading. About 800 amendments are proposed each year, about 300 originating with the government itself. The government amendments are in line with the conclusions of the political negotiations as well as containing various technical corrections. There are no restrictions on proposed amendments.

One set of the government's amendments concerns updating the revenue side of the budget based on the latest economic assumptions. The revenue

estimates are often relatively small, although they can be quite substantial. In one year, the amount of the surplus doubled with this amendment. Parliament does not view that the government purposefully lowers the amount of revenue for negotiating purposes. Parliament would not countenance the government repeatedly making substantial revisions to the revenue estimates.

The Finance Committee meets at the end of the first day and reviews if all amendments have been voted correctly in line with the political agreements. If mistakes have been made, then these are corrected at the beginning of the next day.

Box 8. In-year adjustments to the budget

In-year adjustments to the budget are quite frequent in Denmark. This is not conducted through a supplementary budget but rather by separate submission to the Finance Committee of each individual item needing adjustment. All parliamentary control over in-year adjustments is entrusted to the Finance Committee which approves or rejects the request. At the end of the year, the Ministry of Finance gathers all the issues that the committee has approved during the year into a supplementary budget bill and submits this to parliament. This is purely a legal formality and no debate takes place around the supplementary budget.

About 300 issues each year are adjusted in this fashion. The procedure for doing this is that a spending ministry will propose an adjustment to the Ministry of Finance and, subject to its approval, will then send the request directly to the Finance Committee. The Cabinet Economic Committee may be consulted on especially large adjustments, but this is very rare. The Finance Committee deals with such requests very rapidly with usually only one or two weeks lapsing before its decision is made.

These adjustments normally do not alter the aggregate balance but are more often used for transferring money between budget accounts or for selling real property which must be specifically approved by parliament each time. In practice, the Finance Committee rarely rejects requests for adjustments. When there is a need to appropriate new money during the year to meet unforeseen expenditures, the Finance Committee accepts or rejects the request and the additional spending is then bundled into the supplementary budget at the end of the year.

If new legislation is passed during the year, it will most often contain temporary provisions authorising expenditures until the next fiscal year. The Finance Committee does not need to authorise such expenditures specifically.

The Finance Committee is also authorised to approve the agreements with local and regional governments in a similar manner.

On the second day, there is a general debate on the conclusions of the budget negotiations and a final vote is taken on the budget as a whole. Like many other aspects of the Danish budget process, there is a tradition of consensus that all the established political parties – both government and opposition – vote for the budget.

Parliament's final vote on the budget normally takes place at the middle or end of December. The enacted budget takes effect once it has been signed into law by the Queen and published by the government.⁴

2.3. The political negotiations to approve the budget

As noted above, the government must negotiate with other political parties in order to secure majority support for its budget proposal. Indeed, there is the tradition that once a majority has been secured, all “established” political parties vote for the budget proposal in the end, whether or not they are part of the majority.

Over the years, the specific contents of the original budget proposal have contained various elements for these negotiations:

- The government may include provisions in the original budget proposal specifically for the purpose of being the subject of negotiation.
- A popular measure which the government would intend to introduce in any case may be excluded from the original budget proposal specifically for the purpose of being negotiated into the budget.
- There may be “hidden” reserves in the original budget proposal in order to finance agreements reached with other parties in parliament.
- The budget may not contain the specific means to finance a new initiative. The financing may appear as unspecified savings or new revenues to be decided upon during the negotiations. In other words, the other parties in parliament will have to be part of the agreement to finance a new initiative.
- The budget is not only seen as a vehicle for appropriating funds but also as the prime policy instrument of the government. As a result, a number of substantive policy issues may be negotiated during this process whether or not they have any fiscal impact.

The process of parliamentary negotiations is a continuation of a long stream of budget talks. As noted before, there are a number of features such as multi-year funding agreements and minority governments that force this long series of negotiations. It is interesting that the government makes no attempt to secure a majority for its budget proposal prior to its introduction in parliament.

Parliament is proud that the “price” for its approval has gone up recently. This means that the government has had to make greater concessions (increased spending) than in previous years in order to gain support for the budget.

Following the second “First Reading” of the budget in October, the negotiations begin in earnest. There are four main actors in these negotiations:

- The Minister of Finance who co-ordinates the negotiations on behalf of the government. An official of the Ministry of Finance is present at all negotiations. The Ministry of Finance is often directly involved at the beginning and end of the negotiations. The Minister of Finance would also involve the Cabinet Economic Committee.
- The sectoral ministers who are generally the “front-line” negotiators on behalf of the government in their respective sectors.
- The senior representative of each political party in the Finance Committee (finance spokesperson) who plays a co-ordinating role among the party's senior members in the different sectoral committees and is often directly involved at the beginning and end of the negotiations.
- The senior member of each political party in each sectoral committee of parliament who is generally the “front-line” negotiator on behalf of his/her party in the respective sectors.

It is noteworthy that the Finance Committee itself has practically no role in the negotiations in formal terms.

The negotiations tend to operate in three waves. At first, the Minister of Finance and the “finance spokespersons” of each political party will meet and set out their negotiating agendas. In the second wave, the negotiations become sector-based. The final agreement is in fact a series of smaller agreements. Demands on the government in a specific sector are to be resolved by that respective minister in line with his/her mandate from the Cabinet Economic Committee. All the negotiating elements listed above come into play. The government may have withheld funds for programmes in its original budget proposal specifically for them to be “negotiated” into the budget at this stage. In other cases, a sectoral minister may have to make reallocations from other programmes in his/her ministry in order to finance the demands on the government. In most cases it will be a combination of the two. A sectoral minister may also have to make non-financial concessions. His/her negotiating partners will generally be the ranking member of each party in the respective sectoral committee in parliament. In the third and final wave, the negotiations become centralised again with the Minister of Finance and the “finance spokesperson” of each political party. Outstanding issues from the sector-based negotiations are resolved. It is difficult to generalise as to where the force of the negotiations takes place. In some years, it will be in the sector negotiations whereas in others it will be in the centralised negotiations at the end.

The end result of these negotiations is a series of amendments ahead of the third and final reading of the budget as discussed in the previous section. A supplement to the budget is also printed, detailing the agreements reached.

While the parliamentary process looks open-ended and is in essence serving only to increase spending, there are forces that encourage budget restraint. Most important is the *Denmark 2010* programme which calls for budget surpluses and limited growth in public consumption. As noted previously, this programme enjoys support across the political spectrum and has been supported by successive governments. Politically, it would therefore be difficult for any party to be seen as “too” profligate.

2.4. Conclusion

The parliamentary phase of the budget process is quite active in Denmark due to the government’s need to secure a majority for the passage of its budget proposal. Much of this activity, however, takes place outside the formal structures of parliament.

Due to the broad political consensus on spending, the parliamentary process operates in a responsible manner and does not do serious harm to overall fiscal discipline. Rather, it helps the long process of consensus building that generally extends beyond the government of the day. In this respect, parliament’s involvement should be viewed as a success.

Parliament’s role in holding the government to account could be strengthened. Discussions are ongoing to create an independent arm of parliament to help with overall budget policy including costing amendments and policy changes. Also, as the government moves to a greater focus on outcomes and outputs, parliament should take an active interest in the goals outlined and the resources assigned to the goals. Currently, performance reports are not used by parliament, and the reports that are issued do not accompany the budget documentation. Also, the agreements with regional and local governments – which account for a significant portion of central government spending – are only lightly reviewed by parliament. Given the importance to general government spending, parliament may wish to create a more rigorous review in these areas.

Finally, parliament may wish to review its internal structures. An early vote on the total level of aggregate expenditure would set an overall limit for the subsequent negotiations, but this may be impractical given Denmark’s political environment. Also, a review of the respective roles of the Finance Committee and the sectoral committees and how they communicate with each other may be in order.

Box 9. National Audit Office

The National Audit Office (NAO) is an office of parliament. Parliament has no other investigative or audit body. The NAO is not a constitutionally mandated body but is rather set up by a regular legislative act. The audit plan is drawn up by the NAO itself, although up to one-third of audits come from parliamentary requests or agreements. Audit reports are received by the parliamentary public accounts committee and ministers are held to account for the contents.

The NAO conducts both traditional financial compliance audits and performance/value-for-money audits. The mix of financial and performance/value-for-money/management audits has changed over the last decade as the performance audits now account for 40-50% of all audits performed. There are 250 people on staff, and the mix of professional background is moving away from pure accountancy to policy evaluation disciplines, as is the case in many OECD member countries. Asked to generally characterise the findings of performance reports, staff indicated that documentation and processes are mostly in order, but that the formulation of goals and objectives is difficult and problematic. As the NAO moves towards performance audits, it is fully supportive of efforts to use accruals in the reporting and budget processes.

There has been a move recently to create internal audit arms in ministries and agencies. There are no government-wide requirements for internal audit offices; rather they have been set up on an *ad hoc* basis through agreements between ministries and the NAO. The internal audit offices are supervised by the external audit body (NAO). Internal audit offices principally focus on financial auditing.

3. Budget implementation and management issues

3.1. Introduction

Budget implementation and management in Denmark is characterised by a high degree of decentralisation and flexibility. This part of the paper reviews five aspects of budget implementation and management: budget appropriations, organisational structure, human resource management, financial management and reporting, and performance management.

3.2. Budget appropriations

There are six types of appropriation in the Danish budget:

1. for operating expenditures;
2. for operating expenditures (enhanced flexibility);

3. for capital acquisitions;
4. for transfers (mandatory, prescribed by law);
5. for transfers (discretionary);
6. other appropriations.

Agencies generally receive one appropriation (type 1) to fund their operating expenditures, with a sub-limit for salaries. These are global amounts with no further subdivision for individual items of expenditure. Agencies can carry forward unused appropriations without limit. Agencies can also borrow up to 2% against future appropriations (but not more than DKK 10 million). An agency can be in deficit for one year within the limit. The borrowing facility is considered an “emergency” measure and is very rarely used. It was introduced because there was a tendency for agencies not to spend all of their appropriations since they feared exceeding them, and thereby accumulated unused appropriations.

Agencies that have significant revenue from user charges or sales are covered by a different appropriation (type 2). This entails one appropriation covering both their salaries and other operating expenditures and allows enhanced possibilities for borrowing against future appropriations. Under this appropriation, an agency can be in deficit for three years rather than only one year.

Both of the previous appropriations are based on the concept of net budgeting, although they apply most to type 2 in practice. If an agency is able to increase its user fees and sales by providing additional services, it can hire additional staff and incur additional operating expenditures in that regard.

Agencies receive a specific appropriation to finance capital acquisitions (type 3). This can be carried forward to the next year in accordance with the purpose of the appropriation.

Agencies receive an appropriation for each transfer programme that they manage. There are two types of appropriation for transfer programmes. If the programme is of a “mandatory” nature and governed by the eligibility criteria established in separate legislation, then the agency can spend money in line with the provisions of those laws with the amount in the budget only considered as an estimate (type 4). If the transfer programme is of a discretionary nature (grants, for example), the amount in the budget is the limit for expenditure (type 5). Such transfers can be carried forward to the following year in their entirety.

The last type of appropriation is a residual category for items that do not fit any of the above categories. It is not possible to carry forward or borrow against this type of appropriation. In practice, it is a small category mainly used for discretionary transfers where the possibility to carry forward is not needed.

The budget as enacted by parliament may also contain specific restrictions for individual appropriations, for example mandating changes in programmes or minimum or maximum amounts for specific activities. The use of such restrictions is, however, rare in Denmark. It is not permitted to transfer appropriations between the different types without the prior permission of the Finance Committee of parliament. The appropriations are “permissive” in nature in that they authorise a maximum amount to be spent. It is not a requirement that all appropriations be spent.

There is no contingency reserve in the budget and no provisions for emergency appropriations. The existence of such known funds is believed to undermine effective budget implementation. All such requirements are to be achieved through internal reallocations within a ministry. Only in truly exceptional circumstances would the government seek to increase funding through a request to the Finance Committee of parliament.

Overall, the experience with Denmark’s flexible system of appropriations has been good. It is universally viewed as having enhanced resource allocation. The main concern would appear to lie with the fact that some agencies have built up over time relatively large amounts of accumulated carry-forwards. Responding to this without undermining the purpose of the carry-forwards is an acknowledged challenge.

As was discussed previously, it is also most notable how the Finance Committee of parliament responds in a very timely manner to requests for in-year adjustments.

3.3. Organisational structure

As in the other Nordic countries, Denmark has a long tradition of organising government on a ministry-and-agency basis. In principle, ministries conduct policy making and agencies conduct policy implementation. At present, there are 18 ministries and about 200 agencies. About 98% of all government employees are located in the agencies.

Denmark, however, takes a very pragmatic view on the division of responsibility between ministries and agencies, as opposed to the more rigid and clear-cut division as is practiced in some other countries employing this model of organising government.

First, the very nature of this organisational structure is very flexible. It is entirely at the discretion of the Prime Minister to create, abolish or merge ministries, and such changes are generally made at the time each new government takes office and can be quite substantial. This is considered an internal management function for the government and does not require legislative approval. The government also has considerable discretion as far as the organisation of agencies is concerned, although these are often prescribed by law.

Second, a minister is responsible for all actions taken in his/her ministry and its agencies in constitutional terms. He or she can therefore intervene at any stage in the operations of the agencies of the ministry. (It should be noted that ministerial intervention in individual cases is forbidden by law in the case of enforcement and regulatory agencies.)

In practical terms, this means that ministries have delegated various policy-making functions to agencies. It is not uncommon in Denmark for agencies to, for example, draft proposed laws in their respective spheres. Conversely, a ministry may issue direct instructions to an agency on matters of details that one would expect an agency to decide internally. In both these regards, it should be stressed that ministries and agencies are in continuous communication.

Third, a ministry and its agencies are all considered one “workplace” for human resource management purposes. This means that an employee can be transferred between the ministry and its agencies and transferred from one agency to another without restrictions. This greatly enhances labour mobility within a portfolio. This very pragmatic and flexible system of organising government into ministries and agencies would by all accounts appear to work well in Denmark.

It is most notable in Denmark that the minister is generally the only politically appointed person in the ministry. There are no deputy ministers or state secretaries, and politically-appointed special assistants to ministers are rare. The minister relies on his/her permanent secretary and his/her staff for assistance.

The permanent secretary is the senior civil servant in a ministry. All positions of permanent secretary are advertised publicly. There is no career system in Denmark and any person is free to apply, from within or outside government. In practice, most permanent secretaries come from the ranks of senior civil servants. Although permanent secretaries are tenured in Denmark, their turn-over is much greater than such indefinite appointments would suggest.

The respective minister is formally responsible for hiring permanent secretaries. There is no independent review procedure. A cabinet committee composed of the different coalition partners and chaired by the Prime Minister must however be “consulted” before such decisions are made.

Each agency is headed by a director-general. The hiring procedure is the same as that for permanent secretaries. Once hired, the directors-general report to the permanent secretary of their parent ministry. Most directors-general sign performance contracts and performance pay contracts with their respective permanent secretary. This is discussed further below.

It is acknowledged in Denmark that the quality of both permanent secretaries and directors-general is generally very high. There are several cases of directors-general being removed from their positions for poor performance, which reinforces that point.

Boards of directors for agencies are not widely used in Denmark. In the cases where they exist, they are usually composed of representatives of the relevant interest groups affected by the operations of the agency, and they act only in an advisory role.

3.4. Human resource management

The recruitment, hiring, and dismissal of staff are the responsibility of each respective agency, and this has historically been the case. Pay and related issues, on the other hand, have traditionally been the responsibility of the Ministry of Finance. Despite recent reforms to introduce a degree of decentralisation, pay and related issues remain largely centralised in Denmark.

All positions in government are advertised publicly and any person may apply, from within or outside government. As noted above, there is no career system in Denmark. Most positions – especially as they become more senior – are nonetheless filled from within the government. Positions are filled from among the applications received according to criteria established by each respective agency. Staff is either hired on a permanent basis or on a fixed-term basis. In recent years, there has been a government-wide policy to hire increasingly on a fixed-term basis in order to increase mobility and renewal in the public sector.

As noted above, pay and pay-related issues are conducted on a largely centralised basis despite recent reforms. The current system operates on a three-level cascading system of collective bargaining.

In the first instance, national negotiations take place between the Ministry of Finance and several national associations of public sector employees (unions). These are the “main” negotiations. They focus on the level of pay increases in each pay grade, the general framework for the placement of individual positions into pay grades, and benefit issues such as annual leave, sick leave, maternity and paternity leave, etc.

In the second instance, the Ministry of Finance conducts negotiations with individual national unions – as opposed to their national associations. For example, there is a national association of academic (university educated staff) unions; there are also national unions for each specific profession within the national association of academic unions. The focus of these negotiations is to set more specific frameworks for the placement of individual positions into pay grades, i.e. narrowing down the grading criteria from that established in the first-level negotiations. In some instances, the Ministry of Finance has

Box 10. **Civil servants vs. contract employees**

Government employees in Denmark are either hired as civil servants proper, or as collective agreement (contract) employees. A policy has been in place for some time to reduce the share of employees hired as civil servants and to limit that designation to only the most senior officials and to staff that “exercise the power of the state”. These include members of the armed forces, the police, the prison service, the courts and the Evangelical Lutheran Church (national church). All in all, it is estimated that only 15% of total government employees will be designated as civil servants when this policy is fully implemented.

