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Foreword

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Off-Budget Expenditure: An Economic and Political Framework

by
Allen Schick*

This paper, originally presented at the 1981 meeting of the OECD Working Party of Senior Budget Officials, discusses the fundamental purposes of budgeting and explores how off-budget expenditures weaken a government's financial control. The paper gives insights on many aspects of budgeting that are still relevant today: the transformation of the public sector, the interface with the private sector, the scope and size of government, the role of regulation, the emergence of new organisational forms, and the use of performance objectives and long-term planning.

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A sense that government expenditures are out of control pervades contemporary budgeting. This feeling is not confined to critics of enlarged public spending but is shared by government officials in many developed countries. Budget officials hold to this view most intensely; they see the process which they command as unable to control the trend in government spending. Their best efforts are of little avail against the forces that dictate fiscal outcomes.

Evidence of weakened budget control is plentiful. Governments habitually announce their determination to curb public sector deficits and to hold spending increases to the growth in gross national product (GNP), only to have these objectives aborted by economic and political realities. Total expenditures and the amounts spent on particular programmes often exceed the levels authorised in the budget. For many programmes, the budget has been transformed from an instrument for making government financial decisions into a process for estimating the costs of decisions made by other means. Worse yet, major expenditures are undertaken without any cognisance of them in the budget. The budget no longer controls: *force majeure* rules public finance.

Inadequate financial control affects not only the amount of expenditure but its propriety as well. Fraud and abuse have become widespread concerns in many OECD countries, and the controls that once guarded against the misuse of public funds seem incapable of restoring trust to public expenditure.

The erosion of financial control has seriously weakened the effectiveness of government budgeting. The primary function of budgeting, upon which other critical uses are predicated, is to ensure that public funds are spent only for authorised purposes. Without reliable financial controls, the budget cannot be used for other important government functions such as managing the economy, improving administrative efficiency, and formulating public objectives and priorities. If actual expenditures do not conform to the levels specified in the budget, or if the real spending decisions are made outside of the budget framework, it is of little value for the government to go through the rituals of deciding what should be in the budget. Only when it controls spending can the budget be effectively applied to larger political, economic and management purposes.

When modern budget systems were introduced (in the late 19th century in some European countries; in the early 20th century in the United States), reformers gave highest attention to the imposition of financial controls. Toward this end, accounting practices were standardised, budget staffs were

organised and empowered to review the activities of spending ministries, rules for the handling of public funds were elaborated, and audit procedures were developed. By the 1950s, budgeting in various OECD countries had progressed to the point where the basic requirements of financial control were deemed to have been satisfied. It was possible, therefore, to orient budgeting to more ambitious purposes such as economic stabilisaton and programme planning. Planning programming budgeting (PPB) and other advanced budget techniques reflected this shift in emphasis from financial control to policy formulation.

Budget makers are no longer confident that the controls they operate are adequate to the conditions of contemporary government. Every budget brings fresh confirmation of their lack of control. They must constantly remake their budgets in response to changes in economic conditions and other factors beyond their control. Rather than the budget controlling expenditures, spending controls the budget.

No single factor accounts for the attrition in budget control. Weak economic performance, the indexation of government expenditures, expansion of entitlements and other legal claims on public funds have all taken a toll. This paper examines one of the factors in the loss of budget control: off-budget expenditures. In order for the budget to be an instrument of financial control, it has to be the process by which financial decisions are made and enforced. Off-budget expenditures violate this condition and thereby impair budgetary control.

Strictly defined, off-budget expenditures refer to financial transactions that are not accounted for in the budget. Rather than being a complete statement of public expenditures, the budgets of most countries exclude certain governmental activities. Off-budget expenditures can apply to direct spending by government ministries, but they are more likely to involve special transactions such as the activities of public enterprises, credit provided or guaranteed by government, or subsidies channelled through the tax system. Because of their special characteristics, these types of activities are often excluded from the regular accounts.

From the perspective of financial control, a mechanistic definition of off-budget expenditures does not suffice. The key issue is not whether an item happens to be entered in the budget, but whether its expenditures can be effectively controlled through the budget. Many of the off-budget expenditures have characteristics that would impair their controllability even if they were nominally brought within the budget's scope. In addressing the problem of off-budget expenditures, one should focus on the factors that facilitate or impede budget control, not on the accounting issue alone. (It might be

appropriate if these transactions were designated "extraordinary" expenditures, but this term is applied in some countries to different purposes.)

Yet one must also be wary of broadening the off-budget concept to cover any expenditure that escapes effective budget control. Although governments typically exercise weak control over entitlements, indexed programmes and payments on the public debt, these generally are not classified as off-budget expenditures. Perhaps the most useful definition of off-budget expenditure is one that considers both the extent to which an activity is accounted for in the budget and its controllability. As used in this paper, off-budget refers to various classes of transactions that are often (but not always) excluded from the budget and are difficult to control through ordinary budgetary processes.

Off-budget expenditures pervade contemporary governments. They are neither aberrations of the budget process nor occasional deviations from established norms. Although they are sometimes used to escape budget control, off-budget practices are normal incidents of modern governments. They flourish where government actively seeks to manage the economy, redistribute resources, promote investments and pursue a broad range of social objectives. Off-budget expenditures are most likely to occur in mixed, interventionist economies where the boundaries between the public and private sectors are blurred and where the government attempts to influence private behaviour with incentives and sanctions.

1. The transformation of the public sector

To understand the contemporary problem of off-budget expenditure, it is necessary to take account of the transformation of national governments from providers of public services into purchasers of services provided by others and redistributors of income. This transformation has proceeded in all OECD countries, though not to the same extent everywhere. Although the traditional service role (for example, the protection of health and safety) continues, it consumes a declining portion of the government's budget. A much larger share is disbursed to various private or quasi-governmental spenders.

At one time, governments operated in a simple two-stage expenditure process. First the national legislature voted appropriations for agencies; then the agencies spent these funds on their own operations. This arrangement applied to almost all of the public sector though, of course, agencies also spent some of their funds to purchase goods and services from private vendors. The budget was essentially an accounting for government administration, and it covered virtually all of the financial activity of government. In these circumstances, "comprehensiveness" emerged as one of the cardinal principles of budgeting. Since the budget was spent on agency operations, it was not difficult to satisfy the comprehensiveness rule. The main violations occurred

in the treatment of extraordinary income (earmarked revenues, bond proceeds and development assistance) and extraordinary expenses (capital improvements, development projects and spending out of special funds). In many countries, the budget was divided into ordinary and extraordinary accounts, but by annexing the special funds to the budget, it was possible to display the full financial activity of the government. The chief problem was not the incompleteness of the budget, but the preferential status of the extraordinary items.

This simple budget arrangement no longer prevails. Nowadays, the budget is dominated by transfers from government to "third" parties. Most of the budget goes to contractors or enterprises, subnational governments, and recipients of transfer payments. This transformation of the public sector occurred much later in the United States than in most OECD countries. Yet even in the United States, more than 75% of the national budget is distributed to outsiders; the percentage is surely higher in various OECD countries.

When the public sector spills beyond agency boundaries, comprehensiveness no longer offers a useful criterion for determining the scope of the budget. After all, when the scope of the public sector is uncertain, the composition of its budget cannot be fixed with precision. In effect, contemporary governments have inherited budget practices designed for a self-contained public sector, but ill-suited for the interactions that regularly occur between public and private entities.

In place of the two-stage budget process, there now exists a third stage in which appropriations nominally made to public agencies are disbursed to parties on the margins of government. But more has been changed than the locus of final expenditure; the relationship between the public and private sectors has also been altered. By offering financial inducements, governments pursue public objectives through private actions. In so doing, the social costs are no different than if the funds had been directly spent by government agencies. Thus, financial accounts confined to items conventionally reported in national budgets would not show a full picture of the costs imposed on society by government.

2. Guidelines for determining off-budget expenditures

As long as governments spent primarily for their own operations, comprehensiveness provided an operational rule for determining the proper scope of the budget. Now that governments influence private behaviour in myriad ways, a new rule is needed to determine what should be included in the budget (or in a broader process that might supersede the budget for making financial decisions). The rule applied here is frequently used in economic analysis: any cost that serves the same public objectives as a direct expenditure should be included in the government's accounts. This

"substitution" rule would enable government to consider costs borne by society, not only those charged to its own agencies.

Consider, for example, a government objective to relieve congestion at certain airports. It could pursue this objective in a number of ways, some of which would be on budget and some off budget:

- It could appropriate funds to the aviation ministry for the expansion of airport facilities. This direct expenditure is conventionally included in public budgets.
- It could authorise a public enterprise to borrow funds for expansion and to cover debt service with user charges. The extent to which these transactions were accounted for in the budget would depend primarily on the status of the enterprise.
- Alternatively, the government could raise airport fees to discourage use, thereby relieving congestion without new facilities. The fees would normally be recorded as receipts in the budget.
- Rather than raising revenues to discourage use, the government might lower them to subsidise expansion. For example, it could extend tax credits to private airport operators who would invest in new facilities. In conventional budgeting, these credits reduce receipts but would not be recorded as expenditures.
- Instead of tax credits, the government could offer loans (at market or preferential rates) to airport operators. The budget treatment of these loans varies greatly among developed countries. In some instances, loans are converted into grants or repayment is deferred because the borrowers are unable (or unwilling) to repay them.
- A variant of direct loans would be for the government to guarantee loans made to airports by private institutions. Because it is a contingent liability, the guarantee is likely to be off budget, though outlays pursuant to default would be entered in the budget.
- Rather than offering financial inducements, the government could limit use of the airport, thereby obviating the need for expansion. The regulatory costs would not appear in the budget.

This illustration pertains to the use of physical assets, but it could be applied to income transfers and many other public objectives as well. Whenever government has the option of relying on indirect action (through "quasi" public or private entities), it can shift from direct to off-budget expenditure. Clearly this option generally is not practicable for the conduct of foreign policy or the maintenance of armed forces, but it applies to the bulk of public activity.

The airport illustration shows that off-budget expenditures can be measured in a variety of ways. In a narrow sense, off-budget expenditures can

be limited to "government costs" such as direct expenditures or credit provided at concessional rates. A broader definition would encompass all financial costs imposed on society by government, whether or not the goverment bears the costs. According to this "social cost" definition, any government policy or action that uses resources, or compels their use by others, would incur off-budget expenditures, even if no funds were actually spent by the government.

The broader "social costs" approach has several advantages. Inasmuch as interest in off-budget expenditures arises from concern that ministries and governments might conceal the true cost of their policies, it would be inappropriate to disregard the means by which governments shift costs from themselves to society. In terms of the substitution principle discussed earlier, social costs provide a fuller measure of government options than can be gleaned from a consideration of government costs. If the budget were confined to government expenditures, public officials would have an incentive to shift costs from government to society. But if all substitutes for direct expenditures were defined as costs, decision makers would be indifferent on aggregate economic grounds to the form that the costs would take.

Yet, one must be mindful of the real difficulties of devising an expanded resource allocation process to encompass social costs. Not the least of the virtues of conventional budgeting are the ease of accounting for direct expenditures and the political agreement that can be obtained concerning programme costs. Once government ventures beyond its own accounts, however, it encounters technical and political problems in estimating social costs. In lieu of cash outlays, government needs proxy measures for the costs of its policies, and these often entail value judgments.

As a practical matter, governments are unlikely to convert from direct-expenditure budgeting to comprehensive social-cost accounting. They are likely to extend budget coverage only to those costs for which agreement can be secured, while treating other costs in auxiliary presentations rather than in the core budget.

For the most part, this paper deals with government costs. However, in order to provide a broad treatment of the off-budget problem, at various points the analysis is applied to both government and social costs.

3. Choosing among budget options

When governments can operate through direct expenditure or by off-budget means, they often take the latter course. It is convenient and logical to suppose that they behave in this fashion to escape budget controls. From the standpoint of a public official, it would seem costless to shift to society the burden of performing a public objective rather than to show it in government accounts. The natural incentive to behave this way is stimulated when

government operates under political or legal limits on expenditures or deficits. In these circumstances, it is possible to abide by the limits while spending (or borrowing) more through off-budget instruments. In the United States, evidence of this behaviour comes from state governments that authorise public corporations to issue revenue bonds outside the debt limits established in their constitutions.

Several considerations suggest, however, that more fundamental forces are at work than budgetary expediency alone. For one thing, until recently, budget control was not very stringent in most OECD countries. Why should governments try to evade controls which do not restrict their freedom of action? Moreover, the growth in off-budget expenditure has been concurrent with the growth in direct expenditure. It appears that, although the various forms of expenditure are substitutes, they are all subject to the same forces that have expanded the scope and reach of the public sector.

In seeking cause and effect for the rise in off-budget expenditure, the focus must be shifted from economics to politics, from the aggregate effects of government policy to the distributive outcomes. The various spending instruments available to government differ in the incidence of the cost and in the distribution of benefits. When public officials choose among the options, they are deciding how costs and benefits are to be apportioned in society.

The cost of direct expenditure is borne by taxpayers as a whole; the cost of tax credits, by contrast, is apportioned among all taxpayers other than those receiving the credit. Where public enterprises are required to cover their expenses internally, users pay the costs; when enterprises have access to "soft" loans, the cost is shifted to taxpayers or to other borrowers competing for available funds. In the case of regulation, the costs might be internalised (borne by those directly subject to the regulation) or externalised (shifted to third parties).

Just as the distribution of costs varies with the option used, so too does the distribution of benefits, for what is a cost from one perspective is a benefit from another. Direct expenditure for airport expansion benefits air travellers; fees that discourage airport use benefit persons who travel on expense accounts; tax credits assist airport operators in acquiring physical assets; loan guarantees help marginal borrowers who might otherwise be shut out of the market or be compelled to pay higher interest costs.

The conclusion can be drawn that distributive politics, not budgetary evasion, is the principal consideration in selecting the instrument of government policy. The process of selection is not simply one of analysing the economic consequences, but one in which the potential beneficiaries and losers vigilantly seek to influence the decision. The changing composition of the public sector

means not only that government spends more on outsiders, but that these outsiders have become parties to the budget.

Consider again the two-step expenditure process outlined above. An agency seeking appropriations deals directly with central authorities (the finance ministry, a legislative committee, or a cabinet subcommittee, for example). The process tends to be insular; government officials negotiate with government officials and reach agreement on the budget. But when a third step is added to the expenditure process (for example, the transfer of funds from ministries to outside entities), the making of a budget is opened to outside influence. Enterprises manœuvre for loans and subsidies; taxpayers press for various preferences; lenders seek guarantees and borrowers look for below-market loans; subnational governments demand assistance in meeting their own expenses; and interest groups petition for new regulations.

When deciding among the available policy instruments, governments respond to and often negotiate with these outside claimants. Among the arguments used by these outsiders is that it is costless for government to assist them through off-budget expenditures. The arguments are quite familiar to anyone who has served in a central budget role: borrowers claim that loans are costless because government does not have to advance any of its own funds; enterprises promise that, with an adequate infusion of public money, they ultimately will be able to return a profit.

The magnitude of off-budget expenditures attests to the political potency of these arguments. Yet when government chooses among policy alternatives, it does more than apportion costs and benefits; it is also defining its scope and role, and the relationship between the public and private sectors. This side-effect can be shown by comparing direct subsidies and tax expenditures. A tax expenditure represents income forgone by government. From the perspective of the beneficiary, it has the same value as a direct subsidy. But the two forms of expenditure are not politically equivalent. Spending through tax expenditures reduces the relative size of the public sector; direct expenditures enlarge the public sector. Thus, every trade-off between these two policy instruments entails a political decision concerning the scope and size of government.

When examining the various policy alternatives, therefore, it would be appropriate for public officials to consider macropolitical issues (the role of government) in addition to micropolitical questions (who pays and who benefits). Although it is difficult to design and operate, an off-budget expenditure framework is essential for considering these issues.

4. Types of off-budget expenditure

Before assessing the effects of off-budget expenditures on control of the budget and finances, it is necessary to identify the main off-budget practices.

This is not an easy task because there is no limit to the types of off-budget expenditures that can be contrived. Off-budget expenditures can be classified into four categories, distinguished from one another in the type of expenditure. These are:

- forgoing revenues through preferences to taxpayers (tax expenditures);
- providing credit to private borrowers (direct and guaranteed loans);
- imposing private costs on private parties (regulation);
- direct expenditure by entities that are excluded from the budget (public enterprises).

4.1. Tax expenditures

Tax expenditures are the revenues forgone by government because of its deviations from its basic tax structure. For government, a tax expenditure is a loss in revenue; for a taxpayer, it is a reduction in tax liability. The term suggests that revenue losses have expenditure and subsidy effects similar to those of direct expenditures. The term was introduced in the United States in the 1970s and has gained currency in other OECD countries, though terms such as tax reliefs, tax aids and tax subsidies are also used.

Tax expenditures take various forms, such as exclusions from income, special tax rates, credits against tax liability, deductions, and the deferral of tax payments. The common element in these techniques is that they reduce tax liability and government revenues.

The concept of tax expenditures has provoked intense ideological controversy. Some reject the term because (they argue) it connotes that all income belongs to the government unless it is returned in the form of tax expenditures. Others insist, however, that the term merely indicates that a government can accomplish public objectives by forgoing revenues and that it therefore ought to regard tax expenditures as alternatives to direct expenditures.

This ideological dispute is linked to the issue of whether tax expenditures entail social costs. Every tax expenditure is by definition a cost to government. A tax expenditure also incurs a social cost if it induces private expenditures that would not otherwise be made. Many tax expenditures change private consumption or investment; some, however, reduce taxes without stimulating additional expenditures. For example, if a firm has already planned for the purchase of equipment, an investment credit might provide it with higher after-tax income without generating additional investment. Those who reject the concept of tax expenditures would not impute any social cost to the investment credit since it leaves society in exactly the same position it would have been without any tax. Those who endorse the concept would regard the

investment credit as a social cost since it produces a different distribution of income than would prevail in the absence of the credit.

Because a tax expenditure is a cost to it, a government can face the issue without trying to resolve the ideological question. The basic issue for government is whether a particular objective is to be pursued through tax incentives or direct expenditures. The trade-off between tax and spending methods involves economic considerations (which is the more efficient course of action?), macropolitical questions (should the activity be conducted in the public or the private sector?) and micropolitical questions (who benefits and who bears the costs?).

Tax and direct expenditures are not pure substitutes. They can lead to quite different distributions of social resources and social costs. These differences, more than the evasion of expenditure controls, account for the widespread use of tax expenditures. If tax expenditures were to leave everybody no better or worse off than would direct expenditure, taxpayers would be indifferent as to the course that government follows. Taxpayers are not indifferent because tax expenditures promise a better deal than they expect to get through direct expenditure.

Tax expenditures are a function of tax burdens. Where tax rates are high, tax expenditures also tend to be high. The simplest way to curb tax expenditures (other than through credits of fixed value) would be to lower the basic tax rates. Conversely, when tax burdens rise (whether because of inflation, economic growth or discretionary policy), tax expenditures also rise. High tax rates have a political as well as an arithmetic link to tax expenditures. Where tax burdens are high, taxpayers have greater incentive to seek relief than if the burden were lower.

4.1.1. Budgeting for tax expenditures

In order for tax expenditures to be used in budgeting, they have to be measurable. But the measurement of tax expenditures is much more problematic than the measurement of direct expenditures. Value judgments cannot be avoided, and these are likely to vary among OECD countries. A classification of tax expenditures that comports with the practices in one country might be unsuitable for international comparisons. In general, the concept of tax expenditures can be more appropriately used to analyse tax and spending policies within than between countries.

The problem begins with definition of the "basic tax structure". It is generally agreed that "structural" elements of a tax system should not be recorded as tax expenditures, while "programmatic" features should be. Most tax subsidies do not pose any difficulty; they are intended for a particular social objective and can be classified as deviations from the normal structure.

Some exclusions or preferences are not so clear cut, however. The United States practice is to exclude deductions for dependents from the list of tax expenditures. On this basis, the United Kingdom child tax allowances might be regarded as structural elements, though the recent substitution of child benefit payments for these allowances suggests that they should be treated as tax expenditures. On the other hand, the United Kingdom Treasury has suggested that mortgage interest relief be considered part of a progressive tax structure and not just a subsidy for housing. Because countries differ in their tax structures, comparisons of tax expenditures in OECD countries would be of questionable value unless they were put on a uniform basis.

Since tax expenditures are not actual outlays, the amounts "spent" are notional; that is, they are based on assumptions and estimates as to how taxpayers would behave under particular conditions. The United States practice has been to estimate the revenue loss of each tax expenditure separately, disregarding the interdependencies among the various items. The virtue of this approach is its simplicity; it is not necessary to consider the extent to which the curtailment of any particular tax expenditure might spur taxpayers to use others. Moreover, this approach assumes that a retrenchment in tax expenditures would not result in changes in the basic tax structure. For both political and economic reasons, this is not a tenable position. Total tax expenditures cannot properly be computed as the sum of all the separately estimated tax expenditures.

Estimates of particular tax expenditures also must be hedged with qualifications. Since the value of any tax expenditure depends on the extent to which taxpayers avail themselves of the opportunities provided by the tax system, the estimates are based on assumptions about private behaviour, not on firm appropriations. These assumptions tend to be grounded on past behaviour and cannot confidently take into account changes that might ensue from inflation, economic growth, or other new conditions. The estimates are especially questionable when they are applied to changes in government tax policy – paradoxically the very instances when they are most needed. In the late 1970s, official United States estimates of the revenue loss that would ensue from a reduction in the taxation of capital gains proved to be wide of the mark. Apparently the lower rates spurred increased sale of assets, substantially offsetting the expected revenue loss.

The foregoing considerations lead to the conclusion that efforts to construct a comprehensive and authoritative "tax expenditure budget" should proceed cautiously. A survey in 1976 found only two countries (Germany and the United States) that published tax expenditure budgets. Since then, other OECD countries including Canada and France have developed tax expenditure budgets. These budgets, which purport to set forth all revenue losses, are of more value for public relations than for analysis. They can encourage public

officials to make simplistic decisions. In 1979, for example, a leading member of the United States Congress filed legislation to establish a single limitation (as a percentage of GNP) on combined direct and tax expenditures.

A more appropriate use of tax expenditure data would be to assist government officials to gauge the total input of public resources into a particular activity such as housing or education. They would then be prepared to trade off between direct and tax assistance or to vary the mix of the two. Yet trade-offs are hampered in many countries by the fact that different sets of officials are involved in the making of direct expenditure and tax policies. In the usual case, the finance ministry is the dominant voice in tax matters while the functional ministry has a lead role in shaping direct programmes. Thus, a trade-in of a tax expenditure for a direct expenditure (or *vice versa*) might redistribute political power as well.