The main difference between the two groups is that civil servants are employed in accordance with the Law on Public Servants which contains unique rights and obligations for them, whereas contract employees are hired on essentially the same conditions that govern the private sector labour market. Civil servants cannot strike whereas contract employees can. Civil servants enjoy a defined benefit pension plan whereas contract employees enjoy a less generous defined contribution plan. Civil servants enjoy special administrative protection from dismissal. In cases where civil servants are dismissed, they enjoy generous severance payments – for example, if a tenured civil servant is dismissed on redundancy grounds (i.e. not due to cause), he/she shall receive three years full salary as payment. The dismissal of contract employees is in line with that practice in the private sector and no special severance payments are made.

delegated the negotiating authority for these negotiations to specific ministries and agencies.

In the third instance, negotiations take place at each agency between it and the local bargaining units of each individual national union. The focus of these negotiations is to finalise the criteria for the grading of individual positions into the national pay grades and to negotiate whether an element of performance pay should be introduced and, if so, what the criteria for awarding performance pay should be.

This three-fold cascading system of negotiating pay and pay-related issues was introduced in 1998. Its objective was to introduce a degree of flexibility in individual agencies, because the central agreements which were uniform across the entire state sector did not recognise local circumstances in individual agencies in any way. The degree of actual flexibility, however, is very low despite these reforms, and the system can be characterised as almost entirely central in nature. It is clear that Denmark will have to take bolder steps in decentralising pay and pay-related issues if it wants to increase the degree of local pay creation in agencies.

Performance pay is an established part of the compensation of directors-general of agencies. In other areas, it is of a more nascent nature. Agencies are permitted to supplement the negotiated wages as described above with performance pay. Practices vary from ministry to ministry. They are the subject of negotiations with unions and, more often than not, this results in little discretion to managers in awarding performance pay. It is not uncommon for all staff to receive performance pay in accordance with very basic criteria.

Box 11. Uniform public sector and private sector pay trends

Denmark has a system in place to ensure that average public sector pay develops in line with that in the private sector. This is accomplished by the so-called “adjustment programme”. If state sector wage trends do not collectively follow the private wage trend, the adjustment programme will ensure that the state wage is raised during the following period. Conversely, a state sector wage trend that collectively exceeds the private sector wage trends will entail the reduction of state sector wages during the following period. Due to the adjustment programme, state sector wage trends will therefore always be adjusted to the private sector wage trend over time.

Finally, the Ministry of Finance maintains numerical controls on the number of positions in the three highest layers in an organisation – in a ministry this would be the permanent secretary, the deputy permanent secretary (secretaries), and heads of divisions. In agencies, this would be the director-general, deputy director(s)-general and heads of divisions. Such numerical controls were in place for all positions until the 1980s. The stated purpose of the current controls on the three categories is to limit the proportion of senior executives in the public sector.

3.5. Financial management and reporting

Denmark employs a modern financial management and reporting framework. Denmark operated a full accrual accounting and budgeting system from the 1930s to the 1950s. Since then, the system has steadily migrated towards a modified cash-basis system although several transactions are currently treated on an accrual basis, most notably employee pensions and interest on the public debt. During the period 2003-04, a pilot project is being conducted in several agencies to introduce full accrual accounting. It is envisaged that full accrual accounting will be implemented on a whole-of-government basis starting in 2005. At that time, it is envisaged to introduce

full accrual budgeting on a pilot basis. In 2007, it is then planned to introduce full accrual budgeting on a whole-of-government basis.

All government entities have a number of bank accounts in a commercial bank that was contracted by the Ministry of Finance following a competitive bid to administer the government's receipts and payments. All deposits to the government are made to this bank and all payment requests go to this bank. All accounts are swept overnight and deposited with the government's single account at the central bank.

A monthly disbursement schedule is made for appropriated operating expenditures to all ministries and agencies. An incentive based system is in place to better manage the operating expenses of larger agencies. In those circumstances, the appropriation for operating expenses is divided equally among the months – i.e. one-twelfth each month. An agency that spends more than one-twelfth each month pays interest on the difference. An agency that spends less than one-twelfth each month receives interest on the difference.

It is not envisaged to introduce a capital charging regime with the accrual accounting and budgeting reforms. It should be noted, however, that an agency of the Ministry of Finance supplies much of the office accommodation used by government entities and that it incorporates a rate of return on assets employed in setting its rental fees for ministries and agencies.

The government's apportionment schedule, daily statement of receipts and outlays and monthly statement of receipts and outlays are internal to the government. The government makes a comprehensive statement on public finances every four months. This includes a statement of receipts and outlays. The government's annual financial statement is presented in an un-audited form by the Ministry of Finance in mid-April each year, i.e. 3½ months following the end of the fiscal year. The audited annual financial statements are presented in mid-June, or 6½ months following the end of the fiscal year.

The government move to accrual accounting and budgeting is proceeding at a measured pace and recognises the need for buy-in from all stakeholders. The government's cash management practices are exemplary, especially the incentive system applied for operating expenditures. The lack of a capital charging regime is largely explained by the existence of a central agency that manages much of the government's real assets. The government's in-year reporting on the implementation of the budget is relatively sparse. According to the standards recommended in the *OECD Best Practices for Budget Transparency*, Denmark should report more frequently during the year. The comprehensiveness of the government's trimester reports is, however, commendable. It should also be a matter of urgency to reduce the time delay in the presentation of the government's audited annual financial statements – presenting them three months following the end of the fiscal year is a reasonable goal.

3.6. Performance management

Performance management arrangements are in place in all ministries and agencies in Denmark. Performance management consists of the following three main instruments:

- A **performance contract** between a ministry (permanent secretary) and an agency (director-general) for the production of the agency's outcomes or outputs.
- An **annual report** showing the results achieved against those specified in the performance contract. These results are audited by the National Audit Office.
- A **performance pay** system linking the salary of the director-general of an agency with the results achieved against those specified in the performance contract.

The Ministry of Finance issues broad guidelines on performance management, and each ministry is required to put in place an official "strategy for efficiency policy" detailing what specific actions it will take in implementing performance management and related measures in the respective ministries. The Ministry of Finance grants a great deal of discretion to each ministry in setting its individual performance management policies, and there is indeed much variety of arrangement from one ministry to another. The Ministry of Finance views the "ownership" of the respective ministries to be of paramount importance in this respect. Evaluations of past efforts have been extensively used in order to improve successive performance management reforms.

The performance contracts were introduced in the late 1980s on a pilot basis but have now become an established feature of the management of the Danish public sector. They contain the mission statement of the agency, a review of the agency's operating environment, the duration of the contract (normally for four years, updated annually), a description of the outcomes and outputs that the agency is to deliver, and measurable targets for each.

The overall quality of the performance contracts has improved over time but the quality of the outcome/output descriptions is still viewed as leaving room for improvement, sometimes significant improvement. The performance contracts tend to focus on the "inner life" of agencies, i.e. internal processes rather than external outcomes and outputs. Also, the comprehensiveness of the outcomes/outputs descriptions was cited as one of the key problems, i.e. agencies would focus on those aspects of their operations which lent themselves to measurement while ignoring or downplaying other less measurable aspects of their operations. Furthermore, the targets contained for each outcome/output may not be set at a challenging level, as evidenced by the very high rates of target achievement. This suggests that ministries are not using the performance contracts as effectively as they could.

The agency annual report shows the results achieved against targets for all specified outcomes/outputs and is published three months following the end of each fiscal year. The format of these reports has changed considerably over time. They used to be long narrative reports which in turn were not widely read. In order to increase the user friendliness, the Ministry of Finance decided that the annual performance report should be integrated with the annual financial reports of the agencies. A statement of outcomes and outputs is now to be included as one of the statements, alongside the income statement, the balance sheet and the cash-flow statement; it is a very condensed statement showing results against targets with practically no discussion.

The performance pay system for directors-general was introduced in the mid-1990s. At first, the criteria for performance were to a large degree separate and distinct from the contents of the performance contracts. Now, the criteria for performance pay are based on achieving the targets specified in the agencies' performance contracts. A weight is placed on the achievement of each element of the contract. In addition, one-fourth of the performance pay is based on the management and leadership skills of the director-general. This is assessed by the permanent secretary of the respective ministry. The permanent secretary can also add or subtract an amount on a discretionary basis so that performance pay can total up to 25% of the annual salary.

Danish officials emphasised that the performance management system was not truly viewed as a contractual arrangement but rather as providing a formal structure for ministries and agencies to discuss the results to be achieved by each respective agency and for the ministry to highlight areas it viewed as especially important and urgent. The performance management system has also introduced a more results-oriented culture.

Due to the great information asymmetry between ministries and agencies, the agencies will tend to have the upper hand in these discussions. Ministries do, however, play an active role in this process although this varies from one ministry to another. Some ministries have established the position of "performance controller", responsible for setting the objectives and targets of agencies and for monitoring their implementation throughout the year with regular meetings.

The general performance management tools are not used in the annual budget process by the Ministry of Finance or parliament to any meaningful degree. They can in essence be viewed as a communications device between ministries and their respective agencies.

3.7. Conclusions

This part of the paper has reviewed budget implementation and management practices in Denmark. As has been noted in the individual

sections, these are generally of a very high standing. The system is predicated on a high degree of trust between the Ministry of Finance and spending ministries, and in turn between spending ministries and their respective agencies. A number of unique contextual factors in Denmark make this system possible.

There are three areas where improvements can be made. First, the pay and pay-related issues of the human resource management system are very centralised in relation to other management systems in Denmark. This impairs the management of agencies. Special attention should be paid to overcoming the obstacles to greater decentralisation in this area.

Second, fiscal reporting should be increased in line with the provisions of the *OECD Best Practices for Budget Transparency*. This applies especially to increased frequency of in-year reporting and a shorter time lag for the publication of the audited annual financial statements.

Finally, performance management poses the same challenges in Denmark as encountered in other member countries that have embarked on similar reforms.

Notes

1. There is another committee – the Cabinet Co-ordination Committee – which is relevant for budget policy. It is chaired by the Prime Minister and serviced by the Office of the Prime Minister. The division of responsibility between the two is not fixed and one committee will tend to enjoy pre-eminence in any given government. This paper will make reference to the Cabinet Economic Committee only, but it may be the case that both committees are involved in the respective decisions.
2. For further information on the *Denmark 2010* programme, see *OECD Economic Surveys: Denmark – Volume 2003, Issue 10* (July 2003), OECD, Paris.
3. Depending on the composition of parliament, all parties in parliament are not always represented in the Committee. Normally this is resolved by “gentlemen’s agreements”.
4. The budget enjoys privileged status *vis-à-vis* other legislation. According to the constitution, a certain number of members of parliament can normally ask for postponements in parliament’s discussion of a bill, or ask for a public referendum on an act. Neither of these provisions is applicable to the budget or related acts.

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Twenty-five Years of Budgeting Reform

by

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The network of senior budget officials (SBO) was launched in 1980 as an *ad hoc* response to the budget stress that beset most developed countries in the aftermath of oil price shocks, high inflation, and economic stagnation. The long post-war expansion had come to a halt, but spending pressures did not abate, leaving national governments with large structural budget deficits. Voter sentiment and fiscal realities precluded political leaders from easing their country's budget plight by boosting taxes. Their only recourse was to take a stricter line on spending, and they needed budget tools that could do the job for them. Meeting for the first time under OECD auspices, senior budget officials perceived that they faced similar predicaments and could learn from the experiences of member countries.

When they met, budget officials brought a distinctive perspective to SBO, for they bridge the political and administrative domains of government. Every budget is a statement of policy by elected leaders and an administrative plan for the ongoing operations of public programmes and agencies. Senior budget officials are brokers between these realms. They deal on a continuing basis with politicians and administrators, and they must be sufficiently agile to satisfy both constituencies. Most budget directors are drawn from the ranks of senior civil servants, but to succeed they must be alert to political demands and perspectives. This quality – managerial capacity and political astuteness – has characterised both SBO delegations and discussions at the annual meetings.

The mystery of SBO is not that it became a regular event, but that it took so long for budget officials to convene. Before SBO, budget officials lacked an international forum for exchanging views and discussing recent developments. They probably were among the few governmental professionals who did not meet periodically. This lack was due, I believe, to an inherent characteristic of budgeting that has had an impact on the content and conduct of SBO meetings. Budgeting is an inward-looking process in which officials and politicians communicate within the confines of the government. Each bureaucratic echelon talks about spending matters to the levels immediately above and below it; ministers and department officials converse throughout the year with their own budget staffs and during the budget season with the central budget office; senior budget officials discuss financial and programme issues with cabinet members and parliamentarians. For the most part, budgeting is government talking to itself, with outside interests eavesdropping and occasionally joining in. Budgeting has the village quality so well described a

generation ago by Helco and Wildavsky in their splendid study of Britain's budget practices. Each government has its particular language for these conversations, embedded in forms, classifications, and rules of the budget process, as well as in the behaviour, roles and relationships of those who make and implement budgets. There are universal elements in the language of budgeting, but every country has its peculiar ways and terminology, and these reinforce the insularity of budgeting.

Having met for the first time a quarter of a century ago, budget officials discovered that they share common interests and concerns. Breaking down the insular perspective of budgeters has not been easy, however, and did not occur immediately upon the convening of SBO. In its first decade, SBO typically began each meeting with descriptions by delegates of practices and innovations in their country. Although the presentations rarely generated substantive discussion, they encouraged budget officials to be more open in discussing budget practices. A generation later, some delegates are still guarded in sharing experiences and appear more willing to describe new reforms than to explain how past innovations have actually worked. Others, however, come to SBO eager to discuss successes and failures and to trace the evolution of budget practices from one generation of reform to the next.

Over time, SBO has secured a niche on the calendars of most OECD member countries and has become an annual routine, like the preparation of the budget. As routine, there is risk of the discussions going stale, of repeating that which was taken up in the past. There is a need, therefore, to freshen the discussion, both by pointing to future issues that budget officials may face and by broadening the scope to consider matters that have generally been outside the SBO agenda. I hope this paper contributes to invigorating future SBO meetings.

The 25th annual meeting is an appropriate occasion for assessing the practice of budgeting and for reflecting on the challenges and opportunities that may impact budgeting in the decades ahead. I am honoured to have been invited to provide a forthright assessment of SBO, and hope that my somewhat critical observations do not detract from due consideration of the important issues facing budgeting. In preparing this paper, I have benefited from attendance at more than half the SBO meetings, review of almost all the agendas, and perusal of many SBO documents accumulated by me over the years. This paper is one observer's musings on the evolution of budgeting, as viewed through the SBO framework. Other observers would undoubtedly draw different lessons from the same material.

In viewing contemporary budgeting through SBO, I am mindful that the picture which emerges is incomplete. Over the years, SBO has evolved from an annual meeting into a platform for year-round activities on the functioning of budget systems. In fact, SBO has nurtured four sub-networks, each focusing

on a particular facet of budget practice. One network deals with accounting issues and links budgeting with other financial management tasks. Another addresses the challenges of orienting budgeting (and public management generally) to performance and results. A third recognises the growing role of national parliaments in budget policy, and the fourth frames budgeting within the organisational structure of government. From time to time each network feeds into the SBO, but each has its own network of practitioners and scholars. SBO has also encouraged and sponsored a compilation of a comprehensive database on budgeting practices, as well as in-depth holistic reviews of budgeting in particular countries.

Paradoxically, SBO's greatest accomplishment has been to launch these networks while keeping the high-level meeting for themselves. They meet once a year, but research and dissemination continues throughout the year.

Section 1 of this paper provides the context for SBO by comparing the budget performance of OECD member countries before and after the convening of these annual meetings. The contrast between the two periods is striking, for there has been a fundamental reorientation of budgeting from expansion to constraint. While this shift has been spurred by SBO, changes in political and economic conditions have been more important factors than the machinery of budgeting. Budgeting has been the dependent variable; it has been remoulded from time to time to fit changing political preferences and economic circumstances.

Section 2 considers budgeting from the vantage point of the SBO agenda. It examines the main topics discussed at the meetings, and also reflects on why some important issues have been outside SBO's purview. My not surprising conclusion is that when they meet, budget officials converse on the matters that preoccupy them on the job – the techniques and processes of budgeting. These are their daily concerns, and these are what they want to learn about from counterparts in other countries. This confined agenda comes at a cost, however, for it pulls them away from the political, economic and social conditions that influence both the behaviour of budget makers and the outcomes of the process.

SBO shows evidence of breaking out of this confined agenda, though at a slower pace than this writer would like. The comprehensive country reviews are especially noteworthy, for they provide a template for taking a broad view of the forces that shape budgeting in each country.

Section 3 turns to the basic functions of budgeting and questions whether governments are adequately suited to perform essential tasks. The key functions considered here are:

- establishing a fiscal framework that is sustainable over the medium term and beyond;
- allocating resources to programmes on the basis of government priorities and programme effectiveness;

- operating government and delivering public services efficiently;
- assuring that the budget reflects citizen preferences; and
- assuring that spending units are accountable for their actions.

Some of the conclusions presented here are drawn from previous SBO (and other) work, but the focus is on overall budget capacity, not on specific reforms.