Fiscal experts do not agree on the value of comparing direct and tax expenditures. Some believe that it is impossible to fully compare the two types of expenditure, while others insist that the principal gain from the tax expenditure concept is to facilitate such comparisons. Regardless of the arguments, these comparisons have become much more prevalent since the mid 1970s, though they have been incorporated into the basic budget routine in only a few countries.

Trade-offs can be made even in the absence of a tax expenditure budget. The shift from child tax allowances to direct benefits in the United Kingdom has already been mentioned. In a similar move, the Netherlands now provides family allowances in lieu of child tax relief. New Zealand substituted higher cash payments for families with dependent children for tax subsidies in 1972, while Germany followed suit in 1977 and Austria in 1978. Trade-offs in the United States have tended to be less formal. In the late 1970s, Congress faced demands for assistance to parents of college students. One proposal would have provided tax credits to help offset tuition payments; another would have made direct grants to low-income students. The budget committees juxtaposed the two proposals (which had been advanced under separate auspices) and showed that if both the tax credits and the direct payments were enacted, the cost to the treasury would be far greater than the advocates of either proposal intended. This analysis contributed to rejection of the tuition tax credit.

Trade-offs appear to be most formalised in Canada where a new (and not fully tested) "envelope" system requires ministers proposing tax expenditures to offset the revenue loss with reductions in direct expenditures. The great virtue of the system is that it sensitises ministers to the reality that tax relief is not costless. Yet a one-for-one trade-in poses two problems. First, even when the tax and direct expenditures are estimated to be of equal value in the

year that the trade-in is made, the costs to government might diverge from this pattern in subsequent years. Second, presumably the trade-in system should also allow ministers to increase direct expenditures by curtailing the tax expenditures in their sectors. But, as noted earlier, this exchange would lead to growth in the relative size of the public sector.

4.1.2. Distributing tax expenditures

Tax expenditures entail not only revenue losses but private benefits. The distribution of tax benefits is not likely to be the same as the distribution of direct expenditure. The reasons for this difference include: 1) the incentive for those who would benefit more from tax preferences to pursue this course rather than seek direct assistance, and 2) the likelihood that different government officials (with different perspectives and constituencies) would be in charge of tax and direct spending decisions.

The main reason, however, for the differences between the two forms of assistance is that the value of most tax expenditures depends on tax liability. A dollar of deductions or exclusions is three times more valuable to a taxpayer in a 60% marginal tax bracket than to one taxed 20% at the margin. Since higher income taxpayers tend to be in higher marginal brackets, tax expenditures tend to be much more valuable to them than to lower income persons. Moreover, expenditures are generally "open ended", the limit (in most cases) being full tax liability. Thus, the higher the tax that would otherwise be paid, the greater the potential value of the tax expenditure.

A study in the United States found that tax expenditures in 1977 and 1978 amounted to 8.2% of adjusted gross income for all taxpayers, but 22.2% of adjusted gross income for taxpayers with more than USD 50 000 in income. Further, tax expenditures ranged from 30.2% of "full taxes" (the sum of actual taxes and tax expenditures) for middle income taxpayers to 41.6% for those in the highest income class. Significantly, tax expenditures provided less percentage reduction in tax liability for middle income taxpayers than for those in the lowest or the highest income categories.

It is technically feasible to hold the value of a tax expenditure constant across all income classes and to retain the progressivity of the basic tax structure. One possibility would be to substitute credits against actual tax liability for deductions from taxable income. Another approach would be to allow deductions at a fixed percentage rate for all taxpayers rather than at marginal tax rates.

Although techniques are available for mitigating the redistributive effects of tax expenditures, they tend not to be used much. Obviously a "neutral" tax expenditure system (that is, one that does not impair the distribution of burden in the basic tax structure) would offer less incentive for seeking tax

benefits rather than direct benefits. There is reason to believe that one of the underlying purposes of tax expenditures is to counter the high marginal rates in countries with progressive tax structures. For various political reasons, governments and voters need to believe that their country has a highly progressive tax structure. However, high "real" rates are not politically or economically acceptable; hence, governments resort to tax expenditures. As a result, effective tax rates tend to be more proportional than the nominal rates. The difference between the real and nominal rates represents the discrepancy between the type of tax system society believes it ought to have and the one it is willing to have. This discrepancy reflects a common condition in modern democracies: the clash between egalitarian values and the unequal distribution of economic power.

The United States has moved to improve the progressivity of a few tax expenditures by making them "refundable" (or "nonwasteable"). In these cases, if the value of the tax expenditure exceeds tax liability, the taxpayer receives a direct payment from the treasury for the excess. Refundable tax expenditures virtually erase the boundaries between direct and tax expenditures and can give rise to new off-budget practices.

4.1.3. Controlling tax expenditures

Tax expenditures are not as amenable to budgetary control as are direct expenditures. A comparison of the two types of expenditure would help to illustrate the lack of control over tax expenditures.

Consider a government decision to assist investment in a particular area. One course of action would be to issue grants to firms that make the desired investment; another would be to reduce the tax liability of these firms. When it proceeds by direct grants, government typically formulates detailed rules setting forth eligibility requirements, application procedures and other administrative prerequisites for obtaining a grant. Moreover, government officials review the applications for grants and can turn them down if they are not convinced that the funds would be spent for the intended purposes. They can also require periodic reports by grantees and can audit the investments to determine whether they are being properly made and recorded. A further element of control comes through the appropriations process, by means of which the government limits total spending for the programme.

A tax incentive, by contrast, is likely to be open ended, with the amount of expenditure dependent on the behaviour (and skills) of taxpayers rather than on direct government decision. A firm would not have to satisfy any application procedure, nor would the expenditure be reviewed by government officials in advance. Tax incentives usually operate unilaterally, with taxpayers making their own determination as to whether they are eligible for the relief.

While some portion of the tax returns would be audited, the likelihood is that most would escape serious review.

This illustration enables us to identify some of the reasons for the comparative lack of control over tax expenditures. These transactions tend to be encumbered by fewer administrative rules than are applied to direct expenditures. Government programmes are often criticised for red tape, delay and cumbersome procedures; tax expenditures avoid these problems, but only because government control is looser.

Tax expenditures are also subjected to weaker political control. Many tax advantages are established on a permanent basis. Unlike regular appropriations, there is no periodic review by the legislature. Because they are deemed to be permanent features of the tax structure, tax expenditures often continue in practice without examination of their effectiveness. Political control also is impaired by the "invisibility" of these expenditures. Although estimates of their cost might be published when they are introduced, in subsequent years, tax expenditures are absorbed into aggregate revenue forecasts.

There is widespread belief that, once implemented, tax expenditures are more difficult to terminate than direct expenditures. This proposition lacks empirical support, but it reflects a feeling that tax expenditures escape effective government control.

In assessing the impact of tax expenditures on fiscal control, one must be mindful of their implications for the tax system as a whole. The proliferation of tax subsidies has complicated the tax structures in most OECD countries. It is difficult for ordinary taxpayers to determine whether they are paying more or less than the law requires, and for tax officials to monitor compliance with the laws. In addition, these incentives erode the tax base and compel governments to levy high marginal rates in order to obtain needed revenues. Marginal rates in most countries would be significantly lower if tax expenditures were curtailed. The 1981 Netherlands "Budget Memorandum" comments that taxpayers increasingly "resort to deductible items to counter the increased pressure observed in the tax bands and to mitigate the feared increase in the burden of taxes." It further notes that one of the reasons for "the scale of the fraudulent practices is … the level of taxation and the increase in the tax burden over the years." The Swedish government's 1980/81 "Budget Statement" came to a similar conclusion, that "deductions are being abused more and more and contribute to a systematic erosion of the progressive tax system."

Tax expenditures will not be effectively controlled unless they are perceived by the public and by government as the functional equivalents of direct expenditure. Clearly, such is not the case at present. For the most part, tax expenditures are seen as the retained income of taxpayers, not as a grant from government. Under these circumstances, it is quite understandable that they

are not subjected to the same measure of control as is commonly expected of direct expenditures.

The foregoing considerations lead this author to the conclusion that a tax expenditure budget is likely to be more useful for economic analysis than for budget practice. One should be wary of pushing the tax expenditure concept to the point where it is treated in the same manner as direct expenditures. Notional budgets can provide useful supporting material but they cannot be decisional budgets for controlling and managing public resources.

4.2. Government loans

When governments spent public funds solely (or predominantly) on their own operations, the budget deficit (or surplus) was an accurate measure of their participation in the credit markets. This condition no longer prevails; in addition to paying for their own operations, contemporary governments finance outside activity. When they do so through direct grants, the transactions are usually recorded as budget expenditures, but when they lend money to others, the expenditure is often off budget.

During the 1960s and 1970s, government loans have become a major means of assistance to various groups. Governments make loans to public enterprises, business firms, homeowners, subnational governments and others. They also guarantee private loans, and they buy and sell debt instruments (such as mortgages, debentures and promissory notes). Because these credit transactions are often excluded, the budget tends to misrepresent the government's impact on economic activity and on the allocation of resources.

If credit assistance were fully accounted for, government economic policy in the 1970s would have probably been found more expansive than intended. Credit activities in many OECD countries appear to have shifted capital from investment in plant and equipment to investment in housing. The growth in credit programmes, many observers contend, has contributed to inflation in recent years.

The failure of government budgets to fully report credit activities is partly due to the fact that budgets were once deemed financial statements rather than expressions of economic policy. Accounting and economic criteria differ, especially as they relate to the treatment of government lending. Because budgetary concepts and practices were developed for different purposes than are now called for, new budgetary methods to deal with credit activities have to be devised.

The problem can be illustrated by reference to the treatment of government loans in the United States budget. When the government lends money, the loan is recorded as an outlay, on a net basis – new loans minus repayments. This treatment is a compromise between accounting and economic concepts. From

an accounting perspective, the loan should not be regarded as an outlay since the government's financial condition is not altered by it; the government is merely exchanging one asset (money) for another (a promise of future repayment). Indeed, loans are not recorded on business profit-and-loss statements and appear as assets on their balance sheets. However, from an economic standpoint, the loan should be recorded since the government will have to increase its own borrowing or have a smaller deficit. Moreover, a case can be made for reporting loans on a gross basis (that is, the full amount of new loans) since this represents the full scope of government activity, though it might overstate the economic effect of loans.

The disparity between economic and accounting criteria has opened the door to off-budget practices. Here, too, the United States experience illustrates the problem of handling credit transactions in the budget. When a government agency makes a loan, it receives an obligation (such as a mortgage or a note) from the borrower. The agency can pool these "loan assets" into new obligations which it sells to the Federal Financing Bank, a government agency whose transactions are excluded from the budget. The income from this sale offsets the original loan, thereby reducing the budget outlay to zero, even though the government must still borrow (or reduce its surplus) to finance the loan.

While this particular practice is an intentional evasion of budget control, most off-budget credit activities have a more legitimate purpose. One of the most prevalent off-budget practices is a government guarantee of private indebtedness. Guaranteed loans are generally excluded from the budget because they represent contingent rather than direct liabilities of government. But guarantees can affect the level and distribution of economic activity.

Government loan programmes can impede economic stabilisation because the amount of lending tends to fluctuate more widely than direct expenditures and can deviate significantly from the budgeted level. In recent years, efforts by the International Monetary Fund to require countries to reduce their deficits and public sector borrowing as a condition of assistance have also been impeded by loan practices in some countries.

4.2.1. The cost of government loans

One of the reasons why credit assistance is popular is that public officials often believe (or pretend) that it is costless. Direct loans, the argument runs, do not cost government anything because they are repaid. On this ground, direct loans are often preferred to grants in which the government does not recover any of its expenditure. An even stronger claim is made for guaranteed loans in which the government makes no outlay except in case of default. Government can make a profit by charging a premium for its guarantee.

Yet there is no such thing as a "free" loan. When the government makes or guarantees a loan, it also influences the availability of credit to other borrowers. Under certain conditions, it can significantly raise the cost of credit to those who cannot borrow from public sources or it might force some borrowers out of the market.

4.2.2. Direct loans

The cost of a direct loan depends on the terms under which it is made. When it charges an interest rate below its own borrowing cost, a government provides a direct subsidy which is paid for by taxpayers. But even it if charges the same rate as it pays, a government might bear higher interest costs because of the additional borrowing that it must undertake. If a government has a USD 25 billion deficit in its own operations, but must borrow USD 50 billion in order to finance both the deficit and the loans it is making, it probably would have higher interest charges than if it only borrowed for its own needs.

Even when government charges its full cost, a direct loan usually provides more favourable terms than a borrower can obtain privately. A government generally pays lower interest rates than other borrowers, and it normally passes these savings on to those who borrow from it. A borrower who can get the same terms privately would have little reason to come to government for credit assistance. These borrowers almost always pay below-market rates, and they are thereby accorded preference over those who must seek credit on less favourable terms. Those who borrow from private sources not only pay more but they also might find it more difficult to obtain credit.

Although the declared purpose of many credit programmes is to assist marginal borrowers who might otherwise be unable to obtain credit, they often provide funds to borrowers who would otherwise be willing and able to borrow at market rates. It is difficult to design a credit programme targeted exclusively to those who would be shut out of the market, and there is reason to believe that government officials do not really want to do so.

Interest rates on government loans are usually not standardised. Interest on direct loans is more often determined by the amount of assistance to be provided borrowers than by the cost of money to government. It is common for governments to charge concessional rates below their own borrowing costs. The interest rate can be regarded as a measure of the borrower's political power and of the value attached to the programme by government.

The cost of these loans is affected by fluctuations in interest rates. If, as often happens, the interest rate for a loan programme is fixed, the value of the loan (and the cost to government) will vary with subsequent changes in market rates and in the government's own borrowing costs. Thus, the cost of credit

programmes can rise automatically and uncontrollably without government action.

Some loans have features which make them virtually indistinguishable from grants. Some, for example, have forgiveness provisions that cancel all or part of the debt. Others can be converted to gifts if it becomes evident that the borrower is unable to repay. In still other instances, governments extend credit to marginal borrowers with little prospect of repayment. Sometimes loans are carried on the books long after the borrower has defaulted because the government lacks procedures for writing them off as bad debts. In sum, governments may prefer to label assistance as loans rather than as grants in order to conceal the true costs.

4.2.3. Guaranteed loans

Unlike direct loans, guaranteed loans require payment out of the treasury only in case of default. The guarantee is excluded from the budget because, as noted, it is a contingent liability. However, any payments necessitated by default would be budgeted as outlays. Loan guarantees are not the only form of contingent liability. Governments sometimes guarantee the price enterprises wll receive for their output, or pledge to pay the difference between market prices and the cost of production. These and other contingent liabilities are also excluded from the budget.

Loan guarantees transfer risk from private lenders to the government. This means that two of the credit market's key functions – evaluating the credit worthiness of borrowers and the element of risk – are not adequately performed. Rather than being concerned about the borrower's ability to repay, lenders are primarily interested in whether the guarantee is sound. The task of evaluating risk and credit worthiness thus must be performed by government or not at all. Governments, however, might be unprepared or unwilling to assume this role. A rigorous examination of the financial condition of marginal borrowers might bar them from obtaining the assistance that loan guarantees are intended to provide them.

Guaranteed loans can reduce the possibility of default or bankruptcy by giving marginal borrowers access to credit. It may, therefore, enable these borrowers to disregard market signals and to continue inefficient practices. Nevertheless, governments can condition loan guarantees on the adoption of efficiency-improving changes. Thus, in the United States, loan guarantees to New York City and the Chrysler Corporation required these borrowers to implement cost savings and other changes as a condition of assistance.

Guaranteed loans reduce the cost of credit for borrowers. Sometimes the subsidy is explicit, as when the government agrees to pay the difference between the market interest rate and the rate that lenders participating in the

programme are permitted to charge. In most cases, however, the subsidy is implicit: the borrower is able to obtain credit at a lower rate than would otherwise be possible.

The value of a guarantee depends on the risk of the loan. Marginal buyers usually have to pay a "risk premium" (above-market interest rates) in order to obtain private credit. Thus, the greater the risk, the higher the subsidy provided by the government guarantee. In cases of extreme risk, borrowers might not be able to obtain any credit without government assistance.

Loan guarantees raise the cost of credit to unassisted borrowers. But in periods of tight credit, the main effect might be to reallocate credit from some borrowers to others. In effect, borrowers who lack guarantees subsidise guaranteed borrowers.

In the United States and elsewhere, guarantees tendered in the late 1970s have differed from older loan programmes. In the past, loan programmes guaranteed small loans to numerous borrowers. For example, 97% of the loans guaranteed by the United States government in 1950 went to help families purchase their homes. In these types of loans, the risk of default was pooled among a large number of borrowers, each of whom paid a premium to cover possible default. Some recent loan guarantees (such as for energy development), by contrast, have entailed very large loans to very few borrowers. The risk is concentrated – not shared – and default by a major borrower can compel the government to spend large amounts of money. Moreover, guarantees often go to venture or financially troubled enterprises where the risk of default is higher than in the older types of loan programmes.

4.2.4. Controlling loan programmes

The problems and costs of direct and guaranteed loans have prompted a number of countries to consider credit policies in terms of the overall condition of the public sector rather than in terms of the budget. One approach has been to limit the borrowing undertaken by the public sector. This method is used in the United Kingdom which establishes a public sector borrowing requirement (PSBR) in tandem with the annual budget. The PSBR includes nationalised industries and imposes a single limit on public sector borrowing. The PSBR concept is also used in Australia, where it includes net borrowing by state and local governments and by public enterprises. Italy, under pressure from the IMF, has adopted an "enlarged public sector" concept that encompasses all levels of general government and certain public enterprises. In the United States, where the concept of the public sector is not widely used, control has been sought through implementation of a credit budget which sets annual limits on total direct and guaranteed loans, as well as limitations on individual credit programmes.

Integration of credit transactions into the budget process requires more than information; it also means that credit is seen as a policy instrument that can achieve the same objectives as direct expenditures. This level of integration appears to have been successfully attained in Japan which has a fiscal investment and loan programme (FILP) that covers virtually all of the credit activities of the government. The FILP has been designated "the second budget" not only because of its size (almost half of the general account budget) but also because it is considered to be as important to the economy as the regular budget. The FILP is presented to the legislature in tandem with the budget. It sets forth the supply of funds to public corporations, local governments, government-affiliated agencies and various other institutions.

The advantage of a combined statement of the public sector deficit and borrowing cannot be doubted, but this approach can introduce some problems. Enterprises with standby lines of credit to the treasury can "crowd out" spending on public services by government agencies. This predicament has confronted the United Kingdom in the late 1970s. Perhaps the point to be made is that information on public sector borrowing is not a substitute for financial control. Aggregate controls on credit can be effective only when particular loan programmes are controlled as well.

If governments are to control their budgets and manage the economy, they must be able to control the credit they extend to others. This is often difficult to accomplish because the amount of loans can depend as much on the behaviour of borrowers as on the current policies of government. In many cases, the amount of credit authorised for a particular programme is open ended, and eligible borrowers do not have to compete against one another for available funds. In other cases, government has little choice but to provide needed credit to public enterprises or to weak industries.

4.3. Government regulation

Regulation can be an effective substitute for direct expenditures. If a government wants to curb the pollution of rivers and streams, it could appropriate funds for the construction and operation of sewage treatment facilities. Alternatively, it could provide loans or tax preferenes to firms that invest in pollution control practices. These types of expenditure would be recorded in government accounts, though not all would appear in the budget. Still another option would be to order polluters to stop discharging effluents into the waters. Except for the administrative expenses of government agencies, the costs of these and other regulations would not be reported in government accounts.

Through regulation, it would be possible to shift the costs of achieving many public objectives from public budgets to private ledgers. If stringent

spending or budget limitations were imposed, government might resort to regulation in lieu of direct services. The costs to society would be no less, and might be a great deal more; they would show up in the costs of production, in the prices paid by consumers, and in other adverse effects on the economy.

Concern about the costs of regulation appears to be much greater in the United States than in other OECD countries. This might be due to the fact that regulation is more pervasive in the United States than elsewhere. In other countries, public enterprises operate services (such as railroads, telecommunications and utilities) that are provided by regulated industries in the United States. The prevalence of regulation in the United States might also be due to its legalistic political culture and a tendency to define rights and obligations through laws and rules.

During the 1970s, regulatory activity increased significantly, and social objectives were emphasised (such as protection of the environment, the health and safety of workers, and automobile safety). This new type of regulation has proved to be costlier and broader in its impact than older economic regulations that dealt with rates, services and entry into markets. The new "quality of life" regulations are not confined to a single industry; in many cases, the jurisdiction of the regulating agency extends to most of the private sector. But despite its jurisdictional breadth, the agency usually has a narrow regulatory objective. It is not called upon to weigh the value of its objective against competing ones or to consider the effects of its regulations on particular firms or industries.

It should not be surprising, therefore, that some of the regulations promulgated in the 1970s were extremely costly. According to some estimates, as much as 4% of GNP has been diverted to satisfy regulatory requirements. While the estimates are based on questionable assumptions and have been disputed by critics, there is little doubt that the costs of regulation have been very high.

Only a small portion of the costs of regulation are accounted for in the budget. Regulatory agencies are usually quite small, and their expenses ordinarily are not a major consideration in the preparation or review of the budget. The costs of administering thousands of regulations do not add up to one per cent of the United States budget. It has been estimated that compliance with regulations costs the private sector USD 20 for each dollar spent by the United States government.

The direct costs of compliance include the specifications mandated by government regulators. There is a tendency for government agencies to prescribe specific designs or technologies, leaving the affected industry with little incentive (or discretion) to select the most efficient course of action.

Moreover, once established, regulations often continue in effect long after their original purpose has been served.

Some critics claim that the "opportunity costs" of regulation may be much greater than the directly measurable ones. Excessive regulation, it is alleged, impedes innovation, diverts capital from productive investment to satisfying government requirements, diminishes risk-taking by entrepreneurs and dampens competition. According to this view, the full cost of regulation includes lost employment and production, higher prices, and a reduced ability to compete in world markets.

4.3.1. Controlling government regulation

As the costs of regulation have escalated, so too have requirements that regulatory agencies consider the costs and benefits of their actions. The trend has been toward broader requirements: President Ford called for the examination of the effect of regulations on inflation; President Carter ordered analyses of economic impacts; and President Reagan directed full cost-benefit analyses of regulations.

It would seem ironic that the United States, which has had only limited success in applying cost-benefit analysis to its own budget, would undertake the much more difficult task of analysing the effects of regulation on the private sector. The measurement of the effects of regulations cannot avoid difficult value questions, and the more ambitious the analysis, the more controversial and problematic are the findings likely to be.