The questioning tone of this paper's perspective has been influenced by the "Beyond Budgeting" movement that has spread from the business sector to government. This movement regards budgeting as an impediment to strategic decision making and argues that firms and governments are impeded by the routines of budgeting from managing themselves effectively. Although this movement has not significantly influenced budget theory or practice, it has raised important questions that should not be ignored in thinking about the future of budgeting. Interest in the Beyond Budgeting concept has been sparked by a sense that although the process has undergone numerous reforms, fundamental limitations persist. Despite repeated efforts to uproot incrementalist tendencies, budgeting serves better as a means of continuing the past into the future than as a means of shaping the future directions of government or society. It may be that the agenda of budget reform will have to be bolder and broader if it is to significantly alter the way the process is used or the results produced.

1. Budget trends: 1960-2000

In 1930, during the bleak years of the Great Depression, John Maynard Keynes, the 20th century's pre-eminent economist, predicted in a mass circulation magazine that our grandchildren will enjoy economic affluence that far surpasses anything previous generations had experienced. Keynes' prediction was based solely on the arithmetic of compounding: if developed economies were to grow at a rate of about 2% per year, output would double every generation or so. Keynes' prescience was not fulfilled until the post-war period, but actual economic growth in OECD member countries turned out to be vastly higher than he had foreseen. Real GDP averaged almost 5% annual growth during the 1960-73 period, the earliest years for which the OECD publishes such data. With this growth rate, economic output in 1973 was double what it had been in 1960. Inasmuch as growth was even more buoyant in the immediate post-war period, it is likely that economic output in OECD member countries was at least four times greater in the mid-1970s than it had been a quarter of a century earlier.

The economic boom fuelled and financed a vast expansion of government. Total government outlays in the OECD community rose from an average of 28% of GDP in 1960 to almost 39% in 1980, SBO's first year. This one-half percentage

point increase per year in spending as a share of GDP is truly extraordinary in view of the post-war economic boom. Government spending in OECD member countries averaged at least six times more in 1980 than it had done 30 years earlier. Although part of the spending increase was due to the rise in the prices of goods and services produced by government relative to the overall price level, most of the spending increase was due to a real rise in public spending. The post-war era offers strong validation of Wagner's Law, the proposition that, as it becomes more affluent, a society spends a rising share of its wealth on public goods and services. With affluence, citizens demanded better roads, more teachers, additional educational services, expanded health care, stronger environmental protection, and other services. With the exception of national defence, virtually all sectors gained resources.

In the aftermath of depression and war, citizens in OECD member countries coveted economic security, and national governments responded by establishing or enlarging various income support schemes. More than half of the total rise in relative public spending was in social security transfers, which soared from 7% of GDP in 1969 to almost 13% two decades later. The resulting change in the composition of public expenditure greatly complicated the task of managing public finances. With a rising portion of the budget spent on entitlements, OECD member countries could not as easily adjust spending levels to changes in their fiscal position.

The advance in public spending was broad and relentless; in most countries, it rose almost every year. Spending increased in good times when resources were plentiful and often also increased when the economy weakened and the budget was tight. It increased in good times because government could afford to spend more, and in less favourable circumstances because government felt obliged to counter the shortfall in economic performance. Spending grew because government took on new commitments, and because of the momentum of old commitments.

Although an expanding economy fed more money into government coffers each year, revenue increases often did not keep pace with escalating demands for public goods and services. Governments frequently boosted tax rates to finance additional spending. Taxpayer resistance was low as long as disposable (after-tax) income was also rising. Consumers had more money to spend on their individual wants; governments had more to spend on collective wants.

Budget processes were contoured to serve the new political and economic realities. Some changes were formal, but the most important ones were behavioural. Budget officials relaxed the input controls they had maintained for decades and consolidated line items into broader categories that gave spending units greater flexibility in using appropriated funds. The central budget office still cast a critical eye on spending demands, but it also joined

the search for ways to enhance public services. In a few countries, efforts were made to reorient budgeting to the objectives and performance of government. Programme budgeting, planning programming budgeting systems and other reforms were attempts to adapt budgeting to the active, enlarged role of government. They failed for a variety of reasons, one of which was that budget offices were ill prepared to change their own behaviour. Yet, even though they fell short of their lofty ambitions, the reforms encouraged budget offices to move away from a control role and to explore means of using the machinery of budgeting to improve government performance.

A more successful transformation occurred in the fiscal posture of government. At the start of the post-war boom, most OECD countries gave lip service to the balanced budget rule; by the end (in the mid-1970s), most had an accommodating posture that allowed government to spend more than it took in when justified by economic conditions. Balancing the economy through fiscal policies that promoted growth, stable prices and low unemployment was regarded as more urgent than balancing the budget. The budget became a pliable instrument of fiscal policy, with built-in stabilisers and discretionary tax and spending decisions shaping each year's outcome. At first, deficit spending was deemed to be justified when the economy was weak; over time, deficits came to be regarded as appropriate whenever actual or projected output was below the economy's potential. Many OECD member countries devised new fiscal tools to determine the appropriate size of the deficit. These typically distinguished between structural deficits that occur when governments spend more than a fully-employed economy would yield in revenue, and cyclical deficits which result from the economy operating below potential. As long as the economy continued on an upward course, public debt was a stable or declining share of GDP. The fact that economic growth persisted was evidence enough that modest deficits do not damage the economy. Quite the opposite, spending in excess of revenue enabled society to make fuller use of economic capacity, gave government additional resources to finance programme improvements, and enhanced the wellbeing of citizens.

The expansion in government did not crowd out private enterprise. Business boomed alongside government, and the notion took hold that each owed a good part of its success to the other. Markets supply government with money, and government establishes favourable conditions, such as an educated workforce and a fair distribution of income, for business to flourish. Government employment in OECD member countries rose 2.7% a year during the 1960-73 period, but industrial employment also advanced, though at a slower pace of 1.4% a year. Unemployment was low, averaging only 3.2% during the entire period, and productivity gains were high, with real GDP per worker rising 3.8% a year. Consumer prices advanced 4% a year, but real interest rates were very low, less than 2% in most of the countries for which data are available.

The halcyon years came to an abrupt end with the oil shocks of the 1970s. Economists conventionally mark 1973 as the close of the post-war boom. Real GDP growth slipped to 2.8% a year during the 1973-79 period, and other vital economic signs also deteriorated. Unemployment averaged 5% a year, and inflation (as measured by changes in consumer prices) exceeded 10% a year. Budget deficits climbed to 2.5% of GDP, still a manageable level, but a harbinger of worse fiscal outcomes in subsequent decades. Governments could justify deficit spending to spur their sluggish economies, but they could not muster sufficient financial resources or political support to do so. As stagnation set in, many questioned the standard prescriptions for combating economic weakness. The post-war Keynesian hegemony showed deep fissures, with dissidents challenging the efficacy of demand management and arguing that fixed rather than elastic fiscal targets and smaller tax burdens were needed to restore economic vigour. Changing course was difficult, however, for the budget model they used was asymmetrical. It was far easier to increase spending than to cut it, and easier to incur a deficit than to curtail it.

These adverse conditions were the backdrop for establishing SBO. In step with the times, early SBO meetings grappled with managing cutbacks and shifting the budget from an incremental to a decremental path. Delegates shared experiences, such as Japan's scrap-and-build policy that required spending initiatives to be offset by cutbacks, the "reconsideration" procedures introduced in the Netherlands to review existing programmes, Sweden's "cheese slicer" that pared 2% a year from operating budgets, and the United Kingdom's experience with cash limits that set hard constraints on spending. The new mood was summed up in a Canadian government report that introduced an "envelope" system for managing public expenditures and urged that budgeting be reoriented from a process that uses programme analysis to rationally expand government into a rationing system that constrains the size of government.

Viewed in the light of its original emphasis, SBO has had modest success. It has not curtailed deficits, which were higher in the 1980s than in the previous decade and, as Europe's difficulty in enforcing the Stability and Growth Pact demonstrates, still persist at an elevated level in quite a few countries. Government spending has stabilised, however, and is now only slightly higher as a share of GDP than it was two decades ago. Trend data suggest that many countries practice "status quo" budgeting. Government commitments and public expectations rule out significant shrinkage in the boundaries of the welfare state, while persistent deficits and opposition to tax increases rule out major expansions in public spending. In many OECD member countries, budgeting has settled into a process of snipping existing programmes at the margins to make room for targeted enhancements. With spending neither growing nor shrinking significantly as a portion of GDP, budgeting has been oriented to extracting greater efficiency and performance from government agencies.

There are two main exceptions to status quo budgeting. One occurs when a government has a surge in revenue that exceeds normal incremental demands on the budget; the other occurs when a financial crisis makes it difficult to sustain incremental budget policies. The quality of budget institutions is particularly important in these circumstances, and the true test of the budget office's effectiveness may come when faced with these opportunities. When windfall revenues open the door to expansion, government needs a budget process that can sift through the options and select cost-effective policies; when crisis knocks at the gates, government needs the capacity to make hard choices and to scale back government commitments in a politically acceptable way. Leadership is essential in both situations, but so too is the machinery of budgeting. A robust process enables government to put expansionary funds to good use and to pare spending to acceptable dimensions.

2. The SBO agenda

There have been few surprises on the SBO agenda; most of the topics have been matters that budget officials deal with year after year. As might be expected, they have given repeated attention to the entitlements and transfer payments that now dominate the budgets of many countries, but they have not made much headway in establishing effective control of these expenditures. Every few years, SBO reflects on the timeframe of the process, yearning for a medium – or longer – term consideration of programmes and spending commitments, but unable to abandon the annual framework that drives the budget cycle. From time to time, they have grappled with off-budget accounts, state-owned enterprises, and other practices that are weakly regulated, if at all, through budget decisions. They occasionally are introspective and review changes in the role and operation of the central budget office and its relation to other governmental organs. Periodically, they get updates on developments in programme evaluation, performance measurement, and other innovations. One recent innovation has attracted considerable interest. Each year the OECD selects a member country's budget system for in-depth, critical review and discusses its findings at SBO in tandem with publication of a report on the country. These reports have consistently been of very high quality, and have covered legislative authority, financial management, and the overall performance of public management in assessing country practices. Interest in these assessments is reflected in the fact that countries now invite the OECD Secretariat to undertake a critical assessment.

Some topics have gained prominence in recent years. SBO now shows greater interest in the budget role and resources of the national legislature, and in linking budget work to accounting and other financial management operations. As already noted, SBO has established networks in these and two

other areas. The networks reflect not only a broader perspective but, more importantly, strong efforts to connect budgeting to other government activities that pertain to managing public money, such as legislative work and accounting practices. When SBO started, each country had its own budget conventions and rules; over the years, the differences have narrowed, largely because of pressure to standardise accounting practices. Although the cash basis still predominates, budget officials have studied accrual methods, as well as the relationship between budget statements and financial reports. SBO has given repeated attention in recent years to the performance management movement, especially the use of the budget to allocate resources on the basis of results. The performance and results network launched by SBO reflects the budget community's awareness that the management of public expenditure is an integral part of public management. This represents a fundamental reorientation in budgeting. When SBO was started, the prevailing view was that budget systems can be modernised independently of the management culture within which budgets are made and implemented. This perspective has been displaced by one that recognises the dependence of budgeting on overall managerial capacity.

The recurrence of certain issues lends support to the notion that there are no permanent solutions in budgeting. Entitlements will be a problem as long as budgeting is practiced, as will efforts by spending units to evade budget control. Deficits are a perennial issue, as are linking resources and results, and the timeframe of budgeting. These will still be on the SBO agenda 25 years from now, as might some issues that do not currently engage the interest of budget officials.

SBO is reform-minded, focusing on recent innovations in OECD member countries. Budget officials are genuinely interested in what counterparts in other countries are doing and why. There is usually an ample stockpile of recent innovations, and reformers are eager to display their new methods for others. Many budget officials aspire to make big, transformative changes, even though they usually settle for marginal ones. Their aspirations speak to an enduring characteristic of budgeting. Those who make and implement government budgets yearn for better ways to handle these chores. There is too much friction and not enough of the right kinds of information. Muddling through one year, budget officials know the next year will likely be as abrasive and difficult as the cycle just completed. They know that decisions are made with inadequate evidence on how money is spent or how much is needed. They strive to focus on the future, but are driven to short-term expedients that enable them to meet deadlines and patch up differences. They are powerful, but they also are aware of the limits of their power imposed by political realities and financial commitments or expectations.

Who in budgeting has not thought from time to time, “There must be a better way”? This sentiment is the wellspring of the endless, frustrating quest for innovation. Reform is the better way, or at least promises to be. It is the quest to transform budgeting into a more rational, less incremental process. And though it may lead to some new methods, most reform falls far short of the mark. The unending parade of reforms is strong evidence that budgeting is still wedded to incremental norms, that short-termism crowds out the longer run, that it is more important to get the work done on time than to get it right.

There are many reasons why budget reforms come up short, the most important of which may have to do with an over-riding need to complete budget work on schedule, no matter how inadequate the data are. Budgeting would be a more rational process if it were less essential, if politicians and officials had the option of gathering all the information they need to optimise public spending. Budgeting would pay more attention to results if it had sufficient time to measure results and feed the data into decisions; it would have a longer perspective if it were not bound by the 12 months of the fiscal year; and it might be less incremental if the decisions were taken by experts rather than politicians.

Budget reform must manoeuvre within boundaries that are largely fixed. The most limiting boundaries are political, temporal and informational. As formidable as these limits are, reform might make more headway if past reforms were systematically examined. Budget officials should strive to learn as much from the many past failures as they do from the relatively few successes. SBO gives much more play to the promise of new reforms than to the results of old ones. The old reforms just fade away, to be replaced by the next generation of innovations, which in many cases has the same objective as previous generations. Reforms come and go, but the quest to make budgeting a more rational process goes on.

SBO gives reform-minded countries a platform for presenting their new ideas; it should also encourage them to explain what they learned from past disappointments. SBO has an enormous stockpile of experience to draw from. Every area of reform is a fertile opportunity for critical analysis. The following are just a few of the many possibilities that may interest budget officials:

- Why has programme evaluation been useful at some times and in some places, but not in others? Why, for example, did Australia have more to show for its investment in evaluation than Canada?
- Under what conditions do fiscal rules, such as those promulgated by Europe’s Stability and Growth Pact and by fiscal responsibility laws, regulate the size of the deficit? Can these rules operate under adverse economic conditions?
- What is the experience of the countries that have introduced the accrual basis into budgeting? How has it affected the way resources are allocated and used?

- How do countries reconcile a multi-year framework with the annual budget process? Do they keep to the multi-year plan or remake the budget each year?

Addressing these types of questions would provide governments a firmer basis for deciding whether and how to restructure their budget practices.

2.1. SBO's non agenda

Budget reform is typically framed within the boundaries of the process: how will particular procedures or requirements be altered if one or another change is introduced? Budget reform is rarely considered within the broader context of government economic and social policy. Because of this confined perspective, much that has happened during the SBO years has been absent from its agenda. The effect has been to treat reform as a technocratic exercise, rather than a means of repositioning the process to better serve contemporary socio-political ends. Nevertheless, many reforms on the SBO agenda have been driven by the political and economic contexts of budgeting. When governments seek to impose fiscal rules, for example, they almost always have been influenced by concern over economic conditions. Similarly, when governments strive for better performance, they are responding to citizen concerns over the efficiency and results of government programmes.

During the past quarter of a century, commerce and culture have been increasingly globalised, making countries more interdependent and less in control of their own budget fate. Interdependence has not yet run its full course; by the time it does, matters that now are domestic will have been internationalised. Agricultural policy and social expenditure are two such issues, but certainly not the only ones. New transnational structures, such as the European Economic and Monetary Union, have been established and more are likely to emerge in the decades ahead. It is not far-fetched to foresee income redistribution defined as a regional or global issue, and for international courts to prescribe or proscribe particular expenditures. The Cold War has ended, allowing defence's overall share of national budgets to decline, but the scourge of terrorism has spread, putting future budgets and underlying socio-economic conditions at grave risk. The revolution in information technology has boosted efficiency in both business and government, and has taken much of the rote work out of compiling and implementing the budget. It also has opened the door to much greater transparency in budgeting, giving citizens access to data that were previously unavailable or withheld. In almost all member countries, the population is ageing and, along with it, the national budget as well. There will be less money in future budgets for programme initiatives. Budgeting risks becoming an accounting of past decisions rather than a means of making new ones.

Less dramatic, but certainly important, trends in the conduct of politics have affected budgeting. In most OECD member countries, citizens now have less trust and less confidence in government and its political leaders, and are less attentive to political matters. The ideal that the best and the brightest seek careers in the public service has faded, and making a career in government is less attractive to young people. Citizen disengagement has been accompanied by a vast increase in the number, activism and influence of interest groups and NGOs, which operate across all sectors and (in most countries) pay considerable attention to budget matters. Interest groups and NGOs vigilantly guard their interests, demand more from government, and campaign against cutbacks. Contemporary national governments also are pressured by global and local entities, and have less space for independent action than before. Under the banner of fiscal decentralisation, quite a few national governments have transferred money and power to regional and local authorities.

In most developed countries, the state has become the risk holder for society, sheltering citizens against the financial wounds of illness, old age, unemployment, disability, and other conditions that reduce personal incomes below a legally defined level. The pooling of risk via government has brought many advantages, including greater economic stability and a fairer distribution of income, but it has taken a bite out of budget control. As risk holder, the government's budget is swayed by social and economic developments that are largely beyond its control, especially within the frame of a single fiscal year. The transfer of risk to government has fed citizen expectations that public benefits are a matter of entitlement. High expectations and low trust in government create budget pressures with which political leaders have difficulty coping.