The unstated but often primary purpose of regulatory analysis is not to obtain the precise measurement of costs and benefits but to slow down the issuance of regulations. By requiring agencies to prepare formal analyses before promulgating regulations, government hopes to sensitise them to the fact that regulations are not costless. Regulatory analyses encourage agencies to consider less costly alternatives and sensitise them to the added costs of securing marginal improvements in benefits.

The United States has established a regulatory review process in the White House. The purpose is to ensure a broader consideration of costs and alternatives than might be undertaken by the agency issuing the regulations. The White House group can stop, or more likely seek to modify, regulations that it considers too costly. The Reagan administration has intervened more forcefully in the regulatory process than previous administrations did.

A novel cost control scheme has been proposed in the form of a regulatory budget. The regulatory budget would list the costs of government regulation much as direct expenditures are accounted for in the regular budget. Some have suggested that the regulatory budget be used to limit the costs that each agency would "spend" by means of regulation. The concept of a regulatory

budget, however, would have to gain broader acceptance before it could be applied in this manner.

4.4. Public enterprises

Conventional budgeting coexisted with an organisational structure in which government operations were the responsibility of ministries and departments. Appropriations to these "core" agencies accounted for the bulk of public expenditure, so that the same agency spent public funds and operated public programmes. These agencies were organised into a cabinet structure which, in parliamentary regimes, exercised collective control, and in presidential systems functioned in a more hierarchical manner. There was little ambiguity as to what constituted a public entity.

Mixed economies do not have neat organisational structures. Governments have contrived a seemingly endless variety of organisational forms in response to particular needs and conditions. Governments set up autonomous agencies outside the cabinet structure or corporations that combine public and private characteristics. In some enterprises, the government holds some or all of the stock; in others, all the stock is privately owned. In some, the officers and directors are appointed by the government; in others, appointments are made by the corporation or its stockholders. In some, employees are covered by civil service rules; in others, they are deemed to be private workers.

Because public enterprises combine elements of public and private organisations, it is difficult to classify them into neat categories. Some are more public than others; some are only nominally public and have all the essential attributes of private organisations. There are so many types of public enterprises, even in the same country, that it is hard to classify them into a few categories.

An OECD working paper (April 1981) reported that "the most difficult aspect of defining the public sector is deciding what makes an enterprise 'public'." The paper noted that while some countries define public enterprise solely in terms of ownership, others add other criteria such as the degree of control exercised by government or the circumstances under which the enterprise became public. The confusion over definition is reflected in the system of national accounts (SNA) devised by the United Nations. The SNA bases the distinction between private and public "on whether the ownership and/or control of an enterprise rests in the public authorities or private parties" but it does not indicate whether ownership and control are joint or alternative criteria. The OECD paper concluded that variations in country definitions of public enterprise are impediments to international comparisons for the public sector.

Many countries have attempted to classify their public enterprises in terms of the control exercised by the government. For example, Sweden distinguishes between public enterprises and government-owned business companies. The government-owned business companies are independent legal entities subject to government regulation. Government exercises control principally through its role as shareholder. The public enterprises are government agencies, though they have more freedom in fiscal and personnel matters than ordinary agencies. These enterprises have no independent borrowing authority; all long-term capital is supplied by the central government.

Japan has a more elaborate classification, dividing its more than 100 public corporations into nine categories depending on the source of financing and the degree of government control. At one extreme are corporations that receive all their capital from the national government and have their budgets approved by the Diet (parliament). At the other extreme are corporations that receive some public financing but enjoy a great deal of autonomy.

Despite the varied forms, it is rare that a public enterprise is subjected to the same financial controls as are applied to core agencies. One of the main reasons for the establishment of state enterprises is to free them from the budget controls applied to regular agencies; it should not be surprising, therefore, that they enjoy considerable fiscal autonomy. Even when they are in the budget, public enterprises tend to have a great deal of freedom, if only because they have their own source of revenues. Moreover, many enterprises are authorised to borrow from the credit markets or from the treasury.

Paradoxically, while enterprises are located on the fringe of government, they do not conduct only fringe activities. In OECD countries, public enterprises run heavy industry, high-risk technologies, communications and transportation, and the production and distribution of energy. These operations are so vital to modern economies that governments cannot remain bystanders if major enterprises encounter financial difficulty or if their policies or performance diverge from the national interest.

But governments have a great deal of difficulty in deciding whether and how to intervene in the affairs of their enterprises. A considerable amount of confusion arises out of the combination of public and private characteristics in the same organisation. Governments frequently establish conflicting norms for their enterprises. They want enterprises to be run efficiently and to serve important social objectives. They want the railroads, for example, to cover their operating costs, but governments also insist that service be provided to many communities regardless of cost. Governments want factories to operate without subsidies, but bar them from dismissing employees and impose costly work rules.

The clash between social and economic objectives can be submerged when public enterprises are growing and showing a profit. But governments frequently turn failing industries over to enterprises, and the conflict between social and economic values leads to zigzagging policies. The inability of the enterprises or the government to maintain a steady course can produce outcomes that nobody wants. Many enterprises are disciplined neither by the market nor by the government budget; they live in perpetual crisis and turbulence. Governments, however, cannot isolate themselves from the problems of their enterprises; the enterprises' financial ills become the government's concern. With or without effective budget control, government must supply the grants and credits to keep the enterprise in business.

4.4.1. Controlling public enterprises

The International Monetary Fund has identified three phases in the financial relationship between governments and enterprises. Enterprises are often established at "arm's length" from the government, with a great deal of discretion. They are purposely given autonomy to insulate them from political influences and to ensure their efficient operation. At a later time, however, the government feels impelled to intervene, either because it is dissatisfied with the enterprise's performance or because the enterprise comes to it with pleas for assistance. Government intervention is not a permanent solution, for it tends to further impair the efficiency of enterprises. In response, therefore, governments seek to set performance objectives, returning to the arm's-length relationship. But, unable to dictate the operations of enterprises, governments might not be able to achieve the level of performance they seek.

The argument for establishng public enterprises outside the normal budgetary framework is that they can thereby be operated in a more businesslike manner than would be possible under government control. Thus, the law establishing the Australian Industry Development Corporation provided that "the corporation shall act in accordance with sound business principles … and … shall not provide finance … or participate in a particular enterprise unless the Board considers that the enterprise … will be carried out in an efficient manner and in accordance with sound financial principles." The law further specified that the corporation "is not subject to direction by or on behalf of the Australian Government".

Once they are vested with political autonomy, public enterprises can maintain their privileged status as long as they stay out of financial trouble. Indeed, enterprises that internally finance their own expenses and have independent access to capital markets often escape any serious scrutiny by government agencies. However, if an enterprise experiences financial difficulty and has to rely on the government to cover its expenses or for investment funds, then the government can recapture some of the political control it yielded in

establishing the enterprise. But at this stage, the government may have no viable option other than to provide the needed financing even if it cannot fully control how the funds are spent.

A penetrating analysis of the problems faced by governments in controlling their public enterprises was issued by Canada's Royal Commission on Financial Management and Accountability in 1979. The commission observed that "the Government must find that delicate balance between excessive control – which would frustrate the purpose of a Crown Agency – and no control, which would be a denial of the Government's involvement and responsibility in the enterprise."

There is no easy way out of the dilemma facing governments in their relationship with enterprises. As the boundaries between the public and private sectors erode, one can expect enterprises to become more prevalent and more important. Governments cannot ignore the impact of enterprises on their budgets, but neither can they impose tight fiscal control over these entities. The trend seems to be to incorporate enterprises into the public sector budget, but not necessarily to control them by means of the budget. In terms of the enterprises, the budget is more an information tool than a means of making and enforcing financial decisions.

5. The problem of control

Off-budget expenditures weaken budget control. This statement has two meanings that lead to different policy conclusions. First, a government's capacity to budget its expenditures has been impaired by the removal of these items from the budget. The obvious remedy would be to return the off-budget expenditure to the budget, thereby restoring the budget's status as a comprehensive process for handling the government's funds.

Second, the statement can mean that the government's capacity to control off-budget expenditures has been weakened by their special status. Here the concern is not restoration of the budget's lost prominence, but an overall weakening of the government's control of its finances. The appropriate remedy, from this point of view, might be to control off-budget expenditures by off-budget means.

Much of the literature on budget control wells out of the first conception of the problem. It assumes that a sound budget is the purpose of government, and that having a comprehensive budget assures financial control. This author would challenge this budget-centric premise, and argue instead that placing off-budget items in a comprehensive account might amount to little more than a bookkeeping improvement. To understand why this might occur, it is necessary to examine how off-budget practices affect government operations.

Off-budget expenditures impair budget control in three ways: they entail a loss of political control, financial control, and internal control.

Political control refers to a government's capacity to dictate the objectives for which the expenditure is made and to enforce its decisions. Political control is strong in line ministries and weak whenever the actual spending is done by outsiders. Within government, command and control processes are well developed. Ministries generally spend funds on the purposes for which the appropriation was made. Despite universal misgivings about bureaucracy, government agencies generally abide by the dictates of higher authority. But when funds are transferred to outsiders, political control is attenuated. A minister does not have the same leverage over an enterprise (even one nominally under his/her jurisdiction) as over a line agency. The minister is likely to have even less say over the behaviour of an entrepreneur making private use of tax credits or guaranteed loans.

Financial control over off-budget expenditures is often weak because, unlike direct expenditures, they tend to be open ended. The amount spent by government (including the social cost) is not usually fixed in appropriations but determined by the behaviour of the beneficiary. Tax subsidies depend on the extent to which taxpayers avail themselves of the opportunities provided by government. Enterprises often have a line of credit to the national treasury. The cost of regulation varies with the response of those affected by it. The cost of subsidised loans depends on interest rates.

Moreover, since government exercises only weak political control over off-budget spenders, even when limits are fixed on these expenditures, they might not be enforceable. The United Kingdom's unfortunate experience with state enterprises shows how ineffective political control can lead to a loss of financial control.

Internal control refers to the fidelity of spenders to the rules and procedures established by government for the handling of public money. When formal budget systems emerged in the Continent and in the United States in the late 19th and early 20th centuries, adherence to these rules was enforced by external control – that is, central budget personnel, auditors and others policed the financial activity of agencies and required approval before obligations were incurred. Their massive expansion and ambitious policy objectives have forced modern governments to rely on internal control. The agency spending the funds has first-instance responsibility for ensuring that the expenditure is proper, for an approved purpose, and in accord with government regulations and its own rules.

Internal control depends on the basic norms of behaviour, more on attitudes than on rule books. Internal control is firmly implanted in many government ministries around the world, though occasional scandals are a

reminder that breaches still occur. But the norms have not been internalised by external spenders. They have their own values and objectives, and these often run counter to those of the government. It should not be surprising that much contemporary fraud and waste in public programmes are concentrated in off-budget expenditures.

The growth of off-budget expenditure produces what might be labelled "the paradox of control". As this paper argues, off-budget expenditures have resulted from the transformation of the public sector from one in which spending was done within government to one in which spending largely occurs outside government. Not the least of the reasons for this transformation has been the striving of government to strengthen its control of the economy, the distribution of income, investment policy, and the supply of goods and services. The paradox is that, in its effort to extend its control over the private sector, government has surrendered a good deal of its control over the public sector.

Restoring off-budget items to the budget would not accomplish much in the way of political control, financial control, or internal control. The budget would be more comprehensive, but this could be deemed salutary only if fundamental changes were made in the relationship between government and outside spenders.

This relationship operates through incentives rather than command and control. By extending credit, changing tax liabilities, chartering independent enterprises and other activities, government "hopes" that the affected parties will behave in accord with its expectations. However, incentives involve not only the expectations of government but those of the recipient as well. And these may be at variance with those of government.

A comprehensive budget process, in sum, might make for a better budget, but not necessarily for more control. If the latter is the pre-eminent objective, governments should devise new methods of control, leaving to secondary consideration the question of whether these controls should operate through the budget process.

6. The problem of planning

The problem of control leads to a second paradox. With the rise in off-budget expenditures, governments sense a heightened need to plan their programmes and finances beyond the next fiscal year, but the efficacy of these plans diminishes as governments transfer funds to outside spenders.

When governments spent primarily on their own operations, they felt little need to plan ahead for a number of years. They could prepare for the future through the normal programming activities of government agencies. But with the transformation of the public sector, government is interested not

only in what it is doing, but in what others (principally the outside spenders) are doing as well. The emergence of national planning has, in fact, been concurrent with the developments described in this paper. There has also been, in most OECD countries, the emergence of multi-year financial plans, such as the public expenditure survey committee system devised in the United Kingdom.

These plans (national, sectoral and financial) attest to the futility of planning when government control is weak. The paradox is that, as the future becomes less certain, the felt need for planning increases; but as the future becomes less certain, the reliability of the plans decreases. Plans are quickly overtaken by unexpected events, especially those outside government control.

Strong planning cannot coexist with weak budget control. But the failure of planning has not diminished the yearning for more effective plans. In response to the control problem, planning now takes two different paths. Indicative planning (such as has been pioneered in France) abandons control in favour of information and consultation. It informs various sectors (particularly the off-budget ones) of government expectations in the hope that, once informed, they will act in a way that makes it possible to achieve the plan's objectives.

The other course is to use planning as an instrument of control. Governments recognise their lack of short-run budget control and try to compensate for this deficiency by establishing a planning process – in effect a multi-year budget process – to strengthen their control over future budgets. The United States is moving in this direction, as are Canada, the Scandinavian countries and the United Kingdom. But one must question whether future budgets will merely accommodate to the lack of control or be used to devise and implement realistic plans and objectives.

7. The path to control

Governments everywhere are troubled by attenuation of control over their budgets. They perceive that off-budget expenditures often escape effective control and they assume, therefore, that placing these transactions in the budget will lead to the restoration of control.

Before stretching their budget processes to encompass off-budget expenditures, governments should contemplate what might be gained and lost from this move.

The notion that off-budget items ought to be incorporated into the budget is predicated on the concept of the budget as a resource allocation process. National budgets have been moving in this direction for more than a generation; in most OECD countries, finance ministries have shifted from

expenditure control to economic management. But this is not the only purpose served by government budgets.

Contemporary budgets excel as instruments of managerial control. They define the programmes to be conducted by ministries and allocate resources for these purposes. They set the operational objectives of ministries and limit the amounts that may be spent on various activities. As instruments of management, budgets can effectively control only where managers can. Extending the budget to off-budget expenditures would be of no avail if government does not dictate the programmes or policies of the off-budget spenders.

Budgets cannot be all things to all users. The skills and data appropriate for managerial control are not the same as those essential for fiscal control. Governments, therefore, must decide whether to use their central budget process for the one purpose or for the other. They must, in effect, choose between using the budget to allocate government costs or to allocate social costs.

Understandably, governments try to avoid choosing one or the other course. They want both types of control. Further, they sense that surrendering the managerial functions of the budget would weaken their macroeconomic capabilities as well. The old budget predicament of "the parts *versus* the whole" would come back to plague them if they settled for a "big picture" budget process.

Perhaps governments will succeed in expanding the budget's scope without losing their hold on the budget itself. This author's view is that not all the off-budget expenditures discussed in this paper equally warrant inclusion in the budget. Not all are equally suitable for trading off with direct expenditures. Governments need many paths to control, not only the one that eventuates in a budget decision. The United States, for example, is experimenting with a credit budget which, though annexed to the regular budget, involves different allocation decisions. Regulatory costs similarly might be "budgeted" for in a separate process. Public enterprises might have their own decision and control procedures. These distinct processes might be linked by an umbrella (rather than omnibus) resource allocation process or by a public sector planning process. The budget would then be but one component of the larger process. It would continue to operate as an instrument of managerial control, but broader control would be sought by other means.

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Budgeting in Austria

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This article discusses budgeting institutions, processes and practices at the federal level in Austria. Separate sections are devoted to the budget formulation process, the role of parliament, and various aspects of budget implementation and government management issues. Each section highlights the government's reform agenda and current practices, and analyses the two vis-à-vis *OECD best practices.*

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1. Budget formulation

Budget formulation in Austria is in the process of evolving from a very traditional, highly legalistic and input-oriented regime to a modern, streamlined and performance-oriented regime. Significant reforms have already taken place and further ones are being planned. These include:

- The introduction of a rolling, medium-term expenditure framework (budget + 3 years), setting expenditure ceilings on an aggregate level, which will be binding and enacted into law. In addition to this law, a separate budget strategy report will be presented; it will explain the economic considerations and political aims of the MTEF and include more information such as revenue forecasts and a discussion on fiscal and budgetary policy. These two documents will be presented in the spring (second quarter), separate from the annual budget law.
- Making "each minister his/her own finance minister" by consolidating appropriation items within a minister's responsibility and giving great(er) flexibility in managing the appropriations under his/her purview.
- A greater focus on the use of performance and results information to guide budget decisions.

This section begins by highlighting special features of the current Austrian budget process and then outlines the key steps in the annual budget process. The section concludes by discussing current practices and the envisaged reforms *vis-à-vis* best practices in other OECD member countries.

1.1. *Special characteristics*

This sub-section highlights six special features of the current Austrian budget formulation process, which mostly reflect reforms introduced in recent years:

- a fiscal rule encompassing all levels of government;
- four-year government coalition agreements;
- biennial budget planning;
- independent economic assumptions;
- global expenditure ceilings;
- manpower controls.

1.1.1. *Fiscal rule encompassing all levels of government*

To co-ordinate the budgets of the three levels of government – federal, state and municipal – the "Austria Stability Pact" was introduced in 1999. From 2001 onwards, this stability pact has set deficit and surplus targets for all three levels of government for a period of four years. The targets are defined in terms of national accounts, the same basis as applied in the Maastricht criteria for the European Economic and Monetary Union (EMU). The current Austria Stability Pact for the years 2005-08 calls for a decline in the general government deficit ratio in order to achieve overall balance for the general government in 2008.

The need for this rule arises from the fact that about one-third of all government expenditure in Austria is carried out by subnational government, principally the states over which the federal government has no control in fiscal matters. The states produce their own budgets and can borrow without needing any approvals from the federal government.

The subnational levels of government, however, have very few own revenues. Most of their revenue comes in the form of fiscal transfers from the federal government. In fact, the federal government collects over 95% of all taxes in Austria. The federal government is responsible for legislation regarding tax and grant financing of the subnational government sectors. Regular negotiations are held between the federal government and lower levels of government on the fiscal transfer arrangements.

The development of the Austria Stability Pact was a by-product of these regular fiscal discussions between the different levels of government. The pact was ratified by the federal parliament and the individual state parliaments, and as such has the force of law. The pact calls for the balanced budget objective to be achieved through a shared effort between the three levels. The states are to have a surplus equivalent to 0.75% of GDP while the federal government can have a deficit equivalent to 0.75% of GDP. The municipalities are to be in balance. The surpluses of the states *vis-à-vis* the deficits of the federal government are a function of the political power of the states. As the states receive their funding primarily from the federal government, the balanced budget objective could have been achieved by lowering their fiscal transfers but this was not considered politically feasible.

The pact includes sanctions if levels of government do not fulfil their balanced budget objective. These sanctions include fines which are to be imposed on the sector that does not fulfil its responsibilities. In the case of the state and municipal levels, the fines would be on the individual state or municipality that did not fulfil its obligations. These sanctions have never been used, however, since all levels have met their obligations.

1.1.2. *Four-year government coalition agreements*

No political party enjoys a majority in the Austrian parliament. As a result, it is necessary to form coalitions between two or more political parties in order to form a majority government. These have most frequently been "grand coalitions" between the country's two dominant political parties – the conservative People's Party (ÖVP) and the Social Democratic Party (SPÖ).

When a new government is created, it announces its major policy objectives in a document known as the "coalition agreement". There is no set template for the contents of these agreements, and their exact form varies each time. The 2002-06 coalition agreement is a document of about 40 pages. It is principally a statement of general policy orientations but also highlights specific reform initiatives to be undertaken during the government's term of office. It is reviewed midterm to accommodate any new policy initiative that the coalition partners may decide upon, and takes into account economic developments since the original agreement.

The coalition agreements address budgeting issues only in broad terms, specifically by setting an explicit deficit target for each year. The Ministry of Finance provides a budgetary forecast for the government's term of office to inform these decisions. The agreement sets no limits on the level of expenditures, either in aggregate or for specific sectors. The agreements do, however, set out numerical targets for savings from specific reforms and specify how much money will be devoted to new initiatives. As such, the agreements are the primary basis for discussion by the coalition parties during the annual budget negotiation rounds.

The agreements can in no sense be considered a medium-term expenditure framework and are not designed as such. They can easily be changed by the coalition partners at low political cost in terms of public credibility, and in practice they cease to exist in the waning moments of the government's term of office.

Aside from providing the budgetary forecast, the Ministry of Finance has no institutional input into the coalition negotiations.

1.1.3. *Biennial budget planning*

For some time, Austria has adopted a biennial budget planning horizon. However, the budgets are enacted into law on an annual basis by parliament as is required by the Austrian constitution. This means that one budget would be enacted in December in line with the typical parliamentary budget calendar, and the second year's budget would be enacted into law early in the following calendar year.

The primary motive for the adoption of biennial budgeting was political. It was seen as a better basis on which to tackle difficult reforms: "easier to take the political hit once every two years than every year". In practical terms, biennial budgeting provided greater funding certainty to spending ministries, which was especially important for programmes that were being reformed and where not all savings occurred in the first year. In the absence of biennial budget planning, such reform initiatives may not have been implemented.

Biennial budgeting must be seen as an interim substitute for a medium-term expenditure framework rather than as a preferred method of operation. In fact, the proposed budget reforms in Austria include a binding four-year medium-term expenditure framework. This new framework does not include biennial budget planning, but still leaves room for such procedures if the government and parliament do choose to adopt them.

1.1.4. Independent economic assumptions

All macroeconomic assumptions used in the budget process are prepared by an independent institution, the Austrian Institute for Economic Research (WIFO, see Box 1). This practice is not enshrined in legislation but is nonetheless an entrenched pillar of Austrian budgeting, reflecting both a broad political consensus and a general consensus in society.

WIFO produces multiple forecasts for the Ministry of Finance, including the four-year perspective used in the coalition negotiations, the economic assumptions for the annual budget, and quarterly in-year updates. WIFO forecasts are also used in international reporting, such as the annual stability programme submitted to the European Commission.

There are no "prudency" biases in the forecasts produced by WIFO. Their objective is to forecast as accurately as possible. Their record of forecast

Box 1. **WIFO: Austrian Institute for Economic Research**

WIFO was founded in 1925 and in legal terms is a free-standing "association". It is funded by the federal government, the state governments and the social partners, as well as by specifically funded and commissioned research. It has a professional staff of about 100 persons. Its work is supervised by a scientific committee composed of independent experts, including Austrian and foreign academics as well as representatives of similar foreign bodies and international organisations.

In addition to providing the economic assumptions used by the Ministry of Finance, WIFO is engaged in a variety of economic research, both macro and micro, and both in Austria and internationally.

accuracy compares favourably to those produced by other organisations such as financial institutions and other research bodies.

1.1.5. *Global expenditure ceilings*

In the mid 1990s, the Ministry of Finance adopted global expenditure ceilings for each budget chapter (see also the discussion in section 3.2). Some ministries may be responsible for more than one budget chapter and, therefore, receive ceilings for each chapter. The Ministry of Finance issues two global amounts for each chapter: one for personnel costs and one for all other expenditures. The spending ministries are given maximum freedom to reallocate within the ceiling for all other expenditures. The ceiling for personnel costs is rigid. This reform represented a huge break with past practice. Previously, all discussion between the Ministry of Finance and spending ministries took place at the level of detailed line items.

Box 2. **Government Debt Committee**

The Government Debt Committee is an independent standing body created in 1970. Its purpose is to contribute to the general public policy debate in Austria, focusing on the promotion of necessary economic and fiscal reforms. It views itself as a "friendly watchdog" that "speaks the language of professors, not politicians". The committee has played an important role in highlighting and advocating necessary reforms – such as old-age pension – in order to promote economic development and fiscal sustainability.

The committee consists of 15 members: six members (including the chair) appointed by the federal government, three by the Austrian chamber of commerce, three by the federal chamber of labour, and one each – without voting right – from the Austrian association of municipalities, the Austrian association of cities, and the conference of provincial governors. The committee meets on an *ad hoc* basis as required by circumstances and on the initiative of the chair, but at least once every quarter. The recommendations of the meetings are published.

The committee publishes an annual report presenting its views on the government's budget, the economic situation, and areas that the committee views as important for the government to launch reform initiatives. The committee also studies and publishes reports on more specialised topics under the supervision of dedicated expert groups; only one or two such reports are usually published each year.

The secretariat for the committee is provided by the central bank.

These aggregate ceilings are not binding, however, neither legally nor politically. They are the stand-alone proposal of the Ministry of Finance and can best be seen as a management tool in the budget formulation phase. The final expenditure ceiling for each chapter will depend on the outcome of subsequent negotiations. The important points are the global nature of the ceiling and the freedom for spending ministries to reallocate among their various appropriations. These are further discussed in section 1.2.

1.1.6. Manpower controls

Austria uses a comprehensive system of manpower controls known as the *Stellenplan*. These manpower controls are enacted into law each year by parliament along with the budget. The *Stellenplan* is set at a very detailed level: at the level of significant units within a ministry and at each grade of staff. Due to the fact that the *Stellenplan* is decided on and set by the parliament, the total number of posts within a ministry cannot be changed by the government. It is possible to adjust the posts within a ministry by government decree as long as no additional costs arise and no additional posts are needed. However, this is a complex, non-routine procedure.

These manpower controls have a long history. They must also be seen in the context of the inflexible civil service labour market where, for all practical purposes, it is impossible to lay off staff. An individual hiring decision is often a 40-year fiscal commitment. At the same time, there are efforts to downsize the civil service in Austria (through natural attrition and early retirement schemes), and the numerical manpower controls as such have great resonance in political terms. Future reforms of the *Stellenplan* include efforts to aggregate posts within ministries, except for top-level positions, in order to gain more flexibility. This is further discussed in section 3 on budget implementation and government management issues.

1.2. Budget formulation process

This sub-section outlines a typical timetable for a regular budget cycle. It does not take specific account of the use of two-year budgets, as biennial budget planning is not an inherent part of the planned reforms.

The budget season traditionally starts in May, seven months prior to the start of the fiscal year the following January, with internal preparations in the Ministry of Finance and in spending ministries.

The Ministry of Finance updates the baseline forecasts for both revenues and expenditures. The ministry maintains a sophisticated and comprehensive internal medium-term expenditure framework for these purposes, which is updated on a rolling quarterly basis, including the impact of updated economic assumptions. The ministry uses the economic assumptions that are transmitted

from WIFO, the Austrian Institute for Economic Research. The Ministry of Finance uses internal models for estimating the impact of demographic developments and take-up rates for various entitlement programmes.

The updated baseline – together with the multi-annual deficit consolidation targets and reform initiatives contained in the coalition agreement and the Austria Stability Pact – will yield the amounts necessary for fiscal consolidation or the available room for fiscal manoeuvre for the coming budget year.

The Minister of Finance will share the conclusions of this exercise with the Chancellor before presenting it to the cabinet. The Chancellor and the leader of the coalition party will discuss the updated baseline from the point of view of their political objectives. However, this discussion is principally in terms of the political priorities to be reflected in the budget. There are no specific expenditure ceilings set for individual ministries at this stage.

To ensure that the outcome of the federal budget is in line with the government's medium-term budgetary programme as laid down in the coalition agreement, the Ministry of Finance then prepares budgetary targets for each chapter (one or more per ministry).

The result of the above-mentioned procedure is the budget guidelines from the Ministry of Finance; these contain expenditure ceilings and expected revenues for each budget chapter, as well as specific accounting policies and directives for each entity. The ceilings contain two global amounts, one for personnel expenditure and one for all other expenditure. Aside from the ring-fencing of personnel expenditure, ministries have complete freedom to reallocate among the various appropriations within the ceiling, taking into account the cabinet's political priorities and mandatory expenditure. The amount is fully fungible between transfers, capital and other expenditures. For the calculation of certain entitlement programmes, the Ministry of Finance also transmits the accepted forecast methodology for the respective programmes.

As noted previously, the ceilings are set by the Ministry of Finance on its own responsibility. They are not endorsed by the cabinet and as such are not binding, neither legally nor politically. The final expenditure "ceilings" emerge following the outcome of negotiations between line ministers and the Minister of Finance and, in some cases, the Chancellor and the leader of the coalition partner.

At the same time, line ministries will have been collecting proposals from the various parts of their ministry: the individual directorates and subsidiary entities. This is a bottom-up exercise in order to inform decision making – reallocations – and to compile an aggregate draft budget proposal for the ministry. It should be noted that an important by-product of the introduction of global expenditure ceilings in the recent top-down budgeting approach has been to enhance the role of the central budget units in each spending ministry. The Ministry of Finance has a policy of only interacting with these units.

Box 3. **Budget formulation timetable**
Fiscal year = calendar year

May	Detailed medium-term forecasts within the Ministry of Finance.
June	The Ministry of Finance issues budget circulars, including expenditure ceilings for each ministry.
End June and July	Line ministries submit allocation proposals in reply to the ceilings suggested by the Ministry of Finance. Exchange of information on outstanding issues between the Ministry of Finance and line ministries.
End August	Discussions and agreement at ministerial level on expenditure ceilings for each ministry.
September	Appeals to the Chancellor for reconciliation, if necessary.
October	Finalisation of budget documentation.
Late October	Budget introduced in parliament.

The spending ministries submit their allocation proposals to the Ministry of Finance from the end of June through July. Their bids will invariably be significantly in excess of the expenditure ceiling set by the Ministry of Finance and will be more a reflection of the conclusions of their internal budget exercises than any attempt to remain within the ceiling set by the Ministry of Finance.

In the following weeks, line ministries and their "mirror" in the Ministry of Finance meet to exchange information and discuss requests for appropriations. No decisions or reconciliation on differences take place during these meetings; they are informational meetings only. The purposes of the meetings are to clarify what line ministries are requesting and to discuss different views on appropriation levels, if any, between the line ministries and the Ministry of Finance. On average, line ministries' requests are about 10% higher than the original ceilings proposed by the Ministry of Finance, but the differences vary considerably between ministries. The discussions take place in *ad hoc* meetings rather than in a preset formal schedule of meetings for these purposes, and they are very open. After this exchange of information and views on appropriation levels, civil servants of line ministries and the Ministry of Finance inform their respective ministers who then meet to resolve outstanding issues. When the line ministers meet with the Ministry of Finance, amounts are decided at chapter level, not individual appropriation level.

It may not be possible to resolve the most politically sensitive issues between the line ministers and the Minister of Finance. Instead, they may reach the level of the Chancellor. These issues are finally decided by the Chancellor and the leader of the coalition partner. (Some issues are not always resolved prior to the budget being introduced in parliament, as is discussed in the next section.)

Following the conclusions of the negotiations, the "final" expenditure ceilings for each chapter (one or more per ministry) are sent to line ministries. They allocate funds to the detailed account structure and provide the Ministry of Finance with draft commentary to be included in the budget documentation. The Ministry of Finance uses these drafts as appropriate in the final budget documentation. This final stage also includes fine-tuning of the manpower controls contained in the *Stellenplan*, and assembling the necessary changes to substantive programme legislation into a single omnibus bill. These are presented to parliament along with the budget proposal in late October.

Box 4. **Directorate-General of Budget and Public Finance**

The Directorate-General of Budget and Public Finance is one of six directorates within the Ministry of Finance. The Directorate consists of 11 divisions. Four divisions are responsible for general issues, co-ordination, planning and administrative reform. The other seven divisions "mirror" individual spending ministries. The staffs of these divisions are responsible for contacts between the Ministry of Finance and line ministries in all phases of the budget process. The Directorate has a professional staff of 110.

1.3. Conclusion

As noted, a cornerstone of the planned reforms is to introduce a **medium-term expenditure framework** which Austria lacks at present. This framework would take the form of legally binding expenditure ceilings with a four-year horizon – the upcoming budget and three forward years. A new fourth year would be added every year. In this new framework, the coalition agreement remains as the key political statement of the government. This political declaration would be complemented by the legally binding medium-term expenditure framework, which is a more operative and detailed document. If the ceilings are to be changed, the government would have to make this explicit and propose relevant amendments in parliament. As such, the medium-term expenditure framework would be built on far stronger foundations than the present merely declarative arrangement, and would be more likely to enforce fiscal consolidation measures.

The draft of the medium-term expenditure framework law will be accompanied by the **budget strategy report,** both being presented to parliament in the spring (second quarter) of each year. The MTEF will be approved by parliament and will set expenditure ceilings on an aggregate level. The accompanying budget strategy report will not be voted on in parliament; it will elaborate further on fiscal and budgetary policy and will be a larger, more comprehensive document. These documents will not discuss individual appropriations, but rather give parliament an opportunity to discuss the budget aggregates from an overall economic and fiscal policy point of view. The detailed appropriations will be discussed in the regular budget which has to be set up within the limits of the medium-term expenditure framework. This is in line with OECD best practices. It is important to ensure that the division between the medium-term expenditure framework (accompanied by the budget strategy report) and the annual budget is clear. Experience from countries such as Sweden shows that discussing the level of appropriations for each chapter in the spring (second quarter) risks expanding the discussion to the level of individual appropriation. This would mean that parliament would in essence discuss the same budget twice in the same year, which may lead to parliamentary fatigue with budget-related work.

The medium-term expenditure framework should also aid in maintaining fiscal discipline in the preparation of each year's budget, as it will be approved by parliament prior to the budget negotiations between the Ministry of Finance and the spending ministries.

The ceilings would be set for each chapter of the budget. These chapters will be amalgamated into five categories, or "rubrics":

- general government affairs, courts and security;
- employment, social services, health and family;
- education, research, art and culture;
- economic affairs, infrastructure and environment;
- financial management and interest.

The ceilings will be binding at the rubric level as well as the chapter level for the following year (t + 1). Since detailed planning is difficult several years in advance, the ceilings for the subsequent years after the following year will only be binding at the rubric level, whereas the limits at chapter level are merely indicative and open to modification within the rubric ceiling. Within each rubric, there may be a small pool of unallocated funds in the forward years to cover unexpected expenditures. Access to these funds is to be limited to only extraordinary and unforeseeable cases.

As a general rule, the ceilings are fixed. Nevertheless, some expenditures such as unemployment programmes depend so heavily on the development of

the business cycle that fixing a ceiling in advance is not considered feasible. Therefore, a limited number of variable ceilings exist. These ceilings are based on economic indicators and thereby automatically adjust: *e.g.* if the unemployment rate goes up, the ceiling for unemployment expenditures will rise accordingly and *vice versa*. The same applies to specific expenditures that depend on revenue – for example, the money provided to subnational governments, which depends on the tax income at federal level. All in all, about 20% of total expenditure would fall into the variable category where the budget changes alongside agreed economic indicators automatically.

The introduction of this medium-term framework is very much in line with best practices in other OECD member countries. However, it is worth highlighting two issues. First, the introduction of an overall fixed ceiling – *i.e.* with no variable component – may strengthen the medium-term expenditure ceilings even further. Experience from countries such as the Netherlands and Sweden has shown that an overall fixed expenditure ceiling is feasible and effective. A buffer ("expenditure margin") – as opposed to a reserve fund – between forecast expenditures and the fixed ceiling would allow volatile expenditures to fluctuate without fiscal policy becoming pro-cyclical. There is also the concern that in due course more and more types of expenditures would be reclassified as variable and thus escape the fixed ceilings. The variable ceilings must therefore remain limited and exceptional in order to keep the medium-term expenditure framework as strong as possible. Second, the unallocated pool of funds in the forward years for each "rubric" may serve to hinder effective budget reallocations to cover unexpected expenditure increases. The Austrian model is to have a reserve at the rubric level to avoid inflation, by budget users, of their forecast, thus making sure that unexpected developments can be financed. However, there is a risk that the existence of this reserve could be seen as a way of solving unexpected expenditure needs or possibly providing room for new expenditure, making the expenditure ceiling – including the reserve – into an expenditure **target**. Experience from countries such as Canada also shows that ministries may be reluctant to offer internal savings to finance a new initiative knowing that such a reserve fund exists, and that any internal savings may actually benefit another programme (indirectly) within the same "rubric". This problem has been considered by the Austrian authorities, and the aim is to make sure that the reserve fund is used only as a second alternative after internal savings.

In addition, the envisaged reforms call for strengthening the role of "**each minister as his/her own finance minister**", by reducing the number of line items and giving spending ministers authority over how to distribute funds among the various appropriations within their budget chapters. In many respects, this is simply a confirmation of existing practice. In order to fulfil this reform goal, ministries will need increased flexibility in the carry-over of

Box 5. **The proposed Austrian budget reforms in brief**

- Introduction of a rolling four-year **medium-term expenditure** f**ramework** with expenditure ceilings for groups of chapters ("rubric" level).
- **Separating the discussion** on overall fiscal policy and the setting of expenditure ceilings in the medium-term expenditure framework (accompanied by the budget strategy report) from the annual appropriations budget.
- Strengthening the role of line ministers by making "**each minister his/her own finance minister**" within the line ministry's area by removing many of the detailed appropriations and staff plans in the current annual budget law.
- Introducing a savings facility by allowing **unused appropriations** to be carried forward at the end of a budget year (to be discussed in section 3).
- Hand in hand with relaxed input control, the use of **performance and results information** will increase (to be discussed in section 3).
- The accounting system will be reformed and updated with the aim of introducing **accrual accounting**, while keeping the **budget on a cash basis** (to be discussed further in section 3).

unused appropriations from one year to another and in the area of manpower controls, the *Stellenplan*. The *quid quo pro* for this increased flexibility is a greater reliance on **performance and results information**. This is very much in line with OECD best practices. These issues are discussed in greater detail in section 3 below.

The Austrian budget is currently on a **cash basis**, employing an obligations framework. The reforms call for the introduction of accrual accounting. Emerging OECD best practice is to introduce full accrual accounting yet retain a cash basis for budget appropriations. Accruals are best used as an analytical tool rather than as a mechanism for decision making and control in budgeting.

2. Role of parliament

There are no restrictions on parliament's role in the budget process; it can amend the budget at will or indeed prepare its own budget without reference to the executive. In reality, however, parliament's role in the budget process is limited. This is primarily a function of Austria's political environment and its long history of strong majority governments.

Austria's politics have traditionally been dominated by the conservative People's Party (ÖVP) and the Social Democratic Party (SPÖ). For most of the post-WWII period, these parties received over 90% of the votes in parliamentary

elections and frequently governed together in "grand coalitions". The two parties also designated a large number of laws as having the status of "constitutional law" thus requiring a two-thirds majority in parliament to amend them. Both parties therefore had a mutual veto over major pieces of legislation regardless of whether they were actually in power or not, thus further cementing their dominance. More recently, however, the political environment in Austria has become more fluid with a greater role being played by other political parties.

This section reviews the Austrian parliamentary budget process. It concludes with an analysis of the current process and the impact of the proposed budgeting reforms, in the light of best practices in other OECD member countries.

Box 6. **The Austrian parliament**

The Austrian parliament – the *Österreichische Parlament* – is a bicameral institution consisting of the National Council and the Federal Council.

The National Council is the pre-eminent chamber of parliament. Its 183 members are elected for a term of no more than four years. The electoral system is based on proportional representation, *i.e.* not the "first past the post" method. Austria is divided into 43 local electoral districts. The number of seats assigned to each local district is based solely on its population. "Surplus" votes in any district are pooled together in order to ensure proportional representation on a national basis. A party must have at least 4% of the nationwide vote in order to gain a seat in the National Council.

The Federal Council's task is to represent the interests of the states. The number of members of the Federal Council varies. At present, there are 62 members who are nominated by the nine state parliaments, *i.e.* they are not elected directly by the people. The terms of the members of the Federal Council reflect the terms of their respective state parliaments.

According to the constitution, the National Council has exclusive competence in budget matters. The Federal Council has no decision rights in this area; the principle is that the states have no right to intervene in the federal government's "housekeeping". The only area where the Federal Council's approval is necessary is in case of intended change of the distribution of competences as laid down in the federal constitution to the detriment of the states. In other matters, the Federal Council can only delay approval of a law, as the National Council must again deliberate on the bill but in so doing may override the objection raised by the Federal Council.

2.1. Parliamentary budget process

According to the Austrian constitution, the government's budget proposal must be presented to parliament no later than eight weeks prior to the start of the fiscal year. An all-party steering group in parliament organises the business of parliament and establishes the exact number of days allowed for each phase of the parliamentary budget process – the first reading, the committee stage, the second reading and the third reading. The time allowed for each stage tends to be rather stable from one year to the next.

The government's budget proposal is an extensive set of documentation totalling over 4 000 pages, including the budget itself, *i.e.* the legal document authorising expenditure. The budget contains about 1 200 separate appropriations for expenditures. In addition, separate supplements are prepared for each budget chapter (one or more per ministry) at a great level of detail. These are however not enacted into law. This documentation can be characterised as legalistic and input oriented. A separate legal document detailing the number of staff permitted in each government entity, the *Stellenplan*, is also enacted into law at a high degree of detail. The remainder of the budget documentation is explanatory and narrative in nature, and generally more user friendly. The budget chapters are further discussed in sub-section 3.2.

Austria operates on the "double law" principle whereby any expenditure must be authorised in **both** the budget and in substantive legislation. This means that laws establishing entitlement programmes do not confer automatic authority to spend. Conversely, separate substantive laws are required for any amount to be spent that is authorised in the budget. As a result, a special omnibus bill reconciling the budget proposal and the many substantive laws accompanies the budget. However, this is not considered part of the official budget documentation.

Box 7. **Parliamentary budget timetable**[1]

Late October	Finance minister's budget speech. General debate on the budget (first reading).
Early November	Budget Committee examines the budget.
Late November/ early December	Plenary debate and vote on each chapter of the budget (second reading).
Late November/ early December	Budget as a whole approved by parliament (third reading).
1 January	Start of fiscal year.

1. This timetable refers to a "typical" budget year as discussed in section 1.

2.1.1. *First reading*

The parliamentary budget process begins with the delivery of the budget speech by the Minister of Finance in late October. This is a very high-profile event. The speech discusses the budget in broad political and economic terms as well as highlighting specific initiatives. It generally lasts one hour.

Following the speech, parliamentary budget debate is adjourned until the following day. This is to give members of parliament sufficient time to examine the budget and formulate responses to the government's proposal. (In addition, members of parliament are given copies of the government's budget proposal on a confidential basis on the evening before the speech.)

The entire day (8-10 hours) following the speech by the Minister of Finance is devoted to deliberation of the government's budget proposal, with members of parliament either praising or criticising it. The Minister of Finance responds to these statements at the end of the day. The minister limits his/her comments to general themes, and directs more detailed and programme-specific questions to the respective ministers in subsequent phases of the parliamentary budget process.

At the conclusion of this debate, the budget proposal is referred to the Budget Committee for further scrutiny.

2.1.2. *Committee stage*

About one to two weeks later, the Budget Committee commences its examination of the budget. The Budget Committee consists of a main committee and a number of subcommittees. The main committee is made up of 26 members of parliament, with each party being represented in proportion to its overall number of seats in parliament. This committee is responsible for the budget proposal as a whole and also for in-year monitoring of budget implementation (see Box 8). There are 13 subcommittees which are responsible for examining the budgets of individual ministries.[1] These subcommittees consist of the members of the respective sectoral committees. For example, members of the Education Committee examine the budget of the Ministry of Education as members of the relevant subcommittee. It is important to note that each subcommittee is chaired by the chair of the main budget committee. Each subcommittee also includes members from the main committee who represent each political party.

The Budget Committee's examination takes place over a one-week period. It starts with the main committee examining the government's overall budget strategy, known as the "budget hearing". This generally last three to four hours. It is in many ways a repetition of the statements and questions made during the first reading of the budget proposal in plenary session but benefiting from additional time to study the document. During this examination,

Box 8. **In-year monitoring of budget implementation**

The Minister of Finance is required to report to the main Budget Committee on a quarterly basis on the implementation of the budget. In strictly legal terms, the minister must report on the use of any delegations from parliament, *i.e.* virements between appropriations (see section 3.2), and any authorisations from parliament, *i.e.* entering into long-term commitments. These reports are also a venue for general discussion on progress with implementing the budget, developments in key programmes, and the likely need for any supplementary budgets.

each political party nominates one outside expert (*i.e.* not an MP) to take a seat on the committee. In fact, most of the discussion takes place between the Minister of Finance and these outside experts. This 3-4 hour examination is the only time that the Budget Committee's meetings are open to the public.

The examination then moves to the subcommittees. The budget(s) of each ministry are examined by the respective subcommittee over an intensive one-week period with about 3-6 hours being spent on each ministry. The questions here are by definition more detailed and programme-specific than in the "budget hearing". Again, it is the respective minister who responds to the questions of the subcommittee. Each sectoral committee completes its work with a report to the main Budget Committee. There are no separate majority and minority reports.