Although budgeting has been greatly impacted by changes that have unfolded over the past 25 years, SBO has not offered a window onto these developments. With few exceptions, it has tended to its own business, centred on the machinery of budgeting. This confined perspective may be due to the insularity of budgeting discussed earlier. The budget has, however, assumed the status of the pre-eminent policy document of governments. In the days of expanding government, substantive policy decisions could be made outside of the context of the budget as the necessary resources would be readily available. Nowadays, all substantive policy decisions must be made in the context of the budget. It is therefore high time for the SBO to take a wider perspective on budgeting.

There is nothing awry with SBO focusing on internal budget processes, but the discussion would be enriched by framing it within the larger movements that drive public spending. It is understandable that the revenue side of the budget has received scant attention because tax policy and administration are in the jurisdiction of other government units. It would be useful to discuss revenue projection methods, tax expenditures, and other

features of revenue that have a direct bearing on expenditure management. In a similar vein, it would be useful to have fuller discussion of intergovernmental fiscal relations, which affect both the revenue and spending sides of the budget.

3. Budgeting's future agenda

Future SBOs will concentrate on matters that budget officials deal with year after year. But it also behoves them to view issues in terms of the overriding purposes that contemporary budgeting serves. While practitioners and observers may disagree on the particular end of budgeting, there is agreement that a sound budget system serves multiple, coexisting purposes. I find it useful to define good budgeting in terms of the following criteria:

- The budget should establish a stable, sustainable fiscal position for the medium term and beyond.
- The budget should facilitate the shift of resources to more effective, higher priority uses.
- The budget should encourage spending units to operate efficiently.
- The budget should be accessible to citizens and responsive to their interests.
- The budget (in tandem with other financial management practices) should assure accountability in the expenditure of public money.

This is an ambitious agenda that cannot be fulfilled, for standards are continually being adjusted upward. The paragraphs that follow set out issues in each of these areas that may be grist for future SBO meetings.

3.1. Sustainable fiscal policy

The fiscal posture of government will be at issue as long as budgeting is practiced. The contemporary role of government and its entanglement in economic matters rule out application of a strict balanced budget norm. But open-ended, unconstrained deficits that result because politicians have incentive to tax less and spend more, or from swings in economic conditions, are likely to be unsustainable and to diminish a country's future economic prospect. It is now widely accepted that political incentives bias budgets toward higher deficits, as politicians favour current voters over future taxpayers. When political leaders behave this way in less developed countries, they may destabilise the economy and provoke a run on capital markets. The adverse effects are likely to be less apparent in affluent countries and may not emerge for some time. In fact, there may be short-term benefits as deficit spending stimulates demand and thereby veils the long-term costs. The political bias to spend in excess of current revenue may be reinforced by short-term economic gains.

These conditions greatly complicate the task of stabilising fiscal policy in OECD member countries. The favoured contemporary solution has been to set fixed fiscal rules, such as those prescribed by the Stability and Growth Pact, and to entrust enforcement to an outside or independent entity that is not swayed by domestic political pressures. But recent difficulties in enforcement of the Stability and Growth Pact call into question the staying power of fixed fiscal rules, even those that allow a modest deficit. These rules may be effective in the short run, as they were in the run-up to the European Economic and Monetary Union. But the longer they are in place, the weaker the rules become, especially when the economy swings from growth to stagnation. Fixed rules which permit modest deficits may be as unworkable as fixed rules which prescribe balanced budgets. The only alternatives, within the framework of fiscal rules, are pliable rules that are adjusted in response to changes in actual or projected economic conditions. Of course, this would return OECD member countries to the situation that prevailed during the post-war “Keynesian” period, but with two big differences. One is that the economies of most OECD member countries are not booming, the other is that enforcement of the rules may be in outside hands. It remains to be seen whether fiscal limits are more stringent when compliance is monitored and enforced by a regional or international body.

Establishing and maintaining a workable fiscal regime should preoccupy SBO in the years ahead. While fiscal rules have received some attention at recent SBOs, economists have colonised these issues as their own. The vast literature on fiscal institutions produced over the past decade attests to the confidence economists have in their capacity to explain why some countries incur deficits and others do not, and to design rules that would constrain deficits. I am not sure that economists have a comparative advantage on this issue. Their models tend to be simplistic and self-fulfilling, and they know less than budget officials about the political and bureaucratic pressures that drive public spending. Budget officials certainly have a deeper understanding of how procedural rules affect spending outcomes. They have a lot to contribute to the design of effective fiscal rules.

3.2. Effective allocation

At its core, budgeting is a process for allocating resources among competing demands for public money. Anyone who has worked in budgeting knows that this is not a fair competition, that old claims on the budget have an advantage over new ones. Now matter how it is structured, budgeting decisions are anchored in the past, varying usually only in small increments from one year to the next. It is time to call a halt to the reformist war against incrementalism and to acknowledge that this is one feature of budgeting that will not and (according to some) should not be abandoned.

If budgeting is inherently incremental, can governments keep spending fresh and responsive to changing priorities? This question is urgent because an ageing society will make national budgets even more rigid, while a changing society will require that budgets be more adaptive. Contemporary budget developments address this problem in quite different ways. One approach arises out of the “Beyond Budgeting” argument referred to earlier in this paper. It considers budgeting in both business and government to be rigid and confining, and urges strategic policy makers and programme managers to devise alternative processes such as strategic plans and operational goals for steering large organisations. The Beyond Budgeting advocates claim that these methods have been applied in some business firms, but that the applicability to government is questionable. Budget reformers, by contrast, have not given up on the process, but are continually searching for means to inject a capacity for change into resource decisions. Contemporary change-oriented reforms include a longer timeframe, more programme evaluation, and fuller use of performance targets and outcome measures. A third approach seeks to transform budgeting by coupling it to other change-driving processes, such as strategic and programme planning, that facilitate policy adjustments. The three paths differ fundamentally in their assessment of budgeting’s capacity for effective allocation. The first gives up on budgeting, the second has confidence that conventional reforms will suffice, the third makes budgeting dependent on other processes. In my view, none has sufficient promise to materially enlarge government’s scope for change.

To finance emerging financial demands, future governments may be impelled to increase taxes if economic growth does not provide sufficient new money. Governments will be able to spend more on new priorities only if they have more to spend. Alternatively, they may continue to make incremental policy adjustments to finance marginal reallocations from lower to higher priorities. One likely tactic will be to tinker with entitlement formulas and user charges in order to save some money on pensions or health care. While such savings will not derigidify budgeting, they will enable pressured governments to muddle through from one year to the next. This is a common way of pacifying the budget. Dealing with budget pressures one year at a time, the future will take care of its problems.

3.3. Efficient operations

Over the years, SBO has devoted more attention to the operational performance of government than to the other core functions of budgeting. This is not surprising because budget officials are involved on a continuing basis with the operations of government. Although transfer payments may claim the largest share of the budget, operational issues claim the largest share of budget officials’ time. Expenditures for running operations and delivering services are

the portions of the budget decided each year and the areas that budget makers look to for short-term savings to align revenues and expenditures.

Performance budgeting has long been the favourite instrument for getting governments to operate more efficiently and to improve public services. As one whose Ph.D. dissertation some 40 years ago was on performance budgeting, I expect this subject to absorb the attention of budget officials for a very long time. Budgeting on the basis of actual or expected results is a simple but elusive objective. It is simple because the idea has universal appeal; it appeals to common sense and should be what budgeting is about. It is elusive because linking resources and results is difficult and complicates the task of producing the budget.

The impediments to budgeting on the basis of results are numerous; the ones outlined briefly here pertain to the budget's role in managing government programmes and agencies. To begin with, performance-based budgeting comes in so many varieties that the term does not offer much guidance on how budgeting is to be structured. At one end of the spectrum, it may connote only that the budget contains supporting information on the outputs and activities of spending units; at the other end, it may indicate that each increment of resources buys an increment of results. The former is so undemanding that just about any government that has workload or output data can claim to budget on this basis; the latter is so challenging that few governments can meet its standards. It is tempting for governments that want to take credit for aligning resources and results to settle for the least demanding version. When they do, just about the only thing changed is the appearance of the budget. Resources and results continue to go their separate ways.

Although it is beyond the current reach of most governments, the demanding version offers useful clues about what it takes to budget on the basis of results. To budget for results, governments must also manage for results; that is, they must organise administrative operations and deliver services to optimise the outputs that agencies produce. It is naïve to think that a government can manage on one basis and budget on an entirely different one. If management is regimented, with administrative actions centrally controlled and managers evaluated on the basis of compliance with procedural rules, it will be futile to try to budget for results. If managers do not care about results when they go about daily tasks, the budget will not care about results either. The practice of budgeting is encased in public management, and it is only when spending units are mobilised to perform well that government will be able to budget for performance. Government's dependence on transforming management vastly increases the difficulty of orienting the budget process to results.

Linking resources and results is also a technical challenge, for it requires data on the cost of producing outputs that are presently unavailable in all but a

few countries. Getting cost data requires managerial accounting systems that break down output into standard units and distinguish between fixed and variable costs and between average and marginal costs, and thereby enable government to estimate the cost of producing each increment of output. Linking resources and results may also require two more fundamental changes: a shift from budgeting on the basis of the cost (or expenditure) of operations to budgeting on the basis of the price paid for services; and a shift from fixed operating budgets (in which the volume of resources does not vary with the volume of output) to a variable budget. Inasmuch as neither of these transformations is underway, most governments that seek to link resources and results end up with performance budgets that resemble conventional budgets.

A government can manage for results without having a full-blown performance budget, either by introducing market-type arrangements that enable recipients of public services to select their suppliers or by enabling providers of these services to operate efficiently. If performance improves through either of these ways (or, more likely, through a combination of both), government will be better primed to budget for results.

3.4. Democratising the budget

The history of budgeting is the history of democratic institutions. From Magna Carta hundreds of years ago, through the emergence of legislative assemblies in the Middle Ages to the development of modern budgeting, the aim has been to limit the power of those in elected or appointed office to spend public money. This is the main reason why budgeting has for so long been grounded on rules and procedures that control the actions of spenders.

This model of budgetary democracy no longer serves the people sufficiently well. In fact, critical features of budgeting may retard democracy and thwart the capacity of the public to decide how public money is spent. The insularity of budgeting, noted at the outset of this paper, veils most spending discussions from public view. At best, budgeting practices a form of *ex post* democracy, with the public informed only after decisions have been taken. Genuine public participation has been impeded by the growth of government and the elaboration of complex budget rules as well as by the emergence of strong political parties and the enforcement of party discipline in national legislatures. On the periphery of budgeting, interest groups and others sometimes join in the discussions, especially in countries with corporatist or pluralistic tendencies, but their influence is uneven and may come at the expense of under-represented interests.

Redemocratising the budget will have higher rank on the SBO agenda in the decades ahead than it has had thus far. It is highly probable that the standards of “democratic adequacy” will continue to rise, opening the process

more, giving a more diverse array of interests the opportunities to influence budget decisions. One channel of discussion might be the legislature's role and capacity in modifying the budget submitted by the government; another might be the opportunities opened up by the information revolution for e-budgeting and other new forms of dissemination and decision. Greater attention might be given to: the distributive effects of national budgets; which groups or sectors get benefits and which do not; and the means by which certain stakeholders might participate more actively in allocating public funds. One should not be surprised if budget officials debate the lack of transparency in compiling the budget and question whether the veil of secrecy ought to be lifted from the process.

At future SBO meetings, voices will be heard arguing that opening the process to outside scrutiny or participation will greatly complicate the task of making ends meet. It is hard enough to reject claims behind closed doors; it may be impossible to do so in the open. The more constrained future budgets are, the greater will be the insistence of affected interests that they have a seat at the table. A strong dose of budgetary democracy will hobble the always difficult task of reallocating money from some uses to others. It may be that the only prudent way to redemocratised the budget is to combine it with measures that safeguard fiscal discipline.

3.5. Genuine accountability

It is an article of faith and practice in OECD member countries that spenders must account for their use of public funds. Toward this end, financial reporting and auditing systems have been established in each country. These generally are regarded as reliable and in compliance with standards prescribed by accountancy and audit groups. In recent years, SBO has examined the spread of accrual standards and has considered whether these are suitable for the budget, which traditionally has been on a cash basis.

Accruals versus cash opens the door to a larger question: the operation of the budget process within the government's financial management framework. To my knowledge, SBO has not examined integrated financial information systems which use advanced information technology to connect the myriad financial operations of government. Although the main selling point of integrated systems is that they improve efficiency and reduce error, tying the budget into them is likely to change both its content and the manner in which it is prepared. Rather than having its own way of counting and compiling the numbers, budgeting will be beholden to accounting rules.

4. SBO 2029

The mood was somber as delegates from the 107 member countries gathered in Qatar for SBO's 50th annual meeting. Fewer than a handful of

countries were absent, and those represented at the meeting came in delegations of 5-10 political leaders and experts. Some years earlier, SBO was formally disbanded and a meeting of senior budget ministers took its place. But out of habit or nostalgia, the meeting was still universally referred to as SBO. Budget directors were members of the country delegations, but with few exceptions each country sent a minister to speak on its behalf and vote on the matters before the body. The switch from officials to ministers was due to the transformation of SBO into the OECD's legislative body for establishing standards of good budget practice. Inasmuch as each country's financial condition was implicated in these decisions, first a handful and over time almost all countries entrusted the work to political leaders who were authorised to speak and vote for their government.

As a standards-setting body, SBO had a full agenda that no longer accommodated abstract papers by academics. The agenda was congested, with barely enough time during the two days to handle the weighty questions that had to be resolved. Some countries urged that SBO be lengthened to as much as a week, but ministers protested that two days were all they could spare. To assure that these days were efficiently organised, SBO had restructured itself around a handful of formal committees, each with a defined jurisdiction and each empowered to make authoritative recommendations to the plenary. In each country, executives and parliamentarians had already been briefed on the agenda, and instructions were issued as to how delegates should vote. The main committees treated accounting rules, fiscal integration, budget procedure, social rights, and legal matters. The Legal Committee was the only one that did not make formal recommendations. Rather, it was responsible for advising the SBO on the budgetary consequences of recent rulings by the International Court of Social and Economic Justice.

The report of the Accounting Rules Committee had been presented months earlier in a disclosure document that evoked widespread criticism. It recommended that the standards applied to country budgets be revised to cover new types of financial instruments and downstream liabilities. The existence of these standards was no longer controversial, though it had been about 15 years earlier when budget directors fought a losing battle to allow each country to set its own budget standards. The majority, however, determined that national economies were so interdependent that it was essential to prescribe budgetary accounting rules. The issue before SBO in 2029, as in most previous meetings, was whether to prescribe additional standards in response to the invention of new financing arrangements. On the basis of statements issued by the leaders of many countries, it was expected that the proposed standards would occasion robust discussion at the SBO meeting but that they would be approved by an overwhelming majority. After all, no political leader wants to be exposed to accusations that the official budget reports are false or misleading.

The Fiscal Integration Committee is making yet another effort to fine-tune deficit and debt rules in response to cyclical changes in economic conditions. This is a perennial issue, for which there is no permanent solution. This year's report deals with a particularly troublesome issue, the fiscal destabilisation arising from shocks and other major disturbances. At one time, it was thought that shocks were problems only in less developed countries, but the globalisation of terrorism and other factors have brought this risk to some of the most developed countries. The initial draft called for a waiver of fiscal rules in case of fundamental shocks, but some countries objected that this was too permissive and would open the door to wholesale evasion. A compromise was reached to suspend fiscal rules for affected countries for as many as three years, but it is certain that this question will be on future SBO agendas.

The Budget Procedure Committee is grappling with a question that has vexed democratic governments for the better part of a decade. Pursuant to an international court ruling, SBO decided years earlier that representatives of key groups should have the right to attend all budget negotiations, including bilaterals between the finance minister and each sectoral minister. SBO has dragged its feet on opening the process, but the courts have given it a deadline by which it must designate eligible groups. If it fails to act in time, the courts will impose their own decision. The Budget Procedure Committee has proposed that each government be authorised to make its own selection. This artful compromise may buy time, but it is likely that the courts will revisit the issue.

The Social Rights Committee is the only committee with members from non OECD countries. Its charter is to prod developed countries to redistribute resources to citizens of less developed countries. The first such redistribution was done under the auspices of the Millennium Development Goals for the year 2020. The second occurred during the past decade, pursuant to the second-generation goals, and the Social Rights Committee has devised a formula for the latest set of goals which run to the year 2040. A close vote is expected on a motion to defer consideration of this issue for at least a year.

The Legal Committee produced an annual compilation of court decisions that have a material impact on government revenue or expenditure. During the past year, 853 such rulings were issued by courts in member countries and another 17 by international panels. The net impact is estimated to exceed 2% of GDP in the OECD area.

During the delegates' lunch, the OECD Secretariat arranged for a retired budget director to reflect on SBO's 50 years. She delighted the assembled delegates by recalling the long-forgotten debates about performance budgeting, multi-year targets, and the like. "We took it all so seriously, then", she concluded.