Box 9. **Executive-legislature protocol**

It is a long established protocol that only ministers respond to the questions of members of parliament and that civil servants do not interact directly with members of parliament. The minister is, however, assisted by a number of civil servants for his/her appearances before parliamentary committees. For example, over 35 officials from the Ministry of Justice attended their respective budget subcommittee to assist the minister, and the Ministry of Justice is one of the smallest ministries. Similarly, all written questions by members of parliament are addressed to the minister or the state secretary, who respond in turn.

The main Budget Committee then reconvenes to discuss the reports of the subcommittees and to consider any amendments to the budget. There are essentially three types of amendments that emerge:

- First, the government may introduce amendments.[2] These can be technical corrections, responses to new political pressures, or – most commonly – the result of negotiations between the coalition parties on sensitive issues that were not finalised prior to the introduction of the budget. The Minister of Finance would have mentioned these areas in his/her budget speech. It should be noted that these negotiations do not take place in the Budget Committee but are rather conducted by the leaders of the coalition parties, who then inform parliament of the decisions. The subsequent amendments may increase total expenditures or – more commonly – involve reallocations of expenditures within the same total level of expenditures.
- Second, the Budget Committee may introduce amendments on its own initiative. This can sometimes be a response to the lobbying efforts of spending ministries – who "lost" in negotiations with the Ministry of Finance – for increased expenditure. It is extremely rare that this practice is successful, but it does happen and is regularly attempted.
- Third, opposition parties may propose amendments. As their amendments would by definition not be agreed by the majority in the committee, the opposition will only announce their amendments in the Budget Committee, and then formally introduce them in plenary session during the second reading of the budget. There is no possibility for the majority to "kill" amendments in committee.

The conclusions of the Budget Committee form the basis for the next reading of the budget.

Box 10. **Analytical capacity of parliament**

All analytical capacity in parliament is channeled through the respective political parties; there is no independent, non-partisan research capacity. In addition to each member of parliament having a personal adviser and receiving a research stipend that may be used as he/she wishes, the political parties receive general research funding in proportion to their number of seats in parliament. Each of the political parties has one to three staff persons specialised in budgeting issues.

2.1.3. Second reading

About one to two weeks following the completion of the Budget Committee's examination, the second reading of the budget takes place in plenary session. It lasts about one week. This is a high-profile event with all members of parliament and ministers in attendance throughout the week.

The second reading commences with the chair of the Budget Committee highlighting its conclusions and outlining agreed amendments and their rationale. Following this, the budget chapters of each ministry are examined in turn. About two to three hours are generally spent on each ministry. The discussion is launched by a senior member of the relevant budget subcommittee. Again, each minister responds to the questions concerning his/her ministry. A separate vote is taken for each budget chapter.

Opposition parties introduce their amendments at this stage. The parties consolidate their proposed amendments into one proposal for each ministry's budget chapter(s). Due to high party discipline, amendments are proposed in the name of the party, not in the name of an individual member of parliament. This means that an individual member of parliament must first seek the approval of his/her political party. It should be emphasised, however, that there is nothing except party discipline to stop an individual member of parliament from putting forward an amendment.

The total amount of approved amendments is less than a half per cent of total expenditures, with nearly all of them accounted for by the government's own amendments. Opposition amendments introduced during the second reading are uniformly rejected.

Box 11. **Provisional budgets**

In exceptional circumstances – for example, during election years – when a budget is not enacted in time for the start of the fiscal year and where parliament has made no specific interim provisions in this regard, the constitution calls for automatic provisional budgets to take effect.

If a draft budget has been presented to parliament, its provisions apply for the first four months of the year (one-twelfth of the budget per month). Following that time period, the provisions of the last budget approved by parliament apply (one-twelfth of the budget per month). If a draft budget has not been submitted, then the limits established in the last budget approved by parliament apply (one-twelfth of the budget per month). Moreover, fiscal debts may only be entered for up to half the amount of the reference budget. This effectively precludes any new initiatives being launched under such conditions.

2.1.4. Third reading

The third reading consists of a vote being taken on the budget as a whole. It takes place immediately following the conclusion of the votes on each chapter. There is no separate debate during the third reading.

As the Federal Council has no role in the budget process, the approved law is sent to the President of the Republic for signature. The budget is thus in place about one month prior to the start of the year.

2.2. Conclusion

Due to historical, constitutional and political reasons, there is no single area of budgeting that differs as widely among OECD member countries as the role of parliament. With that caveat in mind, this section concludes with a brief comparison of the Austrian parliamentary budget process with best practices in other OECD countries.

The **time allocated** to the discussion of the budget in Austria is short. The budget is presented two months in advance of the fiscal year, whereas three months is common in most OECD countries. Moreover, the budget is deliberated very quickly in parliament within the short two-month time period. This applies especially to the committee stage. This timing would appear to be a function of parliament's limited influence on the budget.

Notwithstanding the above, there is no **institutional framework in parliament for promoting fiscal discipline** at present. The proposed introduction of a medium-term expenditure framework and a budget strategy report which will set a legally-binding maximum ceiling on total expenditures ahead of the deliberation of individual appropriations will rectify this lack; such a proposal is in line with OECD best practices.

The present **committee structure** for deliberating the budget is exemplary in most respects, as it seamlessly links the discussion of finance (budget committee) and policy (sectoral committees), in administrative terms. This division of labour could be strengthened further. The Budget Committee could, for example, concentrate more on the aggregates. It could give voice to the "macro" budgetary issues, overall priorities between different chapters, and fiscal sustainability. This is especially important with the introduction of the budget strategy report. The sectoral committees could also concentrate on integrating further the budgetary and substantive policy aspects of their work. This is especially important if performance and results information is to be integrated into the discussion, as envisaged by the proposed budget reforms. The sectoral committees could then be in a position to link budget, policy and performance. It is worth noting, however, that experience shows that the introduction and use of performance and results information by parliaments is difficult in many OECD member countries.

Box 12. **Court of Audit**

The Court of Audit is an independent body responsible for the external audit of the federal government and acts as an agent of the Austrian parliament. Its official goal is to "attain the most effective use of public funds, *i.e.* the reduction of costs and/or the increase in benefits when spending public monies." The audits focus primarily on financial compliance.

The reports of the Court of Audit are sent to the respective entities being audited and to parliament, where they are first considered by a dedicated Public Accounts Committee and are then submitted to parliament as a whole. If the reports are discussed in plenary session, the president of the Court has the right to take the floor. The Court of Audit has no authority to sanction audited entities. It is for the parliament to take any action on the audit reports.

In addition to its independent audit programme, the Court of Audit accepts requests for specific audits by parliament. However, these are limited to three at any given time.

The Court of Audit has a staff of 330 persons. Its president is appointed for a 12-year, non-renewable term by the National Council. All audits are performed in-house by the Court of Audit.

The Court of Audit has the authority to audit any aspect that has financial consequences for the central government. In addition to auditing core federal government functions, the Court of Audit audits all states, on behalf of the state parliaments, and companies where the central government has a majority shareholding as well as companies owned by states and municipalities with a population of more than 20 000 inhabitants.

The continued use of the **detailed input-based supplements for each budget chapter** (discussed further in section 3) – despite being not legally binding – is anachronistic to the spirit of the overall budget reform effort. While recognising that the use of detailed supplements may be a transitory measure in Austria, OECD country experience shows that "culture change" is important to the success of reform efforts. Supplementing input information with performance and results information – rather than replacing the input information – is more likely to detract from the success of the reform effort.

3. Budget implementation and government management issues

This section consists of six distinct sub-sections that briefly describe the organisational structure of government, the execution of budget appropriations, human resource management, financial management and reporting, the

management of real estate, and the use of performance and results information. The section concludes by highlighting current practices and the impact of the proposed budget reforms in Austria *vis-à-vis* best practices in other OECD member countries.

3.1. *Organisational structure of government*

The Austrian government is divided into 13 ministries (see Box 13), including the Federal Chancellery (Prime Minister's Office). This organisational structure has remained fairly constant over time. Changes in the number of ministries, and their respective competencies, generally occur when a new government takes office.

In the past, the ministries were large, vertically-integrated, unitary organisations. All operational aspects of the ministry, including commercial ones, took place in one of the constituent directorates of the ministry. In practical terms, there were no separate subsidiary organisations (agencies).

Each directorate is headed by a director-general who typically reports directly to the minister for his/her respective area of work. It is highly unusual for there to be a separate position – secretary-general – as the overall head civil servant in the ministry, although one director-general may be designated as the "first" director-general. In the more politically sensitive ministries,

Box 13. **List of Austrian ministries**

- Federal Chancellery (including a Federal Minister for Women, Media and Civil Service).
- Ministry for European and International Affairs.
- Ministry for Education, Arts and Culture.
- Ministry of Finance.
- Ministry for Health, Family and Youth.
- Ministry of the Interior.
- Ministry of Justice.
- Ministry of National Defence.
- Ministry of Agriculture and Forestry, Environment and Water Management.
- Ministry of Social Affairs and Consumer Protection.
- Ministry of Transport, Innovation and Technology.
- Ministry of Economics and Labour.
- Ministry of Science and Research.

there is often a political state secretary in addition to the minister; usually this state secretary will be from the coalition partner of the minister's party. Each minister has a large "cabinet" of political advisers (non-civil servants), typically 15 to 20 persons.

In the early 1990s, Austria instituted **dramatic reforms to the organisational structure** of the government. These took the form of breaking discrete parts of ministries into independent bodies reporting to boards. The radical nature of this reform to Austria's highly conservative system cannot be overstated.

The bodies are separate legal entities which operate at arm's length from the government. They are exempt from the various central management regulations described in this section. They receive their appropriations as one lump sum, often on a multi-year basis. Their new staff is hired under private sector employment contracts although existing staff, "inherited" from the old organisation, retain their civil service status. These bodies are collectively referred to as "**hived off**" or "outsourced" entities in Austria, although they remain within the government but distinct from ministries.

These bodies were generally established as either private limited liability companies (*GmbH*) or as specific public entities/agencies (*Anstalt öffentlichen Rechts*). The first form was not only applied for commercial entities but also for core government entities including, for example, the debt management office. The rationale for using this corporate form was entirely pragmatic. The entities enjoyed an established corporate governance structure – *i.e.* clearly defined roles of owner, board of directors and chief executive, respectively – that had been tested over time and had a judicial case history. Although a law is always necessary for setting up such an entity, it was far more convenient to apply the existing company law framework (sometimes with alterations) than to set out a completely new organisational form for each entity. The *GmbH* form was preferred because it allows for easier intervention by the owner and is thus more appropriate in a government context than a public limited company (*AG*).

In line with private sector corporate governance in Austria, the boards of directors of these entities have representatives of both the shareholders and the staff. The size of the boards varies greatly – from 5 persons to 15 in the cases studied for this review. The shareholder representatives can be civil servants, academics or other outside parties. Most boards are chaired by a civil servant from the parent ministry. The Ministry of Finance has a representative on all boards. The boards of directors hire the chief executive. It is striking that a large number of chief executives were recruited from the private sector or were former members of ministerial "cabinets". The boards of directors set the salary for the chief executive in line with private sector practice.

The transformation of these entities was grand in scale. About 100 such bodies have been created, with more than 55% of government employees now working in these entities. Prior to these reforms, 100% of government employees worked in the ministries. It should be noted that the corporatisation of Austrian Railways and Austrian Post accounted for one-third of this reduction.

In terms of operational efficiency and effectiveness, the establishment of the entities is generally acknowledged to have been successful, and often very successful. However, strong concerns were voiced as well. First, the Constitutional Court voiced "scepticism" about the appropriateness of using the private sector corporate form for carrying out inherently governmental functions. Second, parliament complained of less transparency and reduced accountability; ministers would typically say that they were not in a (legal) position to respond to questions by members of parliament concerning the operations of these arm's-length entities. Third, the public sector unions were strongly opposed to this reform – although the government conceded to them the right to represent all the employees of these entities, including new hires employed on the basis of private sector employment contracts. Finally, there was general concern about the proliferation of these bodies and the "hallowing out" of government.

In response, a new reform model was developed at the end of the 1990s, referred to as "**flexible agencies**". This new model did not change the position of the already established arm's-length entities, but only applied to new cases. The key difference between the two is in terms of accountability. The new flexible agencies remain within the ministry. They are not separate legal entities and they do not have boards of directors. The minister is directly responsible for them in both political and legal terms.

Regarding managerial flexibility, details are negotiated on a case-by-case basis in a four-year contract between the agency, the parent ministry and the Ministry of Finance. The flexible agencies generally receive a lump-sum appropriation on a multi-year basis, similar to the arm's-length entities. The staff of the flexible agencies is employed as other staff in the ministry, although they have more opportunities for receiving performance pay. In this respect, the flexible agencies are more constrained than the arm's-length entities.

So far, 14 such flexible agencies have been created. This small number reflects both the fact that the "obvious candidates" had already been transformed into arm's-length entities, and that it may take some time for a widespread "cultural change" in the administration to occur, in order for individual flexibility and responsibility to be preferred over the classical public sector approach. The concept of flexible entities is planned to be extended as part of the budgeting reforms.

3.2. Execution of budget appropriations

The budget is divided into 29 chapters (see Box 14), including six for organs of state such as the presidency and the parliament. Most ministries

Box 14. **List of budget chapters**

01 Presidency of the Republic of Austria.
02 Parliament.
03 Constitutional Court.
04 Appellate Administrative Court.
05 Ombudsman.
06 Federal Court of Audit.
10 Federal Chancellery.
11 Interior.
12 Education and Culture.
13 Art.
14 Science.
15 Social Security.
16 Social Security Funds.
17 Health and Women.
19 Family Policy, Generations and Consumer Policy.
20 Foreign Affairs.
30 Justice.
40 Defence.
50 Finance.
51 Cash Management.
52 Taxes.
53 Intergovernmental Fiscal Relations (transfers to subnational entities).
54 Government Property.
55 Pensions (for civil servants).
58 Federal Debt.
60 Agriculture, Forestry and Water Management.
61 Environment.
63 Economy and Employment.
65 Transport, Innovation and Technology.

have one chapter but there are several examples of ministries having multiple chapters. This applies especially to the Ministry of Finance where public debt, intergovernmental transfers, and similar financial activities each constitute a separate chapter. There are no cases of two ministries jointly having a chapter. Each chapter is further divided by organisational units and specific programmes. All in all, there are 1 200 appropriation line items in the budget as enacted by parliament. About 10% of the appropriations contain 80% of total expenditures. In fact, a great number of appropriations simply have a nominal amount in order to keep the budget line "alive". There has been an ongoing effort to consolidate line items in recent years. For example, individual embassies used to have their own line items; now there is one line item for all embassies.

In addition, a supplement to the main budget is presented for each chapter, showing expenditures at an extreme level of detail, with each object of expenditure presented separately. This document has no formal legal status, but parliament appears to view it as an integral part of the budget and parliamentarians consider it essential for assessing and discussing the budget. It is unclear to what extent this supplement is adhered to, since public information on budget implementation is only presented at the level of the budget as approved by parliament.

Each line item can have up to eight types of appropriation:

- personnel – mandatory;
- other operating expenditure – mandatory;
- other operating expenditure – discretionary;
- investment – mandatory;
- investment – discretionary;
- subsidies – mandatory;
- subsidies – discretionary;
- loans – repayable.

The appropriations marked as mandatory refer to the fact that a specific law mandates the specific amount of expenditure or includes a formula or criteria for calculating the amount.

"Personnel – mandatory" refers to all expenditure in accordance with the posts contained in the *Stellenplan*, discussed previously and described further in sub-section 3.3 below. More "casual" employment – such as consultants – would be classified as "other operating expenditure – discretionary". The category "other operating expenditure – mandatory" is defined broadly to include transfer payments. Examples include unemployment insurance, old-age pensions, and fiscal transfers to the states. The lump-sum payments to arm's-length entities and flexible agencies are also classified as "other

operating expenditure – mandatory". The category "investment – mandatory" is largely obsolete; it was the category for appropriations or capital injections to state-owned enterprises which had special capital expenditure plans approved by parliament. The category "investment – discretionary" includes all capital investment of over EUR 400 in value. This low threshold therefore captures furniture and office equipment. The category "subsidies – mandatory" includes transfers from the European Union for agricultural support. The remaining two categories are very small. The one marked as "loans – repayable" includes conditional (research) financing to companies and similar.

Another important difference between appropriations that are marked as mandatory and the others is the degree of in-year control exercised by the Ministry of Finance. Mandatory appropriations do not require pre-approvals by the Ministry of Finance, whereas other expenditures for transactions of over EUR 73 000 (equivalent to 1 million Austrian Schillings) require pre-approval by the Ministry of Finance. The Ministry of Finance does however give higher thresholds, or has given blanket pre-approvals, for some ministries in recognition of the quality of the budgeting and financial management function in those ministries.

The Ministry of Finance has traditionally taken advantage of an authorisation contained in previous budgets to lower appropriations by up to 3% in order to promote fiscal consolidation. This applies only to non-mandatory appropriations. Most recently, however, this practice has been abolished, with all adjustments taking place in the budget formulation phase.

In principle, virement of funds between organisations, programmes and types of appropriation is not permitted without the prior approval of parliament. However, in certain cases parliament delegates such authority to the Minister of Finance in the budget documentation, although not as a blanket authority but rather attached to specific budget lines – *i.e.* allowing certain moneys to be moved from one specific appropriation to another specific appropriation when certain conditions are fulfilled. For example, the 2006 budget includes 17 paragraphs (taking 14 pages), each setting the conditions for reallocation concerning specific appropriations.

Similarly, parliament has delegated authority to the Ministry of Finance to carry forward appropriations in limited instances where the need for payment is certain but the timing is not. Earmarked revenue not used during the year is also carried forward. In both these cases, the carried-forward amount may only be used in subsequent periods for the original purpose of the appropriation. Due to the restrictions on their use, it is often difficult for ministries to spend this amount, and many prefer to build up their own "rainy day" reserve funds. As a result, such accumulated funds amounted to EUR 3.7 billion at the end of 2006.

The budget appropriations constitute a **maximum** amount that can be spent. There is no requirement to spend all moneys appropriated by parliament.

Borrowing against future appropriations is not possible. The arm's-length entities can in theory borrow money on the capital market in their own name. In practice, this occurs only in exceptional circumstances and requires the *de facto* approval of the Ministry of Finance.

All appropriations are made on an annual basis. The reference to multi-year appropriations in the previous section is an agreement between the Ministry of Finance and the respective entities, subject to the approval of parliament each year.

Austria follows the principle of gross budgeting, with expenditures and any associated revenues treated separately. Line ministries can however take on more costs in response to rising user-financed demand, with the approval of the Ministry of Finance. Again, such approval is not required for the hived-off entities or the flexible agencies.

The federal budget contains a central contingency fund (*Pauschalvorsorge*) in order to cope with certain unavoidable or unexpected expenditures not foreseen in the budget, such as natural catastrophes. The size of this fund in 2006 was approximately EUR 400 million. This amount is not spent by default, but depends on the actual need during the budget year.

Box 15. **Monthly meetings between spending ministries and the Ministry of Finance**

The Ministry of Finance has separate monthly meetings with each spending ministry. Ostensibly, these meeting are to discuss the cash-flow needs of each spending ministry for the following month (see section 3.4). In practice, these meetings cover all aspects of budget implementation, including any deviations – both in substantive and financial terms – and any requests for the Ministry of Finance to exercise delegated authorities from parliament to amend the budget, as well as any other relevant issues.

3.3. Human resource management

Human resource management is exercised by the Federal Chancellery (Office of the Prime Minister). Matters related to remuneration are however exercised jointly with the Ministry of Finance. Starting in 2001, the Chancellery ceased involvement in individual personnel actions – hiring, promotion, and dismissal – except for the highest positions. In the new decentralised environment, each ministry is responsible for its own personnel actions. The Chancellery is now mainly concerned with overall co-ordination and the

establishment of general regulations and standards which the ministries must observe. The arm's-length entities are not subject to these regulations, although they are encouraged "to follow their spirit".

As previously noted, a most conspicuous feature of the Austrian human resource management framework is the detailed manpower controls, the *Stellenplan*, which are approved by parliament together with the budget. The plan sets the maximum permissible number of posts at the level of unit within a ministry and at each grade of staff. New recruitments and reassignments are only possible if there is a vacant post. The Chancellery verifies at the beginning of each month that the number of posts is filled. The government cannot adjust the number of posts in-year but it is possible to reallocate posts within a ministry by government decree as long as no additional costs arise. However, this is a complex, non-routine procedure.

Box 16. **Recruitment of directors-general**

The positions of director-general are advertised as for other positions, but specific selection criteria exist. For each position, a special panel (appraisal commission) is formed to consider the applications. The panel consists of four persons, two representing the employer and two representing employees. In case of a "tie", the votes of the employer's representatives are decisive.

The panel must classify all applicants as either very well suited, well suited, or not suited. They may classify multiple persons in the top category. The panel recommendations are sent to the respective minister for decision. He/she may select any of the applicants regardless of the panel's recommendations, even one classified as not suited. If a candidate who was assessed as well suited is not chosen, the staff association (*Zentralausschuss*) can request an explanation from the minister.

Directors-general are appointed for a period of five years. The positions are then re-advertised, but the incumbent director-general may be re-hired for multiple periods without going through a new panel process. A minister cannot dismiss a director-general; a director-general can only be replaced in very specific circumstances, for example in case of significant structural changes.

It should be noted that Austria had a long-established informal practice, known as *proporz,* to maintain a balance in the numbers of senior civil servants associated with each of the two dominant political parties. This practice has however declined in recent times.

There are two types of public employment framework in Austria: employment under public law (the classic, tenured civil servant position) and employment under private law (contractual, similar to that of private sector employment). As a result of various reform measures, service under the public law regime has now been widely replaced by employment under private contracts. In most respects, however, there are no significant differences between the two. The public law employment framework has been repeatedly updated in recent years to bring it in line with the private law framework. In fact, the government's objective is to have one uniform employment framework for all federal employees which parallels the private sector one, with special regulations only for areas such as police officers, judges, tax investigators and similar positions that exercise the authority of the state.

All government positions are advertised and open to all qualified applicants. In order to ensure merit-based hiring, each applicant must undergo a specific examination to test his/her competency for the post. In most cases, this involves a written test which must conform to the standards set by the Chancellery. Service contracts may be concluded for a specified or unlimited period of time. Usually every new service contract is agreed for a specified time period. A probationary service contract can also be concluded; it must not exceed one month, and it can be suspended at any time by both parties. For civil servants hired on a public law basis, an initial probationary period lasts six months. Upon hiring, staff will generally remain with the same ministry for the duration of their career. It is very rare for officials to move to another ministry and even rarer for officials to move to the private sector. However, efforts are being actively made to promote mobility between ministries. Dismissing staff for poor performance is difficult, if not impossible in practical terms. This also widely applies to civil servants with contracts based on private law.

Salaries are set in an annual salaries law approved by parliament. The salary scales are uniform within the employment regimes and throughout the government, with different grades according to the qualification of the staff and multiple seniority-based steps within each grade. Various groups of employees may also have disparate special allowances in addition to their basic salaries. In fact, harmonising this "jungle of allowances" has been a key government objective in recent years. Some specialised occupations – IT professionals, air force pilots – receive additional retention allowances; this applies to about 2 500 people in total. Initial efforts have been made to introduce performance pay. A maximum amount equivalent to a half of one month's salary can be paid as such. The performance pay regime applies especially in the flexible agencies.

The public sector is heavily unionised. Despite the unilateral setting of salary scales by parliament in formal terms, intensive and centralised collective

Box 17. **Downsizing the public sector**

Austria has in recent years emphasised the downsizing of public sector employment. Explicit across-the-board targets were set for staff reductions. Initially, teachers and police officers were excluded from the cuts, but most recently only teachers are exempted. The reductions were achieved by natural attrition – *i.e.* no new hires for retiring staff – and by offering early retirement. It is estimated that an employment reduction of 2.5% was achieved through natural attrition and an additional 1% through early retirement. There were no involuntary dismissals. It should be highlighted that these are real reductions, not ones achieved through organisational changes.

The early retirement system was heavily used by some of the hived-off entities. They were able to achieve efficiency gains in their own operations by placing staff on early retirement, as such benefits are paid from a central account in the Ministry of Finance and not from the entity's budget. In response, the relevant regulations were changed and the Ministry of Finance now must agree to all cases of early retirement in these entities.

Austria is also engaged in an effort to redeploy staff from areas where surpluses exist to areas where shortages exist. An outstanding example is the redeployment of immigration and customs officials to the police force by special law following the abolishment of border controls with the Schengen agreement. However, redeployment is an extremely sensitive issue, with strong resistance from existing staff and their unions.

Box 18. **Pension reform**

In 2005, a new general pension law (APG) replaced different pension schemes for a number of occupational groups. At that time, the pension system for federal civil servants was harmonised with those of the private sector so there is now only one system for both categories. The previous system for government employees was generous, and this reform represented a steep reduction in benefits. It is estimated that the reform reduced the pensions of government employees by 40%. This was achieved principally by calculating retirement income on the basis of the average of lifetime income, rather than on the last income period prior to retirement. The new APG will be introduced over a 50-year transitional period, with a gradually increasing part of future pensions coming from the new system. Employees born before 1955 will not be affected by the 2005 reform, and people entering the labour market as of 2005 will only be subject to the new system, which is a pay-as-you-go system.

bargaining negotiations take place between the government (Chancellery and Ministry of Finance) and the unions. The government then uses its majority in parliament to legally enact the conclusions of these negotiations. Public sector strikes are illegal but, at critical points in the negotiations, unions might hold "information meetings" for their members, at which time staff stop working. Such actions have not been punished in Austria.

3.4. Financial management and reporting

At present, Austria's accounting is on a cash basis. The proposed budget reforms call for the adoption of accrual basis accounting. The recent comprehensive upgrading of the IT infrastructure (SAP) explicitly envisaged this reform. Accounting standards are set by the Ministry of Finance with the "consent" of the Court of Audit; there is no independent or advisory accounting standards board.

The cash management system is centralised, with all payments and expenditures going through one single account located at the BAWAG/Postal Savings Bank (previously partly government owned but now fully privatised). Any balance at the end of the day in this account is transferred to the government's account at the Central Bank for overnight investment. Government bodies do not have their own bank accounts, either in real or notional terms. Therefore, there is no system of interest receipts and payments to government bodies to promote good cash management practices during the year.

There is however one significant exception: the accumulated carry-forwards of unused appropriations are maintained in special accounts in the names of the respective bodies. These significant balances (EUR 3.7 billion at the end of 2006) are therefore excluded from the government's overall cash management system, *i.e.* they are deposited in separate stand-alone accounts, not notional accounts.

The government prepares a monthly cash apportionment plan at the beginning of the year. This is on the basis of submissions from individual ministries which must be updated monthly (*cf.* the monthly meetings). About three-fourths of the cash flow is fixed from year to year. For the remainder, the Ministry of Finance seeks specific dates for major payments in order to improve its daily cash management. This is now done on an *ad hoc* basis, but it is envisaged to automate this process. The apportionment plan is an internal government document only.

Requests for payments are sent by individual ministries to the Federal Accounting Agency (see Box 19) for processing. The agency verifies that the ministry has pre-audited the payment request and then verifies that the money for this item is available in the monthly apportionment plan. These payment requests, including the invoice, were traditionally made by paper but

are now being made electronically through the so-called ELAK system. The Federal Accounting Agency then instructs the BAWAG/Postal Savings Bank to transfer the money into the recipient's bank account electronically. It is a highly advanced system with nearly all payments being made electronically. Austria relies on the giro system for non-electronic transactions; it does not have its own "retail" treasury offices. The length of time from the payment request to actual payment is very short – overnight in most cases.

The quarterly reports on budget implementation presented to parliament as part of the Minister of Finance's regular meetings with the Budget Committee have traditionally constituted the only external in-year reporting by the government. These quarterly reports show the government's receipts and outlays on an aggregate basis. Most recently, the Ministry of Finance has started publishing monthly online information on the government's revenues and expenditures. Expenditures are shown at the level of each ministry (budget chapter) and compared with the previous year. No comparisons are made with the current year's apportionment plan.

Box 19. **Federal Accounting Agency**

The Federal Accounting Agency was created and set up in May 2004 and employs approximately 600 staff. Earlier, each ministry and some other entities (32 in total) had their own accounting departments. By legislation, the agency is responsible for three broad tasks:

- Payments and cash flows: optimising the flow of funds for the total federal budget.
- Financial accounting, including checking bookkeeping entries and accounting records, monthly check of actual expenditures *versus* planned expenditure, and preparing the federal accounts.
- Operational audit such as internal annual audit of ministries and subordinate bodies with a focus on accordance with regulations and lawfulness.

The responsibility covers all central government expenditures, including all ministries and organs of state, and may soon also cover hived-off entities. All in all, 50 million accounting transactions pass through the agency every year, with a payment volume of EUR 50 billion.

The agency is financed through fees charged to its users. The Ministry of Finance bears the cost of the IT system, and the fees for transactions and audits are set in a contract with the Ministry of Finance. Each ministry is charged according to the amount of transactions and number of audits.

The audited annual financial statements are presented in late September, nine months from the close of the fiscal year.

Austria does not have a system of capital charging *per se*. However, it has moved its real estate holdings into a separate corporation which leases them back to the government ministries at prices that take account of capital costs. This is further described in the next sub-section.

3.5. Management of real estate

In 1992, Austria founded the Federal Real Estate Corporation, a government-owned private limited liability company. It is responsible for all government buildings (except historical palaces, such as the parliament and Hofburg, and military buildings). It is responsible for maintaining the real estate and selling superfluous property, as well as constructing, purchasing and leasing property as required. The value of its total assets exceeds EUR 3 billion.

The company operates on a completely commercial basis and charges market rents from its tenants. Previously, real estate was provided "free of charge" to government bodies. This reform has increased the cost consciousness of tenants as well as increasing the transparency of these costs. Federal entities are not required to lease their property from the company. They can enter into lease agreements with private sector companies, although this is extremely rare.

3.6. Use of performance and results information

The Austrian budget process has traditionally not employed performance and results information to any significant degree, and its use is currently in its infancy. On a trial basis in 2002, the Ministry of Finance requested each ministry to submit outcome and output information on their programmes along with their budget requests. The results were disappointing but not necessarily surprising for such a one-off trial exercise. The arm's-length entities and the flexible agencies do use such information to a greater extent. The quality of this information varies greatly, but in general it could be characterised as incomplete in terms of the activities covered, often process oriented, and geared to the internal operations of the entity concerned rather than an external audience. A summary performance and results report (*Leistungsbericht*) is published annually by the Chancellery.

The Ministry of Finance has adopted a long-term view on how best to improve the use of performance and results information in the budget process, as called for in the planned budget reforms. The Ministry of Finance does not want to take a leading role in defining individual outcomes and outputs. Achieving the buy-in of spending ministries is viewed as imperative for this information to be useful. The Ministry of Finance views its role as establishing principles

and minimum standards in terms of the comprehensiveness, usefulness and comparability of the information. This information will be used to inform budget decisions; no explicit and automatic linkages to the level of appropriations are envisaged.

3.7. Conclusion

Austria has undertaken significant reforms in the area of budget implementation and government management in recent years. In many respects, the organisational renewal efforts – the hived-off entities – launched these reforms, as they represented such a radical break with past practices. The "merging" of the employment legislation between the public sector and the private sector, as well as the reform of civil service pensions, are also formidable achievements. Austria was a leader among OECD member countries in adopting new means to manage the government's extensive real estate holdings. The budgeting reforms currently under discussion will further deepen the improvements in budget implementation and government management.

The reforms will entail further **consolidation of budget appropriation** where Austria has already made considerable progress. The current reforms will also need to modernise (simplify) the types of appropriations and the account structure used. The status of the extensive supplements for each budget chapter should be revisited.

The reforms call for a general system of **carry-forwards of unused appropriations**, replacing the current highly restrictive system. This is in line with OECD best practices. It has not yet been decided whether savings will be kept in one central fund at each ministry or at the level where the savings are actually realised (directorate, agency, etc.). If the former, there is a danger that this will decrease the incentive to save. It is also important to limit the types of appropriations that can be carried forward. In this regard, a distinction can be made between funds that are under the direct control of a manager, such as administrative costs (wages, intermediate consumption), and transfer programmes that are simply administered (entitlements, subsidies). In the latter case, a ministry may reap windfall gains due to circumstances beyond its control. Therefore, the envisaged reform in Austria is to have a separate treatment of administrative funds and appropriations for transfers and entitlements.

The integration of the current stand-alone accounts for carry-forwards (reserve funds) into the government's overall cash management system should be implemented as a matter of urgency, as is indeed planned in the current reforms.

In the present system, **civil service employment** is controlled by both the nominal amounts in the budget for personnel expenditures and by the number of posts as decided at detailed level in the *Stellenplan*. This appears overly rigid and is exacerbated by the fact that responsibility for the budget and the posts is divided between the Ministry of Finance and the Chancellery (Prime Minister's Office). OECD best practices would call for abolishing the control of posts (the *Stellenplan)* and relying on the budget only. The desire to maintain additional safeguards is however understandable since these are tenured positions. A reasonable compromise, described earlier, may be to reform the *Stellenplan* so that it focuses on the number of posts at a more aggregate level – for example, whole-of-ministry – rather than specifying posts at detailed levels within ministries as is currently the practice. This would serve to increase flexibility yet maintain the additional safeguards.

In return for increased flexibility in the use of inputs, the reforms call for greater use of **performance and results information**. This is in line with developments in all other OECD member countries. However, this is a difficult area, and the pragmatic approach of the Ministry of Finance in implementing this reform is appropriate. Austria can also benefit from the experiences of other OECD countries which have already embarked on these reforms.

The introduction of **accrual accounting** – and retaining the budget on a cash basis – is in line with OECD best practices. The coverage of accrual accounting should be comprehensive, including civil service pension obligations. It should be highlighted, however, that recognising the civil service pension obligation in the balance sheet does not imply a need to immediately finance that liability; the two decisions are separate and distinct. The adoption of accruals entails the use of sophisticated accounting standards. It is important for the body that establishes those standards to have a degree of independence from users in order to ensure their integrity. Consideration should be given to the establishment of an independent (advisory) board for the promulgation of accrual accounting standards.

Austria has recently made substantial efforts to improve in-year **financial reporting** and the first results are in line with OECD best practices.

The envisaged reforms present a large step for Austria to reach the current best practices of OECD member countries. This reform could extend the concept of "**each minister as his/her own finance minister**" from the budget formulation phase, where it is already in place, to the budget implementation phase.

Notes

1. In strictly legal terms, there is **one** subcommittee whose membership changes 13 times depending on which chapters of the budget are being discussed.
2. In strictly legal terms, members of parliament supporting the government introduce the amendments on behalf of the government.

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Role of the Legislature in the Budget Process: Recent Trends and Innovations

by
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This article provides a broad historical and conceptual overview of the evolution of legislative roles in budgeting, and assesses the potential consequences of expanded roles. By analysing country budget institutions and practices, the article proposes ways to establish sound relationships between the executive and legislative branches of government.

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1. Introduction

The two most important players in the budget process are the legislature and the executive budget office. Their respective role and power in the budget process differ from country to country and are influenced by many factors, including the wider historical, constitutional and political context as well as the legal and procedural aspects of the budget process itself and internal legislative structures and processes.

The constitutional division of power between executive and legislative branches ranges from presidential systems of separation of powers, such as in the United States, where the legislature has a strong role, to Westminster parliamentary systems, where the executive generally dominates. In between are modified forms including semi-presidential systems and non-Westminster parliamentary systems.

During the 20th century, the size and complexity of government grew exponentially in OECD countries, along with a greater focus on international issues and conflict affairs. In some countries, these trends promoted greater influence by the executive in budgeting. In recent years, however, executive roles have been challenged, as legislatures in certain countries have asserted new roles and responsibilities in budgeting. This trend is driven by many different factors, including the increased political stress on fiscal policy because of fiscal constraints and changes in the composition and cohesiveness of parties and party systems. Even in the United Kingdom, the core Westminster parliamentary system, new measures were introduced in the 1990s to support the legislature's efforts to more effectively control public expenditure. The need to respond to current fiscal problems – and future fiscal risks – arising from ageing populations as well as performance management and budget reforms will continue to challenge both executive and legislative officials to adapt and strengthen their roles in the budget process. As budgeting becomes more relevant for a wider range of policy and management challenges, officials throughout government will increasingly focus on how they can influence these choices by repositioning their roles in budget formulation, execution and oversight.

Given the recent changes in this area, OECD member countries at the 2006 annual Senior Budget Officials meeting requested that the OECD secretariat conduct an in-depth study on this topic. For this purpose, a meeting was held in Paris in October 2006, with delegates from nine countries[1] representative of four different forms of government: presidential, semi-presidential, Westminster

parliamentary, non-Westminster parliamentary. This article draws on the presentations and discussions at that meeting and on previous OECD work in this area (Lienert and Jung, 2004). While it provides a theoretical background, the article focuses on the practical aspects of what the two players actually do in the budget process. By analysing each country's budget institutions and practices, this article highlights policy suggestions for developing co-operation and establishing sound relationships between the two branches of government.

This article provides a broad historical and conceptual overview of the evolution of legislative roles in budgeting, and assesses the potential consequences of expanded legislative roles. The article also contains a review of the relationship between the two branches and some policy suggestions to enhance executive-legislative co-operation in budgeting. The article draws on the experiences of the nine countries that participated in the OECD meeting, highlighting the practices and procedures that are followed by the legislature and the executive during the budget formulation and execution cycle.

2. Legislatures and budgeting

2.1. The historical and institutional background

The legislative role in budgeting has evolved over centuries. In England, the ascendancy of the legislature as a political and fiscal institution was integral to the shift from a monarchy to a democracy. Other countries have had similar experience.

The independent exercise of the "power of the purse" was a primary anchor of the legislature's emerging role in the governance process. Determining the allocation of resources among competing claims was critical to establishing the legitimacy and authority of the legislature as an institution competing with the monarchy.

Over time, the legislature's authority to appropriate public funds became the foundation for public budgeting and accountability, preceding the development of budgets by the executive. The fundamental power of appropriation gave the legislature formative influence in allocating funds among competing priorities. Legislatures went beyond this *ex ante* role to assume *ex post* influence over the process of budget execution and programme administration. Agencies were typically bound to follow the levels in detailed appropriation accounts in order to spend funds during the course of the year. Legislative influence over executive agencies was further reinforced by the exercise of oversight over agencies' management and budget implementation, either directly or through independent audit offices.

The roles currently exercised by legislatures actually range widely. The major influences include broader political, legal and institutional forces

beyond the control of legislatures, as well as internal legislative structures and processes that can be changed by the legislature itself.

The constitutional division of responsibilities between the executive and the legislature has a major impact on legislative-executive roles in budgeting. In presidential separation-of-powers systems, like in the United States, the legislature has a significant role in policy formulation and in budgeting, partly owing to its independent election by constituencies that are different from those of the president. Legislative powers are arguably weakest under the Westminster system, where the executive leadership is drawn from the parliament and where the legislature is politically obligated to support the government. In between are modified forms including the semi-presidential system (France, Korea), the parliamentary republic (Germany, Italy) and the non-Westminster parliamentary monarchy (Netherlands, Sweden) (Lienert, 2005, p. 1).

Party systems play a fundamental role in determining the degree of independence of the legislature *vis-à-vis* the executive. Strong, cohesive two-party systems will generally work to attenuate legislative influence. In these systems, legislatures have a working majority to support executive initiatives. Under these circumstances, there is often little incentive for the executive to bargain and little incentive for the legislature to disagree. In parliamentary systems, the majority party in the legislature can precipitate a downfall of its own government by voting against the budget or by making major amendments. The executive's influence is further strengthened if the national party selects legislative candidates, thereby ensuring that legislative members owe their allegiance more to national party leaders than to local constituencies. On the other hand, weaker two-party systems, as well as multiple-party systems, generally strengthen the role of legislatures in budgeting and in the policy process more broadly. In these systems, the executive must bargain with more independent legislative actors to ensure majority support for budgets and policy goals. Sometimes this bargaining takes place outside of formal legislative channels and institutions, such as in pre-budgetary negotiations, but should nonetheless be considered as an exercise of legislative influence over executive decisions.

The institutional structure and role of the legislature have a bearing on the legislature's ability to act. Generally speaking, bicameral legislatures may have greater possibilities for influence, particularly if one house has a political standing that is different from that of the government's majority. Thus, for instance, the upper house in Australia and in Germany has different electoral constituencies and cycles that can lead to control by parties outside of the majority government. Also, legislatures that are full-time governing bodies will tend to attract members with an interest in promoting the legislature's role, as opposed to legislatures composed of part-time members with careers

outside of government. Legislative bodies whose members serve for a number of terms tend to have greater expertise and interest in participating in governing than do those where membership is considered to be temporary.

The structure of the budget will have a major bearing on the role played by the legislature in the budget process. Generally speaking, comprehensive budgets which afford maximum control to budget decision makers over allocations and levels provide the greatest opportunities for influence for political leaders, whether they are in legislative or executive branches. On the other hand, budgets with large portions deemed "uncontrollable", due to entitlements or to trust funds that are considered to be external to general budgetary debates, will tend to limit the influence of the legislature in the annual budget process. While legislatures can still bid for influence over entitlements or trust funds, they must often pursue their interests outside the annual budget process in such areas as authorising or enabling legislation.

Other factors lending themselves to legislative influence are more in the control of the legislature itself. For instance, as governing has grown more complex, legislative influence is in no small part a function of the capacity of the legislature to marshal the expertise and information necessary to monitor and supervise executive agencies. In this regard, legislatures that organise their budgetary review and oversight in specialised committees help to deconstruct large, complex budgets and divide the labour of reviewing such massive amounts of information. Specialised committees also encourage legislative officials to acquire sufficient expertise to effectively compete with and, when necessary, challenge executive officials.

2.2. Trends in legislative budgeting

The 20th century was a century in which legislatures faced new challenges in asserting their influence in budget formulation and execution. Factors like the growth of government, the increased technical complexity and expansion of bureaucracy, and the seemingly perennial presence of international conflicts all served to solidify and reinforce executive responsibilities for the budget. In some countries, the executive budget was developed to provide coherence to the modern state and accountability to national constituencies that particularistic appropriation bills simply could not do.

Legislatures themselves delegated powers to the executive, wary of their own instincts to favour particular constituency-based policies at the expense of the broader fiscal wellbeing of the country. Moreover, legislatures did not have expertise to keep up with the growing sophistication and complexity of modern budgets, particularly when compared to the detailed knowledge possessed by executive bureaucracies (Schick, 2002).

The eclipse of the legislative role in budget formulation was reflected in the limited formal roles legislatures were given in developing and approving budgets. Legislatures had little formal power to review or approve overarching budget targets or policies, nor were legislatures generally involved in approving medium-term expenditure frameworks. The authority of many legislatures to change executive proposals was limited as well. Many were only able to cut spending, while others that wished to raise spending on line items were forced to search for offsets to neutralise their effects on the budgetary bottom line. In contrast with regular laws, budgets were often not enacted into law, but rather set in motion through executive proposal or legislative resolutions.

Many legislatures had small staffs without the deep institutional knowledge necessary to effectively compete with the executive, and the executive was often loathe to share important information that had been developed in a highly privileged and somewhat secretive process. The limited time available to review government budget documents and plans only compounded the legislature's problems: for instance, the United Kingdom Treasury submits estimates only two weeks before parliament must consider them. The formal limits were offset to some extent by considerable informal consultation and bargaining, particularly in those legislatures where the executive did not enjoy a commanding and cohesive majority of its own partisans.

Even where legislatures had effective control over executive budgeting, their roles were largely defined as checks on executive plans and proposals. In an era where government has become more important in society, a primarily negative role failed to command the respect of citizens who looked to their national leaders to solve a growing menu of increasingly daunting problems. Even in strong legislatures such as the United States Congress, the power to say no fails to capture the public imagination, as government is valued more for what it can do than for what it refuses to do (Cooper, 2001). And acting as a check on executive power is all the more difficult as budgets become dominated by entitlements and tax expenditures: these have become viewed as rights which, if changed, would cause detriment to families and economies alike.

Recent years have witnessed a resurgence of legislative roles and responsibilities in budgeting. In many countries, the efforts have had broad bipartisan support for assisting the legislature in recapturing some of its influence in the budget process. The legislative resurgence was prompted by several important trends:

- First, fiscal balances are increasingly viewed as precarious, particularly over the longer term, and budget and tax policies define the capacity of any system to satisfy the political demands placed by constituencies on legislatures. Moreover, the globalisation of markets has made countries' fiscal position

more precarious and consequential; losing the confidence of world credit markets has broad sweeping consequences for a country's standing at home. Legislative leaders ignore fiscal policy at their peril, for they could thus alienate themselves from the process that can prevent, mitigate or respond to threats to the country's economy and social wellbeing.