The archives of SBO contain a variant set of minutes on the 2029 meeting. According to this version, in 2029, SBO discussed budgeting for results, getting a longer-term perspective, and the legislature's growing role. No votes were taken, and no conclusions were reached.

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Issues in Accrual Budgeting

by

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There would appear to be a growing consensus among OECD member countries concerning the merits of adopting accrual **accounting** in the public sector. Nearly one-third of member countries have adopted full accrual accounting and a number of other member countries have adopted accrual accounting for specific transactions – most frequently for the recording of interest on the public debt and employee pension costs (see Table 1).

There would appear to be less consensus regarding the adoption of accrual **budgeting** (accrual appropriations)¹ where views diverge widely on its desirability. Only three member countries have adopted full accrual budgeting, although several member countries have adopted accruals for specific transactions in the budget – again, most frequently for the recording of interest on the public debt and employee pension costs (see Table 2).

This paper is not designed to advocate a specific stance in regards to the adoption of accrual budgeting. Rather, it is designed to focus attention on some of the key issues involved in accrual budgeting. The adoption of accrual budgeting often offers a wide range of options for implementing many of the key issues, and the paper aims to highlight these.

The paper attempts to isolate the issues relevant to accrual budgeting specifically. For a more general discussion of accruals, see “Accrual Accounting and Budgeting: Key Issues and Recent Developments” (OECD *Journal on Budgeting*, 3:1, 2003).

Box 1. Accruals and cash

Accruals and cash are often portrayed as opposing end-points on a spectrum of possible bases for accounting and budgeting. The cash basis of accounting and budgeting recognises a transaction when the cash is received or when cash is paid out. The accruals basis recognises a transaction when the activity (decision) generating revenue or consuming resources takes place, regardless of when the associated cash is received or paid.

In fact, cash is an inherent feature of the accruals basis and the two work very much in tandem. Accruals records transactions **both** on an accruals basis, as described above, and on a cash basis. The operating (profit and loss) statement presents the information on an accruals basis and the cash-flow statement presents the information on a cash basis.

This paper begins by discussing the benefits of adopting accrual budgeting as highlighted by its advocates together with a discussion of the issues raised by its detractors. The paper then discusses a series of “technical” issues involved with the adoption of accruals – including the treatment of non-cash items in appropriations, cash management systems, controlling capital assets acquisitions and opening balance sheet values. All of these relate directly or indirectly with the capitalisation and depreciation of assets, which is (one of) the fundamental differences between cash and accruals bases. The paper next discusses the implications of accrual budgeting for fiscal policy setting and concludes with a discussion of its impact on the role of parliament.

1. Benefits of accrual budgeting

The advocates of accrual budgeting point to many specific benefits that accrual budgeting may bring. These can usefully be divided into the following six groups:

- First, accrual budgeting provides **improved cost information to decision makers and improved discipline for budget execution purposes**. Decisions will now be based on the total cost of producing outcomes and outputs, rather than only the immediate cash outlay. (Non-cash items are discussed in section 2 below.) Budget execution must also have regard to costs being deferred and is more constrained from undertaking activity for which the cash impact will affect later reporting periods. This is especially relevant when managers have increased autonomy to act on this improved information.

Detractors note that for most transactions the cash and accrual numbers will be the same, as the timing difference in recording transactions only affects relatively few areas. The budget could incorporate accruals for the specific transactions where it is of significance – employee pensions, interest on the public debt, etc. Other approaches such as commitment budgeting can be employed to ensure budget discipline is maintained in a devolved managerial environment.

Various forms of centralised funds in a cash budgeting environment could serve the same purpose – for example, a special charge for employee pensions, a special charge for office accommodations, etc. Such central funds would be on an accruals basis, so in essence this means introducing accruals to specific parts of the budget. Of course, such mechanisms have their limits and would not be appropriate for some types of transaction.

- Second, accruals will focus attention on **improving the management of capital stock**. It provides better incentives to manage assets and dispose of those no longer needed, and better incentives in planning investments, as this affects depreciation. It also provides new impetus **to manage working capital** (debtors, creditors and stocks).

Detractors note that these are all important areas but can be improved without the adoption of full accrual budgeting.

- Third, accrual budgeting **eliminates biases perceived** to exist with the recording of capital investments as a “lump sum” rather than being capitalised and depreciated over its useful life. Capital spending is said to be neglected in the traditional cash-based budget framework, with the state of infrastructure and other capital assets being unsatisfactory as a result. If an asset has a useful life of – say – 25 years, then why should its total acquisition cost be treated as a single item in one year’s budget rather than being capitalised and the costs distributed over its useful life through depreciation?

Detractors note that fiscal discipline may be undermined if it is possible to commit resources in one year with the financial impact (cost) only being recorded over a 25-year period. They note that a different “matching principle” is applicable to the public sector, one that matches the political decision to spend money with the time period when the total cost is recorded in the budget. The fundamental problem of determining depreciation – an integral part of accrual budgeting – also creates a new opportunity for elected officials to expand government programmes without having to show any costs.

- Fourth, accrual budgeting will **illuminate the long-term sustainability of public finances** by highlighting the long-term consequences of current decisions. This derives from the incorporation of a balance sheet in the accrual budgeting framework that encompasses the government’s assets and liabilities.

Detractors note that the government’s greatest asset – its power to tax – and its greatest liability – the costs associated with ageing populations – do not meet the recognition criteria for assets and liabilities, respectively. As a result, accrual budgeting does not present a comprehensive picture of the sustainability of public finances.

Detractors of accrual budgeting also note that very long-term budget forecasts (40-75 years) on a cash basis may be a superior alternative for illuminating the sustainability of public finances. This eliminates the problems associated with the recognition criteria outlined above and other technical accounting issues which are detailed in later sections of this report. It also has the virtue of being easier for elected officials and the general population to understand.

- Fifth, the adoption of accrual budgeting is **a catalyst for other management reforms** in the public sector. The introduction of accrual budgeting cannot be seen in isolation: the countries that have adopted accrual budgeting have done so in the context of wider management reforms in the public sector, i.e. reducing input controls, increasing flexibility, focusing on outcomes and

outputs. The introduction of accrual budgeting was a key lever for changing behaviours in this context and for fostering “culture change” in government.

Detractors note that the great expectations associated with accrual budgeting, not least in terms of its impact on “culture change”, are exaggerated and that relaxing input controls and focusing on outcomes and outputs can be realised without the adoption of accrual budgeting.

- Sixth, proponents claim that accrual budgeting is necessary in order **to ensure symmetry with accrual financial reporting (accounting)**. This of course applies only to countries where accrual accounting has been adopted. It is argued that the two have to be on the same basis in order to enable comparability between the budget and the actual results, making them both easier to understand and assess. This is also fundamental in terms of the government’s accountability for implementing the budget as authorised.

Detractors note that this is a “back door” argument for the adoption of accrual budgeting and as such has no merit. It could equally be stated that accrual accounting should be abandoned for the exact same reason. It should also be borne in mind that a number of member countries have explicitly rejected the linkage, whereas others have done so implicitly as evidenced by the greater acceptance of accrual accounting than accrual budgeting.

Furthermore, detractors note that accruals introduces a great deal of technical complexity into budgeting, thus making it less transparent and less understandable. Accruals also offers new opportunities for manipulation that are of a different nature than in cash budgeting (capitalising expenses, use of depreciation, valuations and revaluations, etc.). Opportunities for manipulation exist in cash budgeting as well but they mainly concern timing issues – i.e. delaying expenses beyond the reporting period, accelerating revenue collection from the next reporting period. Finally, the detractors of accrual budgeting note that its introduction involves significant costs in training and systems upgrades and that the benefits simply are not worth it.

The discussion below focuses on the expenditure side of the budget while Box 2 provides a brief overview of the impact of the accruals treatment of tax revenue.

2. Appropriations for non-cash items

The key difference between the accruals and the cash basis of budgeting is that accruals recognises expenses in the operating (profit and loss) statement when the activity consuming the resources takes place, and not when actual cash exchanges hands. Several accrual expenditures are however non-cash in nature – on an annual basis. These include depreciation, post-employment benefits (pensions, health care), interest payable on government debt, employee

Box 2. Accrual tax revenue

In a “perfect” accruals framework, tax revenue should be recorded at the time that the economic transactions which result in a subsequent taxation liability take place. It is however very difficult, if not impossible, to know when all such transactions take place.

As a result, revenue is generally recognised as accruing at the time the relevant tax law indicates the existence of a requirement to pay an amount of tax, or when a tax liability assessment is made. In short, revenue is only recognised when the taxpayer incurs an assessment to pay tax.

This generally means that the adoption of accrual budgeting requires only two changes to be made to the current cash estimates of tax revenue:

- First, an adjustment for tax receivables. This adjustment recognises revenue for which an assessment has been made but which has not yet been received, and excludes cash received which has already been accounted for in receivables (because it accrued in a previous reporting period).
- Second, an adjustment for bad and doubtful debts. This adjustment recognises the fact that some accounts receivable are never paid and are eventually written off. At the end of each financial year, tax receivables that are likely to become uncollectable are brought to account and expensed to the year just finishing. This matches the “expenditure” to the period in which it was incurred.

The issue of making provision for bad debts does not arise under cash accounting because the government only recognises receipts as they come in. Thus, the accruals treatment of tax revenue has the potential to improve the management of tax revenues (receivables).

Other possibilities exist as well. Some countries treat tax revenue essentially on a cash basis in an otherwise accruals framework. It is also possible to “time shift” the revenue backwards to the “appropriate” time period in accruals terms.

leave entitlements (annual leave, long-service leave), revaluations of assets (downward) and liabilities (upward), and payables at year end.

Questions arise about how such non-cash items should be treated under an accrual appropriations framework. In essence, there are two possible approaches that have been developed:

- Cash is appropriated for the full accrual amounts, including non-cash items such as depreciation. Agencies are expected to replenish their current assets from accumulated depreciation and they have the budget authority to do so (cash-in-hand model).

- Cash is appropriated for only the cash component of full accrual amounts (no-cash-in-hand model).

The **cash-in-hand** model is the more radical of the two. Agencies would receive cash for both the cash required during the year and for the non-cash items – depreciation.² Their cash appropriation would therefore reflect the full cost of operating the agency.

The proponents of this model claim that the adoption of accrual budgeting is not simply about changes in how transactions are technically recorded in the budget, but is rather about introducing fundamental changes in how government is managed. The full cost of government is now to become the focus of the operating budget, rather than the immediate cash requirement. This can only be achieved if appropriations reflect these full costs with cash. Otherwise they will not be effectively managed. It was felt that if the no-cash-in-hand model had been adopted, the desired changes in management behaviour would not have materialised, since the actual appropriations received by ministries and agencies would have been essentially the same as with the old cash-basis budgeting framework.

The cash-in-hand model is especially attractive in cases where reforms of the public sector have involved a clear purchaser-provider split, with the purchaser expected to provide “outputs” in exchange for a given “price” reflecting the full costs of the outputs.

The downside of the cash-in-hand model is that control of cash and capital acquisitions (replacements) can become ambiguous. If an agency is given cash to fund depreciation expense, there is a risk that the money may be used for purposes other than replacing capital assets in the future. This applies equally to the officials in an agency, the Ministry of Finance and to elected officials. Clear criteria are required for the use of depreciation expense, i.e. to replace capital assets.

Similarly, parliament may lose control over how capital assets are acquired since it will have funded them through a depreciation expense in previous years. Cash management policies and specific controls over capital acquisitions can serve to alleviate these problems. They are discussed in subsequent sections of this paper.

The **no-cash-in-hand** model would only appropriate cash for the cash requirement of agencies. Non-cash items – such as depreciation – would not receive a cash appropriation. These items would nonetheless be recognised in the budget as approved by parliament. The budget would contain both the amount of the full accrual costs and the cash required. The financial statements of agencies would report the total accrual amount as revenue on their operating statement – in the same manner that all expenses are treated on an accruals basis. The difference between the cash requirement and the

total full cost appropriations would be treated as accounts receivable in the balance sheet. This would give formal recognition to these non-cash items.

The proponents of the no-cash-in-hand model see it achieving the benefits of accrual budgeting with very little changes to current cash-based appropriation arrangements. Although appropriations would continue to be on a cash basis, the total amount recorded in the budget would also include the non-cash items. It avoids any risks associated with spending cash received for non-cash items on unrelated initiatives and serves to reinforce parliament's control over capital acquisitions.

The detractors of this model note that the very fact that it will not change the current appropriation arrangements means that in effect the old "cash-based" budgeting system is being continued and the desired "culture" shift in managing resources will not take place. There may also not be total faith in agencies ever receiving their accounts receivables as recorded in the balance sheet. This provides a new opportunity to "game" the system.

3. Cash management systems

The management of cash is typically centralised in the Ministry of Finance, and this has not changed for member countries that have implemented an accrual budgeting system.

The nature of appropriations is inherently linked to the cash management systems that the government employs, and therefore the interface between cash management and appropriations differs depending on the extent of "decentralisation" of the appropriation system. The decision on which appropriation system is to be employed will be dependent on views as to which system best aids the control of public finances by the legislature and which best reflects the discretion that agencies need to perform and to be responsive.

Appropriations may be designated as being for:

- the cash expenditure made **by** agencies;
- the cash provided **to** agencies;
- the costs incurred for the production of outputs **by** agencies;
- the price paid **to** agencies for the production of outputs.

The first approach and, in some cases, the second approach represent the no-cash-in-hand model as described above. The nature of the appropriation will ensure that the agency is only allotted the cash required for its operations in a given year. The last two approaches, and sometimes the second approach, represent the cash-in-hand model where the cash management system must also manage the transfer of cash to agencies that will not need the cash resources immediately.

One option is to allocate the cash but retain control of the agency banking arrangements so that the cash is still managed in a centralised manner. Another option would be to allocate to agencies only the cash that they need to cover their cash requirements. In effect, the cash management system would be used to transform the cash-in-hand model into the no-cash-in-hand model. The non-cash items would be a notional amount in their bank accounts – i.e. as receivables.

In all the above cases, strong controls are kept on cash and how it is used. Centralised systems can be put into place to control capital acquisitions (replacements). As with the no-cash-in-hand model described above, the problem with this approach is that it may undermine the desired culture change, i.e. there may be no change in management behaviour from the traditional cash-based budgeting systems.

The other extreme would be for agencies to receive cash “in their account” for the full amount of the non-cash component of their appropriation. Agencies would have the responsibility to manage this part of their appropriation. They would be subject to general cash management arrangements such as sweeping balances in all accounts overnight. More detailed controls could vary. For example, the use of appropriations for non-cash items could be discretionary for each agency only up to a certain amount. All amounts in excess could require the approval of the Ministry of Finance. These issues are further discussed in the next section.

4. Control of capital assets acquisitions

The manner in which control of capital assets acquisitions is exercised is critical to the adoption of accrual budgeting. There are two related issues involved here. The first is a conceptual view on the role of accumulated depreciation in funding new capital assets acquisitions. The second is a practical view on how capital assets acquisitions should be conducted.

The **role of accumulated depreciation** can be characterised as either of the following:

- Accumulated depreciation expense that an agency has acquired gives it a right to capital spending in that amount.
- Accumulated depreciation expense that an agency has acquired DOES NOT give it a right to capital spending in that amount.

The first approach is based on the fact that agencies with accumulated depreciation should be allowed to spend that money on new capital acquisitions. This approach recognises that control over that capital expenditure passed to the agency when the legislature approved the depreciation expense in each previous year. This approach would be in line with the “culture change” argument and the idea of empowering agencies to manage their total expenditure.

A critique of this approach is that it may not result in optimal capital decisions since the accumulated depreciation on past assets may not be a guide to the desired allocation of future capital expenditure, i.e. this approach assumes that capital decisions made in the past would continue to be appropriate in the future. Under this approach, many parliamentarians also feel that they have lost control over capital acquisitions since their only involvement was to approve the depreciation expense on existing assets. Also this approach may be acceptable for minor assets, but will become increasingly risky as the expenditure relates to larger and longer lived assets.

The second approach is that accumulated depreciation gives no right to capital expenditure. Agencies would receive appropriations for non-cash items such as depreciation per the no-cash-in-hand model as described in a previous section above, but would not have any right to use it. This approach recognises that a whole-of-government review of capital requirements is more likely to result in optimal capital decisions than a system which is based on historic capital expenditure patterns. This approach also gives an overall view of assets in terms of their condition and whether their value is being maintained. It also reinforces the role of parliament in approving all expenditures, including specific capital expenditures.

The critique of this approach is that it does not empower managers and would not in effect reflect any changes from the present manner of capital acquisitions.

The second issue – **how capital assets acquisitions should be conducted** – is directly related to the above. If agencies have already received parliamentary authority for capital expenditure in the form of accumulated depreciation, then they can use that money in accordance with guidelines and the approval of the Ministry of Finance. If agencies have no such authority, they will need to seek parliamentary approval for all capital acquisitions in the form of a capital budget.

It should be recognised, however, that new capital acquisitions will often consist of using both accumulated depreciation and new funding. In general, this can either be achieved by a system of internal loans or by separate capital appropriations (equity injections) to the respective agency.

Under the former approach, the Ministry of Finance would lend to the relevant agency sufficient money to cover the cost of new capital acquisitions in excess of accumulated depreciation. This would then be repaid by the agency from future appropriations. Such a facility is most suitable for smaller capital acquisitions. Limits to this regime and effective parliamentary supervision would need to be put in place.