- Second, party systems in many countries have become frayed as emerging economic and demographic forces splinter previously cohesive parties into narrow blocks or factions. Many legislatures are not managed by cohesive party leaders but rather through a turbulent combination of factions and parties. In fragmented political settings, political factions succeeded in using legislative footholds to challenge executive-led fiscal policy, prompting them to champion reforms to institutionalise stronger legislative roles and capacities.
- Third, democratisation in many formerly closed systems, such as in central Europe, has spurred changes to promote legislative activity in budgeting (Wehner, 2004). Assigning new roles to the legislature is part of a broader movement toward openness and transparency in government. Accountability has become a watchword for governance reforms, as reformers dust off historic conceptualisations of legislatures as a check on unilateral and unmitigated central government power.
- Finally, the relationship between the executive and the legislature in budgeting is a competitive one in many systems. Legislatures compete with executives for influence over budget formulation and for control over executive agencies' actions. Ironically, the reforms instituted by executives to strengthen their own roles in budgeting prompted legislatures to adopt similar measures. Thus, as noted below, the adoption of top-down budgeting frameworks in executive budgeting was accepted by legislatures, which realised that failure to do so would weaken their position in the system. Similarly, the superior information on spending and performance possessed by executive budget offices has prompted legislatures to acquire and improve their own information capacities.

2.3. Recent innovations in legislative roles

Legislatures are expanding their roles and influence in budgeting in several different areas. This is not surprising given the wide variance of legislative activities in budgeting. Recent reforms can be characterised as both strengthening traditional legislative controls over executive powers and projecting new legislative roles in setting overall fiscal policy targets and government performance. Legislatures have also taken steps to equip themselves with greater capacity and information to carry out these new responsibilities. It should be noted that, while there is a trend toward expanding legislative involvement in budgeting, the reforms themselves proceed from a very low level

of involvement. As noted above, legislatures have often been given limited roles in the past due to real political, constitutional and technical constraints.

The legislative reforms fall into several categories: approving *ex ante* fiscal frameworks, broadening the portion of the budget subject to legislative review, strengthening institutional budget and deliberative processes, increasing legislative budget capacity, changing appropriation structures and budget execution, and enhancing *ex post* oversight. In many cases, countries have adopted reforms across many of these categories, but some have concentrated their initiatives on only one aspect.

2.3.1. *Legislative approval of* ex ante *fiscal frameworks*

Perhaps the most significant change in legislative roles is the involvement in reviewing and approving overarching fiscal frameworks and targets to complement their traditional roles in enacting detailed appropriations. The evolution of stronger legislative roles parallels the development of top-down budgetary frameworks in many OECD countries (Kim and Park, 2006). As noted above, reforms which strengthened the central budget office in setting targets and frameworks for the annual budget process ultimately served to stimulate expanded legislative roles as well. Legislatures realised that, as budgetary policy shifted to macro frameworks, they would become increasingly irrelevant for resource allocation and influence in ministries if they failed to become relevant in the macro budgetary arena. Importantly, such frameworks provide guidance and constraints for subsequent appropriation actions by parliament and its committees. While the legislature gains new influence in setting and approving macro targets, its degree of freedom in enacting appropriations may be somewhat diminished as a result.

In most countries, the executive budget office produces the medium-term budget framework (MTBF), including projections for aggregate expenditure and revenue and the fiscal strategy for a certain period. The OECD 2007 survey on budget practices and procedures (OECD, 2007) shows that executive budget offices in 26 of the 30 OECD countries present medium-term fiscal policy objectives in documents prepared for the legislature. These frameworks provide the overall fiscal goals for setting annual aggregate expenditure levels and also function as a binding limit in formulating the annual budget.

Legislatures in some countries have gained a role in approving macro fiscal frameworks. The OECD 2007 survey reveals that legislatures in 9 of the 30 OECD countries first vote on the total amount of expenditure before taking separate actions on appropriations.

In Sweden, a pioneer of top-down budgeting, the State Budget Act of 1996 allows the executive to propose expenditure ceilings to parliament that

become binding for the years beyond the budget year. The Swedish parliament approves an aggregate multi-year expenditure ceiling prior to approving the detailed annual budget (Lienert and Jung, 2004). Similarly, the United States Congress approves a budget resolution containing five-year macro fiscal targets and overarching ceilings for discretionary appropriations, although the appropriation ceilings are only binding for one year.

In the Netherlands, a medium-term fiscal framework is negotiated among the coalition parties and becomes the overarching guidance for subsequent legislative consideration of the budget and appropriations. Budgetary policy, including the reduction of the fiscal deficit and the national debt and caps for the level of expenditure, is a key focus of this multi-party coalition agreement, with very explicit agreed objectives for the conduct of budgetary policy for its four-year term of office (Blöndal and Kristensen, 2002).

The United Kingdom MTBF illustrates a framework developed by the executive with little legislative input. Budgets including the annually managed expenditure (AME) and departmental expenditure limit (DEL) are set for three-year periods in a spending review (SR), the British version of the MTBF. However, the SR is only done by the executive, and no formal consultation is held with the legislature before the SR is presented to parliament.

2.3.2. Broader coverage of legislative budget decisions

Countries vary in the extent of their budgetary transactions subject to legislative review. Some countries, such as the United Kingdom, have certain spending categories that are not voted by parliament, including spending for certain public authorities, the country's contribution to the European Community, and various "standby authorities". Decisions by some countries have brought a greater share of the budget into the ambit of legislative review and approval. Norms of unified or unitary budgeting have become more widely adopted, partly as an instrument of fiscal policy and partly to underscore the accountability of all sectors of the budget to legislative oversight and review. In Korea's budget reforms, the National Assembly has gained control of all public funds, whether they be programmes funded by the general fund or those funded by earmarked revenues in so-called special funds (see the chapter on Korea in Lienert and Jung, 2004). Korea has joined other countries in providing that tax expenditures be reported to the legislature as well; the OECD 2007 survey shows that half of the OECD countries that responded now include tax expenditures in budget documents presented to the legislature.

As entitlements consume larger shares of national budgets, some legislatures have sought greater control over their growth through the budget process. In the United States, for instance, expansion of new entitlements had

to be offset with cuts to other entitlements or tax increases, in a process known as PAYGO. Although the formal process has expired, the constraint continues to some extent in the Senate rules of legislative procedure. Sweden has extended spending ceilings to cover existing entitlements. Should spending in these programmes exceed the ceilings due to unanticipated growth in claims, the executive is obligated to present supplemental budgets to the legislature to accommodate the increase. The Italian legislature must also approve spending overruns for existing entitlement programmes. While officials note that legislatures have little choice but to approve these requests, they do provide a "speed bump" that enables the legislature to express its own policy concerns in the process.

2.3.3. Institutional changes in the deliberative process

The legislature's capacity to influence budget decisions is a function of both its authority over executive budget recommendations and its internal processes for decision making. With regard to the scope of legislative authority, Wehner (2004) places legislatures into three categories of influence over budgeting:

- **Budget-making legislatures** have the capacity to amend or reject the budget proposals of the executive and to substitute one of their own (Sweden, United States).
- **Budget-influencing legislatures** can amend or reject executive budget proposals but lack the capacity to formulate their own independent budgets (Italy, Netherlands). The amending power is often constrained as well: many legislatures may cut but not add to executive budgets, while others may add as long as they find offsetting cuts.
- **Legislatures with little or no budget role** lack the capacity to reject or amend executive proposals in any substantive way, largely for fear of prompting the fall of the government (United Kingdom).

The varying influence of legislatures in budgeting reflects, in part, differing authority to modify executive budget proposals. According to the OECD 2007 survey, 18 of the 30 OECD countries report that their legislatures have unrestricted powers to amend the budget. Legislatures in other countries, however, can make amendments only if they do not change the overall fiscal position, while others may only decrease, not increase, proposed spending. In Japan, Sweden and the United States, the legislature has unlimited legal power to amend the budget proposal. In France and Korea, the constitution limits the scope of legislative amendments to the budget, while in the United Kingdom these limitations are contained in the parliamentary regulations. In the United States Congress, the president's budget is regarded as only a recommendation; when Congress is controlled by a different political

party than the president, the executive budget is often referred to as "dead on arrival" (Blöndal, Kraan and Ruffner, 2003).

On the other hand, in countries with a parliamentary system, the tendency is to use amendments carefully because substantial amendment of the executive budget proposal is commonly considered as a vote of no confidence in the cabinet. Sixteen of the 30 OECD countries that responded to the OECD 2007 budget survey report that a legislative vote to change the executive's budget would be considered to be a vote of no confidence. In the United Kingdom, where the executive (*i.e.* HM Treasury) has dominated the budget process, parliament has never made amendments to the budget proposal since World War I, and the last attempt at amendment (which in fact failed) took place in the late 1980s. In Mexico, the Budget and Fiscal Responsibility Law specifies the rules for modifying the budget proposal; any amendment for additional expenditure must identify sources to compensate it, new revenue, or cuts in other programmes.

Legislative influence is also affected by the time available to consider requests: a legislature that has limited time to examine budget proposals is at a disadvantage. The time from budget submission to the beginning of the new fiscal year ranges from eight months in the United States to a general norm of about three months in most of the other countries. The United Kingdom proposals are presented only two weeks before parliamentary consideration, although substantial informal consultation can take place between executive and legislative leaders. As part of recent budget reforms, some legislatures have established a more regularised process with more time for legislatures to consider budget requests. Mexico, for instance, instituted changes requiring presidents to present their budgets earlier than before. Table 1 shows the timing of executive budget submissions for some countries.

Table 1. **Timetable for budget submission to the legislature**

	Start of fiscal year (A)	Deadline for submission (B)	B – A	Source
France	1 January	First Tuesday of October	About 3 months	Organic budget law (*Loi organique relative aux lois de finances*, LOLF)
Japan	1 April	During January	More than 3 months	Law (Public Finance Act)
Korea	1 January	2 October	About 3 months	Constitution
Mexico	1 January	8 September	About 4 months	Law
Netherlands	1 January	Third Tuesday of September	More than 3 months	Constitution
Sweden	1 January	No later than 20 September	More than 3 months	Law (Parliament Act)
United Kingdom	1 April	None (at the discretion of HM Treasury)	–	None
United States	1 October	First Monday in February	About 8 months	Law (Budget and Accounting Act)

The committee structure is the heart of legislative influence. Given the sheer complexity and technical details involved with modern budgets, legislatures have found it essential to divide the task of reviewing the budget into committees. The relationship between the overarching budget committee and sectoral committees is important in determining legislative budgetary outcomes. Schick (2002, p. 29) notes that some legislatures assign full responsibility to a budget committee while others disperse jurisdiction among sectoral committees. The first method makes it easy to co-ordinate and promote consistency in legislative budget action, particularly facilitating fiscal discipline. The second method helps the sectoral interests reflected in the final budget, whereas it may complicate the task of maintaining discipline.

An emerging pattern empowers sectoral committees to review relevant portions of the budget and recommend legislative action within an overall fiscal framework maintained by the budget committee (Schick, 2002, p. 29). Of the nine countries studied, all except the United Kingdom have overarching budget or finance committees, reflecting the growing role of these legislatures in considering aggregate fiscal targets and policies. In-depth discussions on the aggregate expenditure limit and revenue and major fiscal policy issues take place, and reconciliation for budget amendments are made by these committees. Reviews of specific sectors or programmes in the budget, and review of proposed appropriations, are often delegated to sectoral committees within the overall targets and principles approved by the budget or finance committees. In many countries, sectoral committees are responsible for decisions authorising programmes and for appropriations. The role played by these committees has expanded in some systems, in parallel with the growth in the proportion of spending on entitlements, which are funded automatically according to underlying laws enacted by these committees.

In Sweden, for instance, the finance committee sets the overall spending ceilings, while appropriations are handled by the other committees. The United States congressional committee system is among the most complex: a budget committee formulates the overall budget targets to guide subsequent congressional budget decisions by appropriations committees, which consider only discretionary spending, and the authorising committees, which review entitlement and revenue legislation. In Italy's legislative process, the *rapporteur*, a senior politician from the majority or coalition party, plays a unique role as a reconciler between the legislature and the executive in the budget process. He/she presents the budget to the legislature and is responsible for examining the budget bill and amendment arising through the legislative process.

2.3.4. The critical role played by informal executive-legislative relationships

Notwithstanding the potential scope of legislative authority, in fact the extent of legislative modifications to executive proposals appears to be quite modest when examining just the formal record of actions taken in response to executive proposals. For instance, in Korea, legislative amendments constituted 3.8% of the executive budget proposal, while Japan reports no legislative amendments changing budgetary allocations in recent years. Mexico, on the other hand, reports that recent legislative amendments to the president's budget constituted 26% of the total.

However, noting the extent of formal amendments is only one way to assess the impact of legislatures on budget formulation. Legislative officials often exercise informal influence over executive budgets before they are formally announced. Executive officials have incentives to anticipate and take into account potential legislative views and reactions as they develop their proposals, either through informal negotiation or through anticipatory behaviour. Indeed, the absence of amendments may reflect effective informal bargaining and negotiations between executive and legislative officials during the formulation process, where consultation effectively heads off legislative opposition.

Minority and coalition governments have the greatest incentives to negotiate a budget agreement prior to the formal release of the budget itself. In the Netherlands, which has a system with more than ten political parties in the legislature, the government negotiates in advance with the parties in its coalition to develop guidelines for the four-year period of the cabinet. Such guidance contains caps on overall spending, deficit and debt reduction targets, and other macro policy statements. In Sweden, pre-negotiation is used as an important tool for the minority government to secure the parliamentary majority required for budget approval.

Extensive informal consultation can also occur prior to the release of executive proposals in presidential separation-of-powers systems. Korea's system features both formal and informal contact before submission. The formal negotiation between the ruling party and the executive is done during the last stage of confirming the executive budget proposal. Senior officials of the budget office and policy experts of the ruling party have joint meetings for two to three days to discuss budgetary issues and finalise the budget proposal.

Strong incentives exist for governments in parliamentary systems to consult with their party colleagues in the legislature in advance of the publication of the budget. For presidential systems, there is greater potential for conflict when the presidency and the legislature are dominated by different parties, similar to a minority or coalition government in a parliamentary system. Yet, even in presidential regimes, considerable bargaining over the budget occurs between the

two branches, particularly after the budget is published. As Richard Neustadt said, presidential systems are best characterised not as separation of powers but as separated institutions sharing powers (Neustadt, 1960). Each actor has powerful leverage: the legislature can refuse to approve the president's priorities while the president can veto the appropriations. Accordingly, both sides have strong incentives to engage in bargaining and negotiations to avoid a confrontation that can disrupt programmes and operations and cause public disaffection.

In cases when the president does veto appropriations, considerable disruption can occur in agency operations, as questions can be raised about whether government agencies must shut down. In 2005, the lack of adequate institutional mechanisms and legal provisions resulted in a constitutional crisis as the Mexican president vetoed the budget that had been approved by the Congress (controlled by the opposition party). When the president used his veto power, the House of Representatives did not recognise it and a constitutional controversy took place which left the government without a budget for ten months until the Supreme Court ruled that the veto was constitutional.

However, most countries have established provisional budget authority to cover instances when there are delays in legislative approval beyond the legal or conventional deadlines. These provisions provide the authority for the executive to continue to operate. In France and Korea, the provision guarantees that the executive can spend on the basis of the previous year's budget authority. Yet considerable ambiguity remains about the scope of such provisional budget authority. In the United States, on the other hand, there is no standing provisional authority to spend public funds in the absence of an appropriation signed by the president. Accordingly, Congress and the president must agree on a continuing resolution to sustain operations pending enactment of full appropriations, or the government will have to shut down. This in fact occurred during the Clinton presidency when the Republican Congress failed to enact appropriations that the Democratic president could sign. The government shut down for nearly three weeks until both sides were able to reach agreement.

2.3.5. Enhanced legislative capacity

Legislatures have often found they need help to play credible roles in budgeting. As noted earlier, the legislature can be overwhelmed by the sheer magnitude of budget documents, their technical complexity, and the years of expertise possessed by executive central budget offices. Accordingly, legislatures have chosen to invest in separate legislative offices that specialise in budgetary reviews, finding that independent units can put the legislature on a more equal footing with the executive (Anderson, 2005).

Of the nine countries that attended the OECD meeting in October 2006, six have independent offices that help the legislature with budget formulation or oversight. The roles of the offices vary. The Korean National Assembly Budget Office (NABO) has over 100 staff to help members assess executive proposals and further opportunities to strengthen legislative action. Each of Italy's two legislative chambers has a budget office that reviews the executive's estimates and assumptions for legislative officials. Sweden's legislative budget office goes beyond this to prepare its own estimates of budgetary proposals – an important tool which has reportedly emboldened legislative officials to propose more changes to budgetary proposals.

The United States Congressional Budget Office (CBO) is among the most independent budget offices in the world. Established in 1975 to support the new congressional budget process, the CBO prepares its own economic and budgetary forecasts which it uses to re-estimate the costs of the president's budget, as well as any proposal advanced by congressional officials. Moreover, the CBO plays the absolutely vital role of "scorekeeping" where individual proposals are tracked against overarching congressional budget targets and policies throughout the legislative process, thereby helping leaders monitor compliance by a decentralised and entrepreneurial legislative body. With a staff of over 200 economists and budget experts, the CBO has attained credibility among all political factions as a neutral and independent support for the Congress as an institution. Although the director of the CBO is appointed by the leadership of the Congress for a four-year term, the staff is selected without regard to political affiliation.

The House of Commons in the United Kingdom created a Scrutiny Unit as a supporting organisation for the select committees in 2002. The Scrutiny Unit, with around 18 staff[2] including lawyers, accountants, economists and statisticians, provides a wide range of financial expertise to departmental select committees. It undertakes systematic review of estimates, departmental reports, resource accounts and spending review settlements. The Scrutiny Unit also aims to improve the quality of financial scrutiny through compiling examples of best practices. The unit works with committees in pressing departments to improve the quality of the financial information they provide.

2.3.6. Changing roles in budget execution

The role of legislatures in budgeting extends from formulation to the execution of budget authority provided in appropriation acts. Legislatures intent on influencing public budgeting must retain an abiding interest not only in which programmes and priorities gain funding but also in how they are carried out by executive agencies. Armed with expertise and control over the details of programme implementation, agencies can gain significant influence in recasting the actual services delivered under programmes and activities. In

influencing budget execution, legislatures must strike a balance between the goal of exercising control over agencies' operations and the desire to promote efficiency by letting managers and programme experts administer programmes in accord with professional norms and values.

A foundation of legislative control over executive agencies is the structure of appropriation accounts. The specificity of those accounts, as well as the presence of other instructions and guidance attached to appropriations, goes a long way to determining how much discretion and flexibility agencies will be able to enjoy in carrying out the budget. In addition, budgetary regimes provide varying degrees of discretion for agencies to shift or carryover funds across line items or budgetary periods.

Legislatures in several countries broadened the account structures as part of a move toward performance accountability. Korea shifted the orientation of its accounts to performance, reducing the total number of accounts from 3 500 to 800. Italy also consolidated appropriation accounts, downsizing the total accounts from 6 000 to 1 000. In a major performance budgeting reform in France, known as the LOLF, the entire orientation of appropriation accounts was shifted from the object of expenditures to programmatic units. Appropriation bills now divided into 850 chapters are reclassified into over 40 mission areas, corresponding to the major programme goals of the government. The legislature agreed to provide funds in broader accounts to encourage a shift in the focus of legislative appropriation and oversight from inputs to outcomes (Ministry of Economy, Finance and Industry, 2006).

Legislatures vary considerably in their formal control over budget execution. Most countries prohibit ministries from spending money for any purposes other than those appropriated. Japan prohibits transfers across major agencies, accounts and activities except as approved by the Diet. In the United States, agencies may not transfer funds across appropriation accounts or detailed line items above certain thresholds without gaining approval of the congressional appropriations committees. Further, the president generally may not cancel or postpone appropriations without congressional approval.

The executive in other countries has greater authority to cancel or postpone approved appropriations in the execution process under certain conditions specified in a law. The executive in France has authority to cancel up to 1.5% of appropriations by executive decree after notifying the legislature. In Italy, the executive has strong power to cancel discretionary appropriations without informing the legislature. In Sweden, the executive can decide to carry over funds from one year to the next, and can also decide to not spend funds appropriated. The Swedish budget contains contingency funds that can be released by the executive without legislative approval.

Budget reforms had varying implications for legislative authority over budget execution. As noted above, performance budgeting reforms in France provided new flexibility to agency "programme co-ordinators" who gained a single fungible appropriation for their programme, with a separate limit on personnel.

Some countries have provided agencies with greater flexibility in carrying over unspent funds at the end of the fiscal year to avoid wasteful end-year surges. In the United Kingdom, departments may carry forward unspent discretionary funds to the following fiscal year, as long as they adhere to their fixed three-year spending plan. In Korea and the Netherlands, ministries can carry 5% of a certain range of a year's management budget and 1% of a year's budget over to the following year, respectively. In Sweden, the line ministries and agencies can normally carry a part of unspent resources over to the following fiscal year, and the Ministry of Finance decides the rate for allowing carryover by taking into account the gap between the *ex ante* expenditure ceiling and the amount actually spent. In the United States, funds that are appropriated for a single year must be spent in that year, but a majority of budget authority is provided in multi-year spending accounts, giving agencies flexibility in carrying over funds from year to year.

In its recent budget reform, Korea gave its legislature new tools to monitor budget execution. The legislature must approve debt issuance and also must grant its approval for ministries to create "quasi taxes". Korea also has contingency funds built into the budget, but the executive must gain legislative approval afterward for its expenditure.

2.3.7. Ex post *reviews and oversight*

Legislatures sustain influence over executive ministries through oversight following the passage of budgets and appropriations. Legislatures with relatively weak *ex ante* roles in budget formulation tend to play stronger roles in *ex post* oversight. Oversight is promoted both by the production of public information by the executive on budgetary and programme outcomes and by the active use of analysis, audit and investigations by legislatures to target particular programmes and activities for review and reassessment.

In most countries, the executive is required to report information on in-year budget execution to the legislature during the fiscal year according to the budget system laws or requests from the legislature. In Mexico, the executive must inform Congress at regular intervals during the fiscal year about certain activities: transfers to states and public debt evolution every month; performance evaluation every two months; the evolution of public finances including information on revenue, expenditure and debt every quarter; and other information required by Congress. In the United Kingdom, with the

adoption of the Financial Act of 1998, the Treasury has to prepare and present a pre-budget report which contains government achievements, an update of the state of the economy and public finances, and a debt management report. In Korea, the executive regularly reports updated information on budget execution to the budget committee.