In other cases, it may be decided that that the level of capitalisation of an agency needs to be increased and a separate capital appropriations (equity

injection) be made to the agency. This could take place in the context of a capital budget. The importance of the level of capitalisation of agencies is discussed in the next section.

Box 3. Role of accumulated depreciation expense

When it comes to financing new initiatives, the funds that an agency may have in accumulated depreciation can be considered a pool of fungible funds. The agency itself, the Ministry of Finance, and/or parliament may view that the mission of an agency has changed and that the funds should be used for other activities than new capital acquisitions. This raises questions about whether restrictions should be placed on the use of such funds, for example that they can only be used for new capital acquisitions.

5. Opening balance sheet values

A key challenge in accrual budgeting is to ensure that the opening balance sheet is as accurate as possible since the balance sheet provides the base information for the calculation of depreciation – and in turn future capital acquisitions (replacements).

At the time of the switch to accrual budgeting, a decision needs to be made whether the level of assets in a given agency is too low, too high, or appropriate for it to carry out its activities on a sustainable basis. It should not simply be assumed that agencies have the correct level of assets; this needs to be analysed and optimised.

Agencies may of course make proposals for an increased level of assets in future years, but the underlying assumption will generally be that agencies started out with the capital necessary to ensure sustainability of their activities. Capital injections to purchase additional assets will of course become part of the annual budget formulation process in an accruals environment, but such requests should be limited to responses to new demands and needs rather than rectifying past “mistakes”.

Conversely, where there may be concerns that agencies are “asset-rich”, it will be difficult to reduce the level of assets once the switch to accrual budgeting has been implemented because these excess assets represent a source of funding for the agency in the form of depreciation. Member countries that have adopted accrual budgeting have generally introduced a system of “capital charging” as well to align the goals of individual agencies with the whole-of-government perspective. Box 5 highlights a capital charging regime.

Box 4. Registering and valuing assets

The most basic issue, yet often the most time-consuming and difficult one, associated with the adoption of accruals is to identify and value the assets that the government owns. Governments have traditionally not kept accurate and up-to-date registers of assets, a fact noted by supporters of accruals as a good example of the advantages of adopting accruals.

Valuing assets poses special problems in the public sector as well.

First, the government owns categories of assets that are uniquely public sector in nature – military assets and heritage assets such as museums and monuments being prime examples – that can be very difficult to value. The usefulness of such valuation may be quite questionable as well.

Second, accruals offers the choice of valuing assets according to either historical cost or fair value (usually market value, but in the absence of reliable market values, replacement cost is usually used as a proxy). Both are accepted valuation methodologies under GAAP (generally accepted accounting principles). Historical cost gives the advantage that the numbers used are certain in the sense that they are based on a verifiable acquisition price of each asset and do not fluctuate. The disadvantage is that the reported amounts generally bear little relevance to the current value of the asset. Furthermore, the original acquisition price in the public sector is often unknown or at nil or nominal amounts. Market value gives the advantage that the reported amounts are in line with their current value. The disadvantages lie in the fact that professional judgments must be made in assessing their values and that their values can fluctuate sharply between reporting periods. Regardless of which method is adopted, it is of primary importance that that method be applied consistently.

6. Fiscal policy setting

To date, fiscal policy setting has been inherently a cash-based concept – measuring the flows between the budget and the economy as a whole. The accrual balance and the cash balance will – by definition – diverge. (It should be noted that some countries apply the national accounts [statistical] basis for this purpose, which incorporates elements of accruals.) Assessment of the impact of the budget on the economy is therefore more likely to be driven from the cash-flow statement than from the operating (profit and loss) statement.

Reconciliation between the cash-flow statement and the operating statement is mainly due to two factors – revaluations and depreciation/capital expenditure. **Revaluations** reflect changes to the value of assets and liabilities. These revaluations do not affect cash measures of the budget balance; they reflect changes in the value of assets and liabilities resulting from non-

Box 5. Capital charging

A capital charge is levied on an agency and is designed to be a substitute for interest costs and a return on capital. At a minimum, the charge should cover the government's cost of borrowing. This is the bottom line cost of government. However, the activities conducted by governments are not without risk, and it is possible to argue that some form of risk premium in addition to the government's borrowing cost is also appropriate.

A capital charge usually consists of a rate levied on an asset base. The rate will vary depending upon the way in which it is calculated and the countries in which it is operating, but will normally be in the region of 5-15%. The asset base upon which the charge is levied could be: total assets, fixed assets, total assets less current liabilities, or total assets less all liabilities.

One of the main incentives associated with a capital charge regime is that agencies may **retain savings** that they make by reducing the amount of the charge. The impact of this incentive will depend upon the extent to which agencies actually realise the benefits of such savings. In some OECD member countries, the system of legislative appropriations may mean that any additional spending has to be formally approved. Administrative mechanisms may need to be developed to address this issue and to reduce the transaction costs associated with the operation of the incentive.

Another issue which needs to be considered is whether the charge will be **fully funded** in its first year of application. If it is fully funded, then agencies' financial positions do not immediately alter. However, there is an incentive to reduce asset holdings because that will reduce the capital charge in subsequent periods.

For a more comprehensive discussion of capital charging, see "Modern Financial Management Practices" (OECD *Journal on Budgeting*, 2:2, 2002).

transactions – such as changes in market values. **Capital expenditure** is not measured on the operating statement of governments; it considers the depreciation (capital use) instead. The adjustment required here is to add capital expenditure and delete depreciation expense.

Both to aid understanding and to assist in assessing the economic impact of the budget, member countries that budget on an accruals basis report the details of these reconciliations. It may be necessary to offer sector-specific details of the adjustments/cash-flows as well.

Increasingly, fiscal policy has regard to issues of sustainability of the government's policies. The operating statement and the balance sheet provide a richer (although not complete) set of indicators that is regarded by proponents of accrual budgeting as being more useful in these regards.

In particular, a fiscal indicator or target that encapsulates the extent to which assets are being consumed or impaired, and which accounts for growing or reduced provisions in “pay-as-you-go” programmes, is more likely to accurately reflect and influence the sustainability of the government’s policies than targets that do not.

7. The role of parliament

Parliament’s “power of the purse” is the primary vehicle for the legislature to hold the executive to account. It is therefore of fundamental constitutional importance that parliament be fully satisfied with – and fully understand – the nature of accrual budgeting. The experience of countries that have adopted accrual budgeting demonstrates that this can be most challenging. In this respect, it needs to be recognised that budgeting is an inherently political act.

Due to its technical nature, accruals can confuse decision makers, reducing its transparency and understandability, and therefore undermine parliament’s role in the budget process. It should be noted that the three OECD member countries that have adopted accruals are all Westminster countries that give pre-eminence to the executive in budgetary matters and a limited role to Parliament.

Irrespectively, accruals requires a great number of professional judgments to be made on a variety of issues. It can be fairly said that accruals opens up many opportunities for “creative” accounting, as was discussed in a previous section. The role and independence of standards-setters is therefore of primary importance, and this is very much acknowledged by proponents of accrual budgeting.

A specific concern of parliament with the adoption of accruals also has to do with the treatment of capital acquisitions/depreciation. In a sense, parliament can be said to have delegated authority over capital acquisitions to the executive through approving depreciation expenses. Parliament will not have specific controls unless a supporting regime (capital budget, for example) is put in place.

8. Conclusions

This paper discussed the views of proponents and detractors of accrual budgeting and attempted to throw light on many of the “technical issues” surrounding its implementation. The paper has also surveyed the impact on fiscal policy setting and the role of parliament.

What emerges clearly from the discussion is the wide disparity of views among the budgeting community on the desirability of accrual budgeting. The discussion has also revealed that there is a great variety of models for implementing accrual budgeting, some more radical than others. The three member countries that have implemented full accrual budgeting exemplify the differing models in many ways.

It is also important to note that none of the member countries that adopted accrual budgeting did so in isolation; it was done in the context of far-reaching reforms in other areas of government management. Accrual budgeting was therefore part of a much wider reform agenda and it is difficult to assess the role specifically played by accrual budgeting. The importance of implementing accrual budgeting in terms of achieving “culture change” is, however, emphasised by all the countries that have adopted accrual budgeting.

Whether or not to adopt accrual budgeting will likely be on the agenda of member countries for a long time to come. It is an area that is ripe for more in-depth comparative analysis.

Table 1. Use of accrual accounting in OECD member countries

Whole-of-government financial statements

	Cash basis	Cash, except certain transactions on accruals basis	Accruals, except for capitalisation and depreciation of assets	Accruals basis
Australia				X
Austria	X			
Belgium	X			
Canada				X
Czech Republic	X			
Denmark		X		
Finland				X
France		X		
Germany	X			
Greece	X			
Hungary	X			
Iceland			X	
Ireland	X			
Italy	X ¹			X ¹
Japan	X			
Korea		X		
Luxembourg	X			
Mexico		X		
Netherlands	X			
New Zealand				X
Norway	X			
Poland		X		
Portugal		X		
Slovak Republic	X			
Spain		X		
Sweden				X
Switzerland	X			
Turkey	X			
United Kingdom				X
United States				X

1. To be verified.

Source: OECD.

Table 2. **Use of accrual budgeting in OECD member countries**

Accrual appropriations			
	Cash basis	Cash, except certain transactions on accruals basis	Accruals, except for capitalisation and depreciation of assets
Australia			X
Austria	X		
Belgium	X		
Canada		X	
Czech Republic	X		
Denmark		X	
Finland			X
France	X		
Germany	X		
Greece		X	
Hungary	X		
Iceland			X
Ireland	X		
Italy	X ¹		X ¹
Japan	X		
Korea		X	
Luxembourg	X		
Mexico		X	
Netherlands	X		
New Zealand			X
Norway	X		
Poland	X		
Portugal		X	
Slovak Republic	X		
Spain	X		
Sweden		X	
Switzerland	X		
Turkey	X		
United Kingdom			X
United States		X	

1. To be verified.

Source: OECD.

NOTE: Methodology for classification of countries in Table 1 and Table 2

- Refers to core national governments only and does not consider the use of accruals by local/regional governments or state-owned enterprises/other commercial organisations.
- Countries are classified as “full accruals basis” irrespective of whether heritage and military assets, and non-exchange revenue (taxes), are treated on cash basis.

- Countries are classified as “full cash basis” irrespective of whether they have an obligations/commitments system in place.
- Refers to financial reporting and not to statistical reporting (GFS).

Notes

1. This paper uses the term “budget” to refer to the law or collection of laws authorising expenditures, and/or the incurrence of obligations to make expenditures, to be financed from taxes or levies. It is recognised that this term does not have a unified meaning across all member countries, especially Westminster countries.
2. The discussion here uses depreciation as the main example for the treatment of non-cash items in general.

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Off-budget and Tax Expenditures

by

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1. Purpose and scope of the project

This paper reports the work that has been done by the OECD Secretariat on the project on off-budget and tax expenditures. The paper makes use of information that was provided at an expert meeting held in Paris in February 2004.¹ The participants provided written information in response to a questionnaire and made presentations at the meeting.

The purpose of the project is to study ways of ensuring that off-budget and tax expenditures do not impair the proper functioning of the budget. Four functions of the budget are involved:

- The authorisation function: that all money spent from the public treasury be subject to legislative authorisation.
- The allocative/distributive function:² that the budgetary authorities (executive and legislative branches) be able to compare and trade off all changes in expenditures and revenues.
- The macroeconomic function: that the budgetary authorities (executive and legislative branches) be able to decide on the impact upon the economy of totals and composition of expenditure, revenues and the deficit.
- The administrative function: that the budgetary authorities (executive and legislative branches) be able to control the cost efficiency of all public service delivery.

The word “budget” has a different meaning in different countries.³ For the purpose of the present project, the budget is considered as the law or collection of laws authorising expenditures and/or the incurrence of obligations to make expenditures, to be financed from taxes or levies, as well as the specification of the sources of revenue from which expenditures are to be financed. The laws authorising the expenditures or the incurrence of financial obligations will be called appropriations laws in this paper.

In the course of the 19th and 20th centuries, a gradual development took place in many OECD member countries in the direction of more efficient budget institutions. This development has focused on three principles, which can be considered as preconditions for the fulfilment of all budget functions:

- All expenditures financed by taxes or levies and all revenues collected through taxes or levies should be in the budget (the **universality** principle).

- All expenditures in the budget to be made during a certain period of time (usually one or two years) and all revenues in the budget to be collected during that period should be presented to the budgetary authorities for the purpose of decision making in a single document (the **unity** principle).
- Expenditures and revenues should be specified separately in the budget (“gross recording”) and at a level of detail required by the budgetary authorities (the **specificity** principle).

In spite of the gradual development of budget institutions in accordance with these budget principles, in most OECD member countries there remain forms of expenditure that are difficult to reconcile with these principles and thereby threaten the proper functioning of the budget. These forms of expenditures are known as off-budget expenditure and “back door” expenditure. Off-budget expenditures are financed by taxes or levies that are not in the budget (violating the universality principle). “Back door” expenditures are financed by public taxes or levies that are in the budget, but that are materially authorised by substantive laws outside the budget process (violating the unity principle).

The main forms of off-budget expenditures that can be found in OECD member countries are:

- off-budget funds;
- direct loans;
- guarantees;
- public-private partnerships (PPPs).

All these forms can potentially impede one or more function(s) of the budget.⁴

PPPs are a new development in many OECD member countries, thus making it difficult to put forward best practice proposals at this stage. If the use of PPPs continues – which is not yet sure since there is also some reluctance among a number of countries – it may be worthwhile to dedicate a special best practice study to this theme. In this paper, PPPs are not further considered.

The main forms of “back door” expenditures are entitlements (financial obligations created by substantive law) and tax expenditures (tax reliefs created by tax laws). Entitlements and tax expenditures do not necessarily create a problem for the proper functioning of the budget as long as the budget procedure provides for the opportunity to change the substantive laws creating the entitlements and tax expenditures in the course of the budget process. If that is the case, the trade-offs required by the allocative/distributive function, the control of the totals required by the macroeconomic function, and the control of cost efficiency required by the administrative function are ensured, whereas the legislative authorisation required by the authorisation function is automatically ensured because entitlements and tax expenditures are created by substantive

law in the first place. Nevertheless, tax expenditures may cause a problem for the proper functioning of the budget, for two reasons. First, tax expenditures may escape the budgetary control of the prevailing fiscal rule and thereby hamper the macroeconomic and allocative/distributive functions of the budget. Second, tax expenditures are typically the responsibility of the Minister of Finance in the executive branch and the tax or financial committee in the legislative branch; this may impede the trade offs required by the allocative/distributive function and the control of cost efficiency required by the administrative function. For these reasons, this paper will consider tax expenditures separately.

2. Off-budget expenditures

2.1. Off-budget funds

Off-budget funds are special funds owned by the government that are not part of the budget and that receive revenues from earmarked levies, possibly next to other sources such as fees and contributions from the general tax fund. Earmarked levies are different from fees in that they do not reflect the market value of the services that are financed from the revenues. In particular they may be lower or higher in view of social considerations (capacity to pay or equality regardless of costs).

Off-budget funds can mainly be found in European OECD member countries. Of the countries that provided information to this project, the Czech Republic, France,⁵ Greece, Hungary, Italy, and the Netherlands reported the existence of off-budget funds, sometimes large numbers of them. Off-budget funds mainly occur in the areas of social security, health care, transport, and pensions. Central and Eastern European countries report the establishment of off-budget funds in order to facilitate the privatisation process. Off-budget funds seem to be used especially in a number of European countries with a strong tradition of syndicalism or private initiative in the non-profit sector (France, Greece, Italy, and the Netherlands).

The government ownership of off-budget funds refers to economic ownership, not ownership in the legal sense. Economic ownership appears from the fact that the government can dispose of the assets of the fund, if necessary by changing the law by which it is established, without compensation. Economic ownership in this sense usually appears from the fact that a government official, possibly a minister, administers the fund or appoints the board or some member(s) of the board. In a legal sense the fund is sometimes an independent public corporation.

With respect to off-budget funds, there seem to be two distinct traditions in the OECD area, which could be termed the Anglo-Saxon tradition and the continental tradition. In the Anglo-Saxon tradition, there is, at least in theory, no place for off-budget funds. In this tradition all expenditures that are

financed by taxes or levies should be in the budget. However, even in countries adhering to this tradition, exceptions occur. For example, in the United States two off-budget funds were created in the 1980s to resolve the problems of failed thrift institutions (savings and loans). In the continental tradition, off-budget funds are numerous and based on principled argument. The clearest cases are the social security and public health care funds; in these cases, the reasoning is that the premiums are paid by the social partners (employers and employed) and that the funds thus “belong to them” at least to the same degree as to the government. For the same reason, the social partners are often represented in the board of the funds.

Even in the continental tradition not all expenditures that are wholly or partially financed by earmarked levies are off-budget. If the revenue from the levy constitutes a relatively small contribution to the funding of the service or if there is no clear, organised segment of the population that pays the levy and benefits from the service, the expenditures are usually on-budget, regardless of whether the agency supplying the service is an independent public corporation in the legal sense. In a number of OECD member countries, this applies to public universities and other public establishments of higher education (partially paid by educational levies) and to public broadcasting institutions (partially paid by broadcasting levies).

On the other hand there may also be funds and independent public corporations that are not financed by earmarked levies at all, but rather by fees that are supposed to reflect market values – or at least not to exceed market values – possibly supplemented by contributions from the general tax fund. These funds or corporations are “outside the budget”. They are not “off-budget” in the sense of the definition given above (because they are not financed by earmarked taxes). This applies to public universities and other establishments of higher education in countries where these establishments are funded by fees.⁶ It applies also to pension funds in countries that have a largely or fully funded pension system for public employees. In these cases the expenditures of these funds are not only outside the budget, but also netted with the fees, so that only the public contributions and employer fees appear in the budget. In these cases the funds or public corporations concerned are treated on an equal footing with private corporations, for instance private schools that receive subsidies.⁷

The protection that off-budget funds offer to those who have paid the earmarked levies need not be eliminated, but ought to depend on a strict condition, namely that expenditures and revenues of the funds are subjected to regular budgetary control. This implies among other things that expenditures and revenues are published in the budget documentation, that the totals are subjected to the prevailing fiscal rule, that the rules of budgetary discipline regarding compensation of overspending apply, and that expenditures and revenues of the funds are subject to annual review as part of the budget process.

If these conditions are met, the step towards integration into the budget, as the Anglo-Saxon tradition requires, is not very large. However, it is not solely a question of presentation. The essential point is that special funds are based on the idea that certain services are to be paid by the users, although considerations of solidarity require that the prices paid do not reflect market value (are not “fair” in that particular sense) but rather cross-subsidising. This implies that, in so far as macroeconomic, allocative/distributive or administrative considerations require adjustments in connection with the budget process, these adjustments should in principle always apply to levies and service levels simultaneously and not to levies and service levels viewed in isolation. The protection offered by the special fund consists in the special way in which it is to be co-ordinated with the budget (levies and service levels simultaneously and not in isolation). It does not consist in the fact that expenditures or revenues are immune to budgetary control. If the special fund is an independent public corporation, this form of protection gets special emphasis, because its board can then speak out against changes in earmarked levies that would unduly increase its deficit or surplus or increase its dependence on contributions from the general tax fund.

As far as the application of fiscal rules is concerned, the revenues and expenditures of the funds should be presented in the budgetary documentation in consolidated form with the revenues and expenditures that are on-budget. As far as the European countries are concerned, the rules in the 1995 European System of Accounts (ESA 95) prescribe that off-budget funds should be consolidated. Social security (including public health insurance) should be presented separately according to ESA 95, but in such a way that summing does not lead to double counting.⁸

2.2. Direct loans

Direct loans are loans financed from taxes or levies. In general, the conditions of direct loans are more favourable to the borrower than those of bank loans in the private sector because otherwise there was no reason for public lending. It may also be the case that the risk is so high that no loan could be obtained in the private sector at all. The subsidy element in public loans may concern interest rates below market rates or default risk and favourable repayment conditions in so far as they are not reflected in the interest rate or special risk fees (for instance acquittal under certain specified conditions, such as study loans).

Many OECD member countries have gone through successive stages of credit reform in the last two decades. This applies, for instance, to the United States and various countries of the European Union. In a somewhat stylised way, these stages can be described as follows:

- traditional cash budgeting;

- credit budgeting;
- credit subsidy budgeting.

In **traditional cash budgeting**, all cash streams associated with the loans are recorded in the budget at the moment they are expected to occur and in the accounts at the moment they actually occur. The cash outflow includes the disbursement of the principal; the cash inflow includes interest, risk fees (possibly included in the interest) and repayments of the principal. This procedure has important disadvantages: depending on the wording of the appropriations legislation, loan programmes can be continued on a revolving fund basis without legislative authorisation; disbursement and repayment of loans have different macroeconomic effects than regular expenditure and receipts; the real subsidy costs of loan programmes are not revealed so that such programmes cannot be traded off against other programmes on an equal basis; and the real subsidy costs of loans cannot be scrutinised in the budget process, for instance by cost-benefit analysis.

Some OECD member countries have put credit programmes in separate sections of the budget (**credit budgeting**). Disbursements of loans and repayments are excluded from the domain of the fiscal rule, not only if the fiscal rule is on an accruals basis but also if it is on a cash/obligations basis.⁹ On the other hand, loan disbursements and repayments are on-budget and therefore still subject to budgetary control (albeit not at full costs). Credit budgeting has solved the problem of different macroeconomic effects and has eliminated improper elements from the public deficit. It has also made an end to the automatic authorisation of revolving funds. However, it has not removed the other disadvantages inherent to traditional cash budgeting. In particular it does not lead to the revelation of real subsidy costs, which impedes the allocative/distributive and administrative functions of the budget.

Credit subsidy budgeting is the final stage of reform toward which some countries have evolved (New Zealand, United States).¹⁰ Under credit subsidy budgeting, the expected incoming and outgoing cash flows during the lifetime of the loans are all discounted and the resulting balance is authorised as subsidy costs at the moment the loan is made.¹¹ The financial account on which the cash flows related to the loan are recorded is excluded from the domain to which the fiscal rule applies.¹² These cash flows include the appropriated subsidy costs (as a receipt). Credit subsidy budgeting implies that programme funds require authorisation for the new loans made in each year. Furthermore, it makes it possible to compare the costs of credit programmes to the cost of other programmes. Finally, it makes it possible to review the subsidy costs of credit programmes in the course of the annual budget process, for instance by cost-benefit analysis.

Although credit subsidy budgeting is the proper way of treating credit programmes, in practice it is not always easy to execute. Some difficulties are:

- Administrative costs remain excluded (because they can supposedly be controlled during the lifetime of the loan), but this complicates trade-offs and cost-benefit analysis.
- There are the usual problems of choosing the appropriate public discount rate (no proper risk margin).
- Default risk and other risk elements of the loan are hard to estimate; this requires in theory statistical models for each type of loan and advanced risk assessment methods such as options pricing.¹³
- The system requires periodic re-estimation and additional appropriation of subsidy cost increases which leads to administrative costs. New Zealand and the United States both provide the additional appropriation automatically. The United States experience shows that re-estimates can be very large, larger than the initial costs of new loans. These difficulties suggest that estimates are subject to considerable uncertainty. However, studies by the Congressional Budget Office and the General Accounting Office have not found evidence of systemic bias in the United States. The reason may be the checks and balances built into the United States budgetary institutions. This does not rule out bias in particular programmes or at certain times. Other countries that try credit subsidy budgeting may be confronted with less reliable estimates. This could lead to using robust estimating rules (or rules of thumb) which are easily comprehensible to politicians and citizens even if less sophisticated than desirable.

2.3. Guarantees

Loan guarantees are guarantees by the government to non-governmental lenders in case of debtor default. Loan guarantees are supposed to include public insurance of loans by non-governmental lenders against an insurance fee. Loan guarantees are also supposed to include the implicit guarantee that is inherent to loans by public enterprises like government-owned banks.¹⁴

All countries that provided information to this project report the amounts of loan guarantees in their budget documents, but not so many report subsidy costs when the guarantees are made. New Zealand,¹⁵ Norway and the United States include the subsidy costs in the expenditure estimates. Germany includes a provision in the budget, when there is a “strong possibility” that fees will not cover the default risk.

Table 1 shows the amount of outstanding guarantees of selected OECD countries in 2003 as a share of total expenditure of general government (consolidated expenditure of central government, subnational government and the social insurance sector).

Table 1. **Outstanding guarantees as share of total general government expenditure (2003)**

	Percentage of total general government expenditure
Australia	58.2
Canada	1.1
Czech Republic	36.3
Germany	30.9
Greece	14.7
Hungary	14.4
Japan	29.8
Netherlands	38.0
New Zealand	1.0
Norway	8.6
Poland	9.0
Spain	3.5
United States	31.1

Source: OECD.

If subsidy costs are not reflected in the budget at the moment the loans are made, guarantee programmes cannot be traded off against other programmes on an equal basis and the real costs of such programmes cannot be scrutinised in the budget process, for instance by cost-benefit analysis.

The same reasoning that motivates credit subsidy budgeting provides the motive for **guarantee subsidy budgeting**. This reform requires similarly that the expected incoming and outgoing cash flows during the lifetime of the guarantee are all discounted and that the resulting balance is authorised as subsidy cost at the moment the guaranteed loan is made by the private lender. Again, the financial account on which the cash flows related to the guarantee are recorded is excluded from the domain to which the fiscal rule applies. The incoming cash flow includes risk fees and the appropriated subsidy costs; the outgoing cash flow includes compensation to the private lenders for default.

Guarantee subsidy budgeting implies that guarantee programmes require authorisation at each occasion that new guarantees are made. Furthermore, it enables comparison of the costs of guarantee programmes to the costs of other programmes (for instance, direct loans to the same borrowers, provided that direct loans are also budgeted on a subsidy cost basis). Finally, it enables scrutiny of the subsidy costs of guarantee programmes in the course of the annual budget process, for instance by cost-benefit analysis.

Although guarantee subsidy budgeting is the proper way of treating guarantee programmes, in practice it is not always easy to execute for the same reasons that credit subsidy budgeting is not easy to execute: administrative costs remain excluded, the public discount rate may not reflect a proper risk margin, default risk may be hard to estimate, and the system requires annual

re-estimation and additional appropriation – which in some countries, however, may be automatically provided.¹⁶ Again this could lead to using robust estimating rules (or rules of thumb) which are easily comprehensible to politicians and citizens even if less sophisticated than desirable.

A major reason why the government may prefer a guarantee programme to a direct loan programme is that a guarantee programme can assign part of the risk originally associated with the loan to the private lender. The government steps in only if the risk is exceptionally high or of a nature that private lenders are not willing to cover (for instance, political risk in case of export credit). In order to prevent abuse of guarantee programmes, it is therefore necessary that the private lender shares at least a part of the risk.¹⁷

3. Tax expenditures

3.1. Identification of tax expenditures

Tax expenditures can be used as an instrument of government policy and may often be substitutes for direct expenditures. At the beginning of the 1970s, only Germany and the United States recorded tax expenditure in special accounts and reported them to parliament. By 1983, Australia, Austria, Canada, France and Spain were also regularly identifying tax expenditures and reporting them. In 1996, almost all OECD member countries reported tax expenditures. The OECD published studies on tax expenditures in 1984 and 1996 (OECD, 1984; OECD, 1996), and issued a special feature about tax expenditures and tax/GDP ratios in the 2003 edition of the revenue statistics (OECD, 2003). The *OECD Best Practices for Budget Transparency* (OECD, 2002) contain some basic guidelines for the treatment of tax expenditures.

A tax expenditure can be defined as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by a direct expenditure.¹⁸ It has often been observed that this definition has not led to international comparability of tax expenditures, because of differences of opinion about the benchmark tax.

Tax expenditures may take a number of different forms:

- exemptions: amounts excluded from the tax base;
- allowances: amounts deducted from the benchmark to arrive at the tax base;
- credits: amounts deducted from tax liability;
- rate relief: a reduced rate of tax applied to a class of taxpayer or taxable transactions;
- tax deferral: a relief that takes the form of a delay in paying tax.

The transfer of resources emanating from a tax expenditure may be bound to the purchase of a certain good (in which case the tax expenditure is a tax subsidy) or unbound (in which case it is a tax transfer).

The identification of tax expenditures is a classification exercise: dividing the provisions of the tax laws into a benchmark tax and a series of deviations from that benchmark tax. According to the 1996 OECD report, the benchmark tax includes: the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration, and provisions relating to international fiscal obligations. However, these indications leave open many questions. The problem is more profound than the lack of agreement about the types of provisions that belong to the benchmark tax; it is rooted in different views of **the normative tax base**. The normative tax base is the monetary sum in the hands of private households to which the tax ought to be applied, for instance: income, value added, profit, sales. Views of the appropriate normative tax base not only differ between national tax systems, but also between interpretations of the same national tax system by citizens and politicians. If the benchmark for the identification of tax expenditures is equated with the normative tax base, differences of opinion concerning the normative tax base will necessarily translate into differences of opinion about the identification of tax expenditures. Since this approach (equating the benchmark with the normative tax base) has proved to be less fruitful in the past, it is proposed here to distinguish between the benchmark and the normative tax base.

The distinction can be illustrated by the concept of “income” which serves as a normative tax base in many income tax systems. In principle it is possible to define this concept quite precisely. The standard is the Haig-Simons or accretion definition of income which states that income is the difference in wealth of a household between two points in time, plus the value of consumption during that period. However, many citizens and politicians would view income in this sense only as a first approximation of what the fiscal system really ought to tax. Therefore the tax code needs provisions to bridge the difference. The normative tax base may, for instance, take into account:

- Capacity to pay: In this view, special provisions have to exclude everything from the tax base which diminishes the capacity to pay, in particular all costs of necessities for which the taxpayer cannot or should not be held responsible: exceptional health costs, maintenance of dependent family, study costs of children, etc.
- Consumption: In this view, the actual income tax is intended to be a compromise between a comprehensive income tax and a comprehensive consumption tax; in this view special provisions have to exclude certain forms of saving from the tax base (pension premiums, saving plans, etc.) as part of the compromise.¹⁹

- Analytical income: In this view, income should only be taxed if the tax cannot easily be evaded; this leads to taxation at the source and the application of different rates to different sources of income reflecting the costs of evasion; in this view special provisions concerning rate differences between sources of income have to be seen as inherent to the aims of the tax.

The provisions required to bridge the difference between the comprehensive concept of income and a particular normative tax base are part of the definition of the normative tax base and not exceptions to it. However, if opinions differ about the normative tax base, opinions will also differ about what the exceptions are.

Differences of opinion may also occur with respect to the normative base of other taxes, for instance the VAT. In one view, special provisions are required to ensure that a lower rate is applied to the necessities of life (or to exclude the necessities of life from the regular tax base and to include them in a special tax base), taking into account the typical composition of consumption packages of family households and based on capacity to pay. In another view, however, the VAT is considered as a tax that has value added by definition as its exclusive tax base. A special provision for the necessities of life is not a part of the definition of the normative tax base but an exception to it.

Similarly, differences of opinion may occur with respect to the normative base of excise taxes. In one view, such taxes not only have allocative effects but are also aimed at these effects (regulatory taxation). In particular, they may be supposed to decrease the demand for goods that have negative external effects on third parties (for instance, the gasoline tax) or on the consumers themselves (for instance, the levies on alcohol and tobacco). In this view, special provisions are required to ensure that a lower rate is applied to a less harmful product (or to exclude a less harmful product from the regular tax base and include it in a special tax base), for instance, lead-free gasoline. A different view is that excise taxes are not considered as regulatory taxes. A special provision for a less harmful product is not part of the definition of the normative tax base but an exception to it.

Apart from the nature of the normative tax base, its interpretation may be controversial. A well-known dispute in this respect is the treatment of mortgage interest. One interpretation of family income says that a family receives a flow of housing services from an owner-occupied home equal in value to the rent that the property could earn in the market. After deducting the costs of earning that income, including mortgage interest, the remainder – an imputed net rent – is part of Haig-Simons income. In this view, exemption of the mortgage interest is not an exception to the normative tax base, but exemption of imputed rent is. Another interpretation of family income says that the purchase of the family home is the purchase of a durable consumption good. In this view,

mortgage interest should be included in the tax base, but imputed rent should not. In this view, exemption of mortgage interest is an exception to the normative tax base, but exemption of imputed rent is not.

It appears then that the definition of the normative tax base is a very political exercise. For this reason, attempts in the past to define tax expenditures in terms of the normative tax base (“tax expenditures are exceptions to the normative tax base”) have not been very successful. They have led to neither international nor domestic agreement about the concept of tax expenditure. Thus the definition of a tax expenditure proposed above abstracts from the normative tax base. The definition uses rather the more neutral yardstick of the “benchmark tax”. Tax expenditures in this sense are deviations from the benchmark tax. The benchmark has no normative significance. Deviations from it in order to arrive at the normative tax base may be perfectly appropriate. Tax expenditures may thus also be appropriate.

Characteristics of the benchmark are that it is comprehensive and unique. Examples of benchmarks are: comprehensive income (the Haig-Simon concept), comprehensive consumption, value added, sales in a certain product class. If an excise is levied on a harmful product (for example, pure alcohol), no exceptions for less harmful products are necessary. In practice excises are almost never levied on the harmful ingredient *per se*. The normative tax base will then deviate from the benchmark.

The purpose of tax expenditures is not only to demarcate the normative tax base as it is seen in a particular country at a particular time, but also to ensure that the tax office executes certain subsidies and transfers. Indeed there may be good reasons for the administration of subsidies and transfers by the tax office:

- It precludes unnecessary transfers of resources, thus reducing administrative costs.
- It diminishes the incentives for tax evasion.
- The tax office has unique expertise in the administration of transfers and subsidies and unique information about the characteristics of households and businesses which may be relevant for the administration of transfers and subsidies, such as address, income, household composition, and nationality.
- Concentration of the administration of subsidy and transfer entitlements in the tax office leads to economies of scale.

On the other hand, there may also be good reasons why subsidies and transfers should not be enacted as tax expenditures:

- Exemptions, allowances, rate reliefs and deferrals provide benefits in proportion to the tax base of a family or business household. For instance, a

high-income household benefits more from an exemption in the income tax than a low-income household; it only makes sense to enact a subsidy or transfer as a tax expenditure if this effect is desired.

- Tax credits provide equal benefits to households, regardless of the tax base, but can easily lead to negative tax liabilities, which may be difficult to administer: if they are non-wasteable (refundable), they should actually be paid out.
- It is important that the tax office not be overloaded with the administration of tax expenditures which may endanger its primary task, namely the collection of revenues.

Although it seems premature to formulate a best practice list of criteria in this respect, policies in a number of OECD member countries suggest that the following considerations may be relevant:

- The comparative advantage of the tax office has to be sought primarily in the area of means-tested (income-dependent) subsidies and transfers, where tax return data can be used to determine eligibility and the amounts transferred.
- Tax expenditures should only be used for entitlements (not for programmes with administrative discretion in providing subsidies or transfers).
- It is questionable whether the tax office should be used for the administration of entitlements that may lead to net payments by the government to family and business households. This might imply among other things that subsidies and transfers to persons or households that do not pay tax should be enacted as regular expenditures rather than as tax expenditures.

3.2. Budgetary control of tax expenditures

Although there may be good reasons for tax expenditures, it is also important that tax expenditures be subjected to budgetary control in the same way as regular expenditures are. A less rigorous control of tax expenditures than of other expenditures will create an incentive to enact subsidies and transfers in the form of tax expenditures, regardless of the objective considerations that could justify such a choice. This would jeopardise the allocative/distributive, macroeconomic and administrative functions of the budget and could endanger the primary revenue collection function of the tax system.²⁰

For all functions of the budget it is important that all tax expenditures are estimated in addition to tax revenues and integrated into the expenditure documentation that is presented for consideration to the budgetary authorities. Most countries that provided information for this project provide tax expenditure estimates as part of the annual budget documentation, often including multi-annual estimates.

As far as the macroeconomic function is concerned, it is important that tax expenditures do not escape the control of the fiscal rule. There are basically six types of fiscal rule in OECD member countries:²¹

1. Nominal overall deficit rules;
2. Structural overall deficit rules;
3. Medium-term deficit rules with multi-annual expenditure caps;
4. Nominal operating or current²² balance rules;
5. Structural operating or current balance rules;
6. Medium-term operating or current balance rules with multi-annual expenditure caps.

These fiscal rules offer different opportunities to escape budgetary control through the use of tax expenditures.

Under nominal or structural deficit or operating/current balance rules (types 1, 2, 4 and 5), a total expenditure cap is set annually in view of tax revenue estimates. Since tax expenditures are reflected in revenue estimates, they cannot escape the fiscal rule if changes in estimates are taken into account when the expenditure cap is set. However, during budget formulation, expenditures tend to be treated differently than revenues. In general, taxes are less flexible than expenditures, and in periods of fiscal stress the first effort is usually directed at the adjustment of expenditures rather than of revenues. Also, overspending on expenditures during the fiscal year or budget period is treated differently than shortfall of revenues.²³ In order to treat tax expenditures in the same way as regular expenditures rather than as (a negative) part of revenues, it is therefore important that under such rules tax expenditures are included in the total expenditure cap or – what amounts to the same – that a special cap is set for tax expenditures and that under nominal deficit and operating/current balance rules, overspending on tax expenditures during the fiscal year or budget period is fully compensated.

Under medium-term rules with multi-annual expenditure caps (types 3 and 6), the caps for total expenditures cannot be changed in the annual budget process.²⁴ The annual deficit or operating/current balance is allowed to fluctuate (possibly under the proviso that a critical ceiling is not exceeded).²⁵ Without special provisions, tax expenditures under such rules can escape the control of the fiscal rule. Therefore it is necessary that under such rules tax expenditures are included in the total expenditure cap of each year or – what amounts to the same – that a separate cap is set for total tax expenditures of each year and that all changes in tax expenditures are fully compensated, at least in so far as they originate in policy change (change of the tax laws)²⁶ and regardless of whether they occur during the fiscal year or budget period or in the annual budget process.

For both the allocative/distributive and administrative function of the budget, it is important that tax expenditures are reviewed in the same way as regular expenditures. This applies to annual scrutiny in the course of the regular budget process as well to special evaluation procedures. Annual scrutiny in the course of the budget process concerns the activities of financial staff of ministries which may lead to advice to the spending ministers, and the activities of the central budget bureau which may lead to advice to the minister of finance, the prime minister or the president. Special evaluation procedures may concern studies under the responsibility of the spending minister or studies under the responsibility of the budget bureau or the office of the prime minister or president. In the latter case, evaluations often have a broader aim than the control of cost efficiency. They also look at allocative efficiency and typically ask questions such as: what would happen to this programme if funding is reduced by 10 or 20% or if the problem were abolished (this is sometimes called “programme review” as a type of evaluation). Canada, the Netherlands, New Zealand and the United Kingdom apply special evaluation procedures and/or programme review to their tax expenditures.

For all functions of the budget it is important that tax expenditures are assigned to ministries and that individual ministers are made responsible for them. Since tax expenditures must not undermine the efficiency and effectiveness of the tax system, the minister of finance should always be co-responsible. The minister of finance can also be the (only) responsible minister for tax expenditures in his/her own area of responsibility. Legislative proposals concerning tax expenditures should always be signed by the responsible minister and the minister of finance together. Objections of the minister of finance against changes of a specific tax expenditure can never be used as an argument against adjustment of other (tax) expenditures if a ministry is required to diminish its expenditures or find compensation for overspending.

3.3. Estimation of tax expenditure

Tax expenditure estimates can be made by three different methods:

- Initial revenue loss (gain):²⁷ the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure, based upon the assumption of unchanged behaviour and unchanged revenues from other taxes.
- Final revenue loss (gain):²⁸ the amount by which tax revenue is reduced (increased) as a consequence of the introduction (abolition) of a tax expenditure, taking into account the change in behaviour and the effects on revenues from other taxes as a consequence of the introduction (abolition).
- Outlay equivalence: the direct expenditure that would be required in pre-tax terms, to achieve the same after-tax effect on taxpayers' incomes as the

tax expenditure, if the direct expenditure is accorded the tax treatment appropriate to that type of subsidy or transfer in the hands of the recipient.

The method of **initial revenue loss (gain)** is based upon the assumption that the introduction or abolition of tax expenditure does not affect the behaviour of taxpayers and the revenues from other taxes.²⁹ It is therefore the easiest estimation method. In general, taxpayers will change their behaviour in reaction to the introduction of a tax expenditure (increase their demand for the tax-subsidised good or increase/decrease their demand for income³⁰). This change in behaviour is often also intended by the government. Furthermore, there may be second-order effects on other sectors or on the economy as a whole. Tax expenditures may for instance lead to increased growth due to a lower general tax level. Behaviour will be affected in the opposite direction when a tax expenditure is abolished. Taxpayers' behaviour should not be confused with interaction of tax expenditures with other parts of the tax system. For instance, some taxpayers may end up in a lower bracket of the income tax as a result of a new tax expenditure and consequently face a lower marginal rate. This will also imply that for these taxpayers the value of existing tax expenditures is reduced. When using the method of initial revenue loss (gain), it is often assumed that the exempted income is taxed at the same marginal rate as the remaining (c.q. restituted) taxable income, or in other words at the same marginal rate that the taxpayers face after the introduction (c.q. abolition) of the tax expenditure. Furthermore, this also implies that the value of the other tax expenditures is unchanged as a result of the introduction of the new (abolition of the existing) tax expenditure.

The method of **final revenue loss (gain)** takes the behavioural change and the change in tax interaction into account.³¹ Of course this makes the method much more complicated to apply in practice. Although the method is superior in principle, many governments seem to assume that the accuracy that may be gained is not worth the efforts required to apply the method.

Outlay equivalence is a measure that leaves the net budget impact (on the surplus or deficit) and the after-tax incomes of taxpayers the same in the situation with tax expenditure and in the situation with equivalent outlay but without tax expenditure. Outlay equivalence takes into account the fact that regular transfers are sometimes estimated gross of the tax paid by the recipient, whereas tax transfers are by definition net of tax. In order to estimate these tax expenditures on the same basis as regular expenditures, it is necessary in those cases to add the tax that is typically levied upon the regular transfer. Otherwise, it appears as if the tax expenditure is a cheaper way to get the same amount of cash into the hands of the recipient than the regular expenditure. In general, tax equivalence only differs from initial revenue loss (gain) in the case of tax transfers (as opposed to tax subsidies).³²

Moreover, both methods only differ if the analogous expenditure transfer is taxed.

Table 2 illustrates the various measurement methods for the case of an income of 100, a tax exemption of 25 and a progressive income tax with rates 40% and 50% below and above the threshold of 75. The large size of the tax exemption and the choice of the threshold serve to highlight the differences between the estimating methods. In reality the differences will be less dramatic.

Table 2. **Estimation methods for tax expenditure**

	With tax expenditure	Without tax expenditure		
		Initial revenue gain	Final revenue gain	Outlay equivalence
1 Before tax income	100	100	100	100
2 Exemption	25	0	0	0
3 Equivalent outlay	0	0	0	25
4 Taxable income (1-2+3)	75	100	100	125
5 Tax revenue	30	40	42.5	55
6 After-tax income (4-5+2)	70	60	57.5	70
7 Budget impact (5-3)	30	40	42.5	30
8 Tax expenditure		10	12.5	25

Source: OECD.

It is sometimes said that tax expenditures **cannot be added up**. This would appear in the case of a multi-bracket income tax and two tax exemptions. If one exemption is introduced (or removed), some taxpayers would be moved into a different tax bracket and thus the second tax expenditure would be decreased (or increased). If two exemptions are introduced (or removed) at the same time, the change in tax liability would be more (or less) than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force. If the rate structure of the tax is progressive, which is usually the case, tax expenditures except tax credits will have a larger value to the extent that more tax expenditures apply to the same tax base. This effect, however, should be kept in mind while interpreting sums of tax expenditure but need not be seen as an impediment against adding up.³³ In this connection, estimates of regular expenditures are also dependent on the existence of other expenditures, apart from behavioural effects. For instance, a reduction of unemployment benefits will immediately increase the obligations concerning welfare (without any intervening behavioural change). Nevertheless expenditures are routinely added up. However, the interdependence of the estimates has some consequence if the tax expenditures are assigned to the ministries. In general

the responsibility for the estimates cannot be left to the spending ministries, but should remain with the ministry of finance.

Notes

1. The following countries were represented at the expert meeting and provided written information: Canada, the Czech Republic, France, Germany, Greece, Hungary, Italy, Japan, Mexico, the Netherlands, New Zealand, Norway, Poland, Spain, Sweden, and the United States. Australia and the United Kingdom provided written information.
2. The allocative/distributive function is often called the “allocative” function (in a broad sense). However, in view of the important role of the budget in the redistribution of income, it seems preferable to distinguish the distributive aspect. For the role of the “distributive branch” of the budget, see Musgrave (1959).
3. For instance, in the United Kingdom the “budget” has a different meaning than in the United States. In the United Kingdom, the budget is a statement by the Chancellor of the Exchequer that treats taxation and tax estimates (Likierman, 1988). In the United States, the term “budget” commonly means the estimated or proposed receipts, outlays, deficit and authority to incur obligations for a year or a period of years. The term may also be used for the documents that transmit the President’s proposal.
4. It has been observed that certain regulations have much in common with off-budget expenditures, especially when they put financial burdens on private sector households such as business enterprises and families. However, there is an essential difference, namely that these financial burdens do not take the form of taxes or levies. It seems preferable, therefore, to consider regulations as forms of government intervention *sui generis*, which do of course require control, but separate from budgetary control (regulatory control).
5. France has reported a “very large number” of *administrations publiques* (APU), but not all of these are off-budget funds (many not being financed by earmarked levies). However, there are also a large number of off-budget funds in France.
6. The distinction between educational fees and levies may be subtle, especially since fees, too, may be regulated by law. An important indication is whether they are paid to the government or to the establishment.
7. The same reasoning underlies the rule in the United States that the expenditures of governmental agencies that are partially or fully funded by fees should appear on a net basis (netted with the fees) in the budget.
8. Net public contributions to the funds are neither counted as central government expenditures nor as fund revenues.
9. If the fiscal rule is on an accruals basis, disbursements and repayments are excluded from the deficit automatically (because they are financial transactions). For instance, the ESA 95 rules for the computation of the general government deficit exclude financial transactions.
10. Germany includes the interest subsidy in the budget, but this does not seem to take into account the real risk margin that should be included in the interest.
11. The loan transaction date is evident if the estimates are accruals based or obligations based in a cash/obligations based budget (for instance, in the United States, where budget authority or the authority to incur obligations is

- appropriated). It may be less evident if the estimates are cash based (regardless of whether cash is appropriated, as in most European countries, or whether it is provided as information, as in the United States). However it is logical to include subsidy costs also upfront in cash estimates, because that is the year when the costs are made and the (only) year to which the estimates apply.
12. In the United States, the financial accounts that record the cash flows are considered as outside the budget (in concept, thus not off-budget) but this need not necessarily apply to other countries.
 13. See, for instance, Duffie and Singleton (2003).
 14. The *Manual on Fiscal Transparency* of the International Monetary Fund (IMF, 2001) treats loans by the central bank, government-owned financial institutions and public enterprises under the heading of “quasi-financial activities” (together with activities of those enterprises that resemble subsidies). The *Manual* recommends in essence the same approach for those loans as proposed here for guarantees.
 15. In New Zealand, not all guarantee costs are quantified, but the most important ones are. Reporting about guarantees is very extensive: monthly in accounting statements; bi-annually in the Crown financial statements and the budget and December forecasts; immediately in the government “Gazette”.
 16. This might be realised through permanent indefinite appropriations. In countries that do not have the legal possibility of indefinite appropriations, it may be possible to create a special provision in the budget law that allows indefinite appropriation for credit programmes.
 17. Norway holds the principle that guarantees should be “self-financing”, meaning that risk fees should cover the costs. This raises the question of why the guarantee programmes cannot be left to the private insurance sector.
 18. OECD (2003).
 19. For the differences between taxing income and consumption, see Bradford (1984).
 20. The authorisation function raises no particular problem because the tax side of the budget is subjected to annual budgetary review anyway.
 21. Other classifications are also possible. See Banca d'Italia (2001) for various approaches, classifications and surveys. OECD (2004) presents a survey of the fiscal rules of all OECD member countries.
 22. Operating balance allows borrowing only for investment net of depreciation. Current balance permits borrowing to finance gross investment. Operating balance is defined in terms of an accruals-based budget, current balance is defined in terms of a cash/obligations based budget.
 23. Tax expenditures are comparable to entitlement expenditures. The treatment of setbacks and windfalls (lower or higher expenditures than estimated in the budget) in entitlement expenditures differs between countries that use nominal or structural deficit or operating/current balance rules. In general, it would seem logical that overspending on entitlements and tax expenditures due to setbacks would have been compensated under nominal rules and that it could be left uncompensated under structural rules. Spending on entitlements and tax expenditures often fluctuates with the business cycle, and structural norms aim to accommodate the business cycle. Since deficit and operating/current balance rules set ceilings, not targets, windfalls need not allow new expenditures.

24. The cap for total expenditures is usually divided over sectors or ministries. The sectoral or ministerial sub-caps can be changed in the annual budget process through reallocation to accommodate new developments.
25. In Sweden and the Netherlands, the expenditure caps can and must be decreased if the critical ceiling would be exceeded.
26. The treatment of setbacks and windfalls in entitlements expenditures differs between countries that use medium-term rules with expenditure caps. In the United States under the Budget Enforcement Act, setbacks in entitlements did not need to be compensated under the PAYGO rule, and windfalls could not be used for new expenditures. In the Netherlands, there is asymmetric treatment of setbacks and windfalls in entitlements expenditures: setbacks have to be compensated; windfalls can be used for compensation of setbacks but not for new expenditures.
27. In previous OECD studies (OECD, 1984; OECD, 1996) this method was called "revenue forgone". This name was not very illuminating and has therefore been abandoned.
28. In previous OECD studies (OECD, 1984; OECD, 1996) this method was called "revenue gain". This name was not very illuminating and, when applied to the introduction of a new tax expenditure, was incomprehensible; it has therefore been abandoned.
29. This method yields different estimates depending on whether the tax expenditure is introduced (initial revenue loss) or abolished (initial revenue gain). The reason is that in general tax expenditures do affect behaviour and tax interaction, so that behaviour and tax interaction will be different with and without tax expenditure. In general, initial revenue loss will lead to a higher estimate than initial revenue gain because with tax expenditure, behaviour tends to lead to a larger tax base (this effect being stronger than tax interaction which may lead to a lower marginal rate).
30. If a tax transfer is introduced, the substitution effect will work in the direction of more income and less leisure. However in the case of the leisure vs. income choice, the income effect tends to be strong and may overwhelm the substitution effect.
31. The method of final loss yields the same estimate if it is applied to the introduction or the abolition of a tax expenditure. This is the case because the behavioural situation and tax interaction of both situations (with and without tax expenditure) are compared.
32. Tax subsidies do not differ from regular subsidies in the way the subsidised goods or the incomes of those who sell or purchase them are taxed. VAT and sales taxes are levied on market prices after subsidy. Income or corporate tax on sellers is levied on profit after subsidy. Income tax on purchasers is levied on income before the purchase of the subsidised good.
33. See, for instance, Perry (1995).

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