Executives and legislatures in many countries have levied substantially new requirements on agencies for reporting on the performance and financial costs of government. Performance reforms in such countries as France, Korea, the United Kingdom and the United States require agencies to develop performance plans and reports that for the first time portray on a systematic and often public basis how government programmes are working to achieve outputs and outcomes. To date, performance reforms have been largely used by executive budget officials: the United Kingdom articulates performance targets for agencies to meet as part of its three-year spending plan. Korea is adopting a performance assessment instrument used by the United States central budget office – the Program Assessment Rating Tool (PART) – to centrally review programmes in the budget on a systematic basis. Many legislatures have yet to actively use this information in reviewing budgets, and some perceive it as an executive tool to control agencies and programmes to the exclusion of the legislature. However, the Public Expenditure Committee of the Dutch parliament played a dedicated role in introducing performance-based budgeting and encouraging its use in the legislature.

Information alone is rarely sufficient. Most legislators simply do not have the time nor the analytic background to digest the complex information provided in these reports. Accordingly, most legislatures provide for proactive institutions to analyse and use the information to oversee and investigate executive activities, most often through specific committees.

Most legislatures use multiple tools in overseeing executive operations and programmes. In a survey of legislative oversight in 83 countries by the Inter-Parliamentary Union in collaboration with the World Bank Institute, the following tools were used by legislatures in most countries (Pelizzo, Stapenhurst and Olson, 2004):

- questions of executive officials: 96%;
- committee hearings: 95%;
- committee of inquiry: 95%;
- hearing in plenary sitting: 90%;
- ombudsman: 72%.

The United Kingdom has one of the most developed institutional frameworks. A Public Accounts Committee has been established to hold hearings, based on reviews done by the National Audit Office. To incentivise vigorous

oversight of executive ministries, the minority party chairs this committee. As mentioned above, the United Kingdom parliament has a Scrutiny Unit consisting of 18 staff to review departmental reports, financial statements and other information for select committees.

The audit office can be established either as a legislative branch or as an independent body under the executive. In either case, however, the legislature can request that the executive improve spending patterns or the misbehaviour of civil servants by using the results of audit on budget execution. Types of audit offices can be classified as shown in Table 2, according to the degree of independence and the governance structure.

Table 2. **Types of external audit office**

Type	Examples	Head of the office appointed by
Independent bodies entirely at the disposition of the legislature	• United Kingdom National Audit Office (and other Westminster countries) • United States Government Accountability Office	• The executive • Both
Parliamentary auditors with an external audit body serving them	• Swedish National Audit Office	• The legislature
Independent courts without juridical functions, partly serving the executive	• Netherlands Court of Accounts	• Both
Independent courts with juridical functions, partly serving the executive	• Italian Court of Accounts • French Court of Accounts	• The executive • The executive
Independent bodies under the executive	• Japanese Board of Audit • Korean Board of Audit and Inspection	• Both • Both

Source: Lienert and Jung, 2004, pp. 81-83.

National audit offices have come to play growing roles in legislative oversight. Regardless of the type of audit institution, these offices have expanded their roles beyond the traditional audit of government financial accounts to performance audits and value-for-money audits and reviews. These independent institutions have provided invaluable help for legislatures, owing to their reputation for credibility, their access to nearly all executive information, and the institutional knowledge and expertise they provide. Accordingly, legislatures have increasingly sought to capture these offices. In Sweden, the office was transferred from the executive to the legislature several years ago. In the United Kingdom, the audit office informs the agenda for the Public Accounts Committee. In the United States, a majority of the work done by the national audit office – the Government Accountability Office (GAO) – is done at the request of the Congress.

Legislatures have established institutional processes for following up on audit reports and the findings of other assessments. Dedicated committees have been established with the explicit function of holding hearings and issuing

reports based on findings of auditors and other bodies. As noted above, Westminster systems follow the United Kingdom model with a Public Accounts Committee chaired by the minority party. Other systems, like the United States, have specific oversight committees chaired by the majority with jurisdiction to oversee the entire executive branch and with the authority to propose specific legislation to correct problems observed. In most systems, executive agencies are required to track the recommendations of auditors and provide periodic reports on how they have resolved the problems disclosed. In some systems, judicial inquiries may be triggered by audit findings of corruption or other illegal activities by public officials.

In addition to the legislature, other non-governmental institutions play an important role in this accountability and review process. A growing range of interest groups and media in many countries have become active consumers of audit reports, performance information and budgetary reports. These institutions often play an important role in public debates, and their activities can supplement and even stimulate legislative oversight of executive actions.

3. What are the consequences of expanded legislative budget roles?

Greater legislative involvement in budgeting presents important institutional challenges. Legislatures are non-centralised and collegial bodies that are both representative and policy-making institutions. As political bodies, their capacity for collective action is often stymied by a different party, ideology or constituency. Expected to be highly responsive to individual constituencies, legislatures are perennially challenged to produce simultaneously high levels of constituency responsiveness while taking responsible actions on behalf of the entire country (Meyers, 1999, p. 490). Legislative institutions and rules can help structure deliberation and voting to balance these oft-competing incentives, but the rules themselves are political settlements that can be overturned when political winds shift (Shepsle, 1986).

Most certainly, stronger legislative roles in budgeting raise questions about how their expanded roles will affect the following often conflicting budgetary goals and criteria:

- **Fiscal discipline:** Will responsiveness to political constituencies trump responsibility? This is a question about which there is much disagreement. Some research has suggested that fiscal outcomes were better in countries with weak legislative controls. This finding, although controversial, is reflected by legislatures themselves, who delegate power to the executive due to a feeble faith in their own institutional self restraint (Schick, 2002). However, others suggest that the outcomes are not that clear. For instance, research on state legislatures in the United States suggests that more

powerful legislatures actually exercise greater, not less, fiscal responsibility (Joyce, 2005). Research shows that Germany's parliament succeeded in reducing deficits in recent years (Wehner, 2001).

- **Allocation:** Will legislative involvement cause budget resources to be devoted to particularistic, distributive purposes at the expense of broader national priorities? Legislatures have a well-known inclination to reward supporters and constituencies with budgetary largess. However, recent research suggests that legislatures in the United States appropriate earmarks as part of bargains to reach decisions on complex and difficult national policy choices (Evans, 2005).
- **Efficiency:** Will legislatures act to hamper administrative efficiency through "micro management" or will they provide sufficient flexibility for agency managers to manage programmes in the most efficient manner possible? Strong legislatures can and do add conditions and constraints to budget allocations and incentives; whether these constraints are perceived as serving important national goals or hampering valiant managers is often a function of different priorities and perspectives.
- **Accountability:** Will strong legislatures promote greater accountability for decisions, on what terms, and for which groups and objectives? In one sense, legislatures promote greater accountability for budget decisions, almost by definition. In checking unfettered executive power, legislatures help prevent a single-minded executive from acting with impunity. As the American *Federalist Papers* articulated, dividing governmental powers ensures that "ambition will check ambition" (Hamilton, Madison and Jay, 1788). While constituting a check on executive power, the question still remains: for which constituencies is the legislature acting, and for what purposes?

Trade-offs obviously exist among these competing objectives. A budget process with greater legislative control will enhance democratic accountability but with potentially the risk of eroding fiscal discipline or government efficiency. The mix of objectives advanced by legislative control will be dependent on such factors as the nature of the party system, the potential for collaboration and co-operation across the branches of government, the quality and capacity of legislators and their staff, and the incentive structures they face in balancing the potential tensions between constituency responsiveness and making effective national policy.

Schick (2002) also asks what consequences stronger legislative budgeting roles have for legislative powers and for executive powers. Budgeting can potentially limit what legislatures can do. The adoption of ceilings by legislatures, for instance, can restrain the distributive political inclinations of legislatures – a result that many would welcome on efficiency and fiscal discipline grounds alone. Some, however, prize the detailed legislative allocation and control

achieved through appropriations as the centerpiece of legislative power and lament how overarching targets can serve to limit the leeway that legislatures traditionally enjoy.

The new foothold that legislatures gain in *ex ante* fiscal target setting appears to have a centralising effect on the internal distribution of legislative powers. Gaining a seat at the macro table requires legislatures to constrain themselves, often by adopting centralising machinery to enforce macro targets on their own disparate members and committees.

The implications of expanded legislative budgeting roles for executive-legislative relations are decidedly unclear. While advancing legislative interests and priorities, it is by no means evident that these reforms constitute a zero sum game where the legislature's gain is the executive's loss. In fact, the centralised legislative institutions that arise to engage the executive in macro target setting and enforcement arguably provide central budget offices with like-minded partners who share a priority on fiscal conservation and embody a whole-of-government perspective. Budget committees and legislative budget offices may have more in common with central budget officials than their own legislative colleagues involved with other policy arenas.

One final observation concerns the adoption of the so-called "new public management" philosophy of governance and oversight. Legislatures in several of the countries in this study embraced the performance model of legislative oversight and budget execution. In the interests of efficiency, the legislature relinquishes some of its detailed control over executive management and budgeting, in exchange for heightened accountability for performance. Legislatures have consolidated appropriations accounts, for instance, by shifting from an object of expenditure to a programmatic or even outcome orientation. Agencies gain flexibility in return for assuming accountability for the results that are promised for these activities.

While new public management strategies indeed promise greater efficiencies in government, their implications for legislative control and accountability remain untested. From a legislative control perspective alone, the trade-off may prove to be asymmetrical: agencies gain the benefits of increased discretion immediately. However, performance accountability is an exercise that is fraught with ambiguity and whose benefits become apparent only after a multi-year investment in the development of data and metrics. Even when performance outcome targets reach the appropriate level of political agreement and technical development, the link between executive officials' performance and results and outcomes is often tenuous and difficult to establish. Legislatures may be left grasping for someone to blame for performance shortfalls which are caused by various social, economic or demographic forces having little to do with the actions of executive agencies. By contrast, oversight of inputs is far more

straightforward and more directly connected to legislative actions and appropriations. The suggestion is not that these reforms are not worth doing, only that they may have consequences for the power stakes of legislatures *vis-à-vis* the executive.

4. Issues to consider

The new public management movement has led some countries to establish quasi autonomous "agencies" with greater independence from the parent ministry to which they report. While such reforms can promote greater efficiency and flexibility in administration, the "agency" movement may also serve to weaken legislative control and oversight. The parent ministry has the primary relationship with parliament, and the devolution of responsibility to subsidiary agencies may complicate the ability of legislatures to hold a single minister accountable for the actions of these many agency "chief executives".

Legislatures have achieved influence that varies considerably across countries. Many constitutional, political and technical constraints exist that limit the potential roles that legislatures can play in many systems. Nonetheless, the involvement of legislatures with budgeting has grown in recent years, caused by deep-seated forces in the economy, the political system and the culture. Such a trend can be salutary for budget decision making and accountability, depending on how legislatures structure their own budgetary decision making and how the legislatures' demands for influence are addressed by executive officials. Given the growing interest of legislative officials in budgeting, it is not a question of whether legislatures will bid for greater involvement, but how and on whose terms. The question for executive budget officials is how the legislature's interest can be structured to achieve a constructive policy dialogue and process to improve budgetary decisions.

Ideally, stronger legislative involvement can strengthen the entire process, creating a win-win situation for both the executive and the legislature. In certain respects, both branches need one another. The executive provides the expertise and cohesive policy-making capacity that are essential for well-informed budget formulation and execution. The executive branch ultimately contains the officials who must implement legislative laws and priorities, so their buy-in and support are vital to achieving legislative aims. Legislatures provide value to the executive as well. They enhance accountability and help tie the executive to the diverse set of constituencies that is affected by budget decisions in a pluralistic society. While certainly noisier and less efficient, legislative involvement ultimately broadens the base of political support for budget decisions, thereby enhancing their legitimacy and sustainability.

Legislative involvement is particularly vital for formulating and sustaining budgetary reforms addressing such issues as fiscal consolidation

and improving results. Legislative buy-in or ownership is essential not only to gain political support but also to sustain initiatives over a longer period of time. A statutory base is often important in providing an established basis for implementation over the longer term.

There can be no illusions: strong and independent legislatures could very well exacerbate conflict and possibly precipitate budgetary gridlock, depending on the political forces at work. However, there is a clear prospect that such developments can be managed and can lead to more optimal budgetary outcomes. To deal effectively with these developments, executives and legislatures will be equally required to both strengthen their own house and improve the potential for collaboration.

The following agenda can help:

- Reforms to the budget process can strengthen the capacity of both the executive and the legislature to shape budgetary outcomes. The following elements are involved: budgets that are comprehensive in scope, covering all significant commitments of the national government, including processes to review entitlements and tax expenditures. This also includes the development of longer-term time horizons to prompt early action to address the effects of population ageing on budgeting.
- The executive should consider promoting greater sharing of information with legislative budget officials in the interests of setting a common framework for the start of the budget process. Collaboration among technical staff serving both branches can help ensure a common foundation for the budget process across the board. Where possible and politically appropriate, the executive should consult with legislative officials prior to the budget's release as a way of encouraging earlier political agreement and identifying political fallout.
- Legislative officials should consider enhancing institutional processes to deliberate on overall budgetary targets and ensure that subsequent legislative decisions adhere to those constraints. The development of a process to set overall fiscal targets promises to strengthen the legislature's role in formulating fiscal policy as well as provide a framework to structure and discipline legislative budgetary decisions.
- To help track decisions and produce more informed decisions, legislatures should continue to improve their capacity to analyse budget proposals against a common set of assumptions. Whether it is through separate legislative budget offices or through the use of executive staff, legislative debates over budget proposals should be grounded in a process geared to produce reliable and credible estimates. Legislatures should also continue to strengthen their committee structures to enhance the capacity of members to digest and process complex budgetary information.

- Legislative officials should continue to strengthen their capacity to oversee executive performance. This can include engaging audit offices and other independent analytic resources to make assessments of programme performance and management performance. Legislatures should consider ways to improve their incentives to engage in oversight. Along these lines, the Public Accounts Committee model in the United Kingdom provides these incentives by vesting its leadership in the opposition party. While proactive investigations can be important, legislatures should also continue to support reforms requiring executive agencies to produce systematic information on performance and financial costs. Such information not only improves the management of programmes and agencies, but also provides legislatures with a more informed foundation for oversight.
- Executive and legislative officials should explore joint initiatives to improve the information and analytic foundation for budgeting. This should include promoting greater public disclosure of budget information to enable more informed and broader public participation in budget debates. It could also include supporting the strengthening of independent institutions such as audit offices and economic forecasting units to provide credible information on economic assumptions, financial management and performance that is accepted by all sides in the debate.

Notes

1. The nine countries were France, Italy, Japan, Korea, Mexico, the Netherlands, Sweden, the United Kingdom and the United States.
2. The staff has included secondees from the National Audit Office, the Audit Commission, government departments, etc.

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A Principal-Agent Theory Approach to Public Expenditure Management Systems in Developing Countries

by
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A well-functioning public expenditure management system (PEM) is considered a critical pillar of government efficiency. This article discusses PEM systems in developing countries using an analytical framework based on principal-agent theory. This simple model can be applied to various PEM systems and allows for comparisons between institutional settings. To illustrate this, the authors analyse the benefits derived from the use by the ministry of finance of ex post *audits and* ex ante *controls, and assess their value in terms of their ability to deter cheating. The authors derive a set of possible "control regimes" which can be used by the ministry of finance.*

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1. Introduction

A well-functioning public expenditure management (PEM) system is considered to be a critical pillar of government efficiency by most practitioners, who place it on par with a low-distortion tax system and an efficient tax administration. It is therefore unfortunate that there is so little economic research on the design of PEM systems, especially on the theoretical side.[1] On the empirical side, papers have generally focused on the efficiency of public expenditure in key sectors (health and education), and only a few attempts have been made to quantify the welfare losses associated with a weak PEM system. They all point to rather high economic costs. For example, a public spending tracking survey in Uganda concludes that only 13% of nonsalary expenditures earmarked for primary schools reached the intended beneficiaries during 1991-95. The bulk of the allocated spending was either used by public officials for purposes unrelated to education or captured for private gain (Reinikka and Svensson, 2004). In Ghana, a survey concluded that 20% of nonwage public health expenditure and 50% of nonwage education expenditure reached the frontline facilities (Ye and Canagarajah, 2002).

The importance of a good PEM system has come to the forefront of the debate in the context of the debt initiative for Heavily Indebted Poor Countries (HIPCs), which provides substantial debt relief from the international community while requiring eligible countries to pursue good economic policies and to make their budget more "pro-poor" using the HIPC relief for spending on priority areas of a country's poverty reduction strategy. The difficulty in tracking public expenditure has become clear during the systematic assessment of the capacity of some 25 HIPCs by international financial institutions.[2] Without getting into the details of the methodology used to assess PEM systems, it is worth mentioning that it was based on 15 benchmarks (extended to 16 in 2004) relating to the three main components of budget management.[3] The studies indicate that, while progress has been made since the initiative was launched, a majority of HIPCs still require substantial upgrading of their PEM systems to be capable of reliably tracking public spending. In particular, internal control and the production of final audited accounts are the areas in most need of strengthening.

The problem is that the list of recommended key reforms for "getting the basics right" (Schick, 1997) is quite large and, although internal and external controls are identified as priorities, the list of priorities also covers most other

areas (see Diamond, 2006). As HIPCs are, by definition, severely constrained in terms of both financial and human resources, it therefore appears critical to address the key areas of weaknesses in the most effective way possible.

In this article, we use the well researched principal-agent theoretical framework to clarify the issues arising in PEM systems and help prioritise the PEM reform agenda. It has already been argued that a chain of principal-agent relationships characterises PEM systems, which in turn raises the potential for agency problems (see, for example, Tanzi, 2000, p. 445).

We interpret corruption and bad governance as stemming from asymmetric information and interest divergence between those who perform tasks (the agents) and those on whose behalf tasks are performed (the principals). A rent can thus be captured by the agents at the expense of their principal.[4] The reason is that a low level of output can be due either to a low exogenous "state of nature" or to some misbehaviour (such as a low effort level or corruption) by the agent. In our model, the ministry of finance (MoF) acts as the principal, providing public funds to line ministries (for example, the ministry of education, the health ministry, or some other public body) to implement a set of actions. The relationship between the MoF and the line ministries is an agency problem subject to asymmetric information both on some external parameters and on the actions performed. In case of low output, the MoF is not in a position to distinguish the cause, unless it uses some form of audit. The principal's problem is to design the contract that most efficiently forces the agent to meet the requirements. The contract must therefore specify a level of output (depending on the state of nature) associated with a certain level of transfer, as well as some control and sanction parameters.

The MoF has a number of instruments at its disposal to limit rent-seeking behaviours. These include, in particular, internal controls within the line ministry. In the so-called francophone system of public expenditure management (prevailing in most of French-speaking Africa), the MoF usually places some of its employees in the line ministries, and their duty is to check that the operations performed by the line ministries comply with the contract. In the anglophone system (prevailing in most anglophone African countries), the approach is different: the line ministry is accountable for its performance *ex post* (and this is verified by the court of audit) and tries to prevent non-compliance by having some of its own employees check the operations of others. In a sense, the head of the line ministry becomes the principal and its employees are the agents. In most cases (anglophone, francophone or other systems), outcomes are verified *ex post* by a court of audit in charge of analysing the performance of the line ministry and reporting its findings to the relevant authorities (usually parliament).[5] If corruption is detected, the official concerned will be punished by disciplinary action or through the judicial system, sometimes entailing a hefty penalty (such as the "*mise en débêt*" in France).[6] These examples suggest that the

literature on incentives and contract design provides the background for a potentially very useful model to analyse PEM issues and guide reforms.[7] However, most traditional models do not exactly fit the realities of PEM systems, and adjustments are needed to take into account their specific features and constraints. These will be identified and elaborated upon as the model is developed.[8]

The article is structured as follows. We interpret a PEM system in light of the assumptions commonly found in the principal-agent literature in Section 2. We then present the basic features of the model in Section 3. Section 4 discusses *ex post* audits and their value in developing countries, while Section 5 introduces *ex ante* controls. We conclude in Section 6.

2. Interpretation of PEM under the principal-agent theory

2.1. The contract

We base our analysis on standard principal-agent models involving supervision (Kofman and Lawarrée, 1993, 1996; Khalil and Lawarrée, 2006). We essentially focus on the control of line ministries or assimilated bodies by the MoF, which is supposed to represent the public interest. Line ministries can be seen as agents of the MoF (the principal) because they are required to produce a certain level of public output – including the quality of this output – in exchange for their budget appropriation. The pair "expenditure programme – budget appropriation" can be interpreted as the two components of the contract between the MoF and the line ministries.[9] The objective of the MoF is to induce the line ministries into implementing their expenditure programmes, while the line ministries pursue their own objectives. That relationship entails both hidden actions (*e.g.* the productive "effort" of the civil servants, possible perquisite consumption, or corruption) and hidden information (*e.g.* the exogenous productivity of that particular sector of the economy), with the agents having the informational advantage over the principal. Hidden information could also refer to poor programme design, which would lead to inefficiency and would be difficult to dissociate from the inefficiency originating from a weak PEM system.[10]

Importantly, the principal-agent model does not allow for a cheating principal and, while it may be argued that the case can occur, we do not consider it in this article.

As already indicated, a number of government operations can be assimilated to principal-agent relationships. For example, one could consider that the minister (who is the head of the ministry, but also a political appointee) heading the line ministry is a principal whose objective is to make sure that his/her agents (the civil servants) implement what he/she has promised to do. One could also consider that the parliament is the principal, whose objective is to make sure that

the government (the executive) implements the government's programme. Yet another example would be to model the central government as the principal, while the subnational governments are the agents. A paper by Ahmad, Tandberg and Zhang (2002) looks at this issue, using a principal-agent framework to analyse incentive structures that best compel local governments to truthfully reveal their ability to implement national programmes. The paper focuses on the optimal contract between both levels of governments. It also insists on the need to have a multi-period game in order to make punishments credible.

An important element of any principal-agent model is to specify an observable that will be the main element of the contract. When the agent is the line ministry, measuring performance should ideally be based on a mix of indicators including output, outcome, and impact. Such information is usually difficult to obtain, and although simply measuring inputs is clearly not satisfactory, they are often the only variable for which adequate data are available. Furthermore, the level of resources in many developing countries, including the HIPCs, is such that broadening the statistics coverage can lead to the undesirable consequence of a serious degradation in the quality of data (*i.e.* information on inputs). Beyond the availability of data, the complexity of performing meaningful measurements, and potential biases linked to the use of performance indicators, it may also not be fully realistic to assume that the MoF has the capability to judge outcomes. Hence, we will hereafter use the term "output" in a general sense, *i.e.* to mean one variable that the MoF is in a position to measure, and this could include outcomes.

It also follows that we formally model a programme budgeting process, although the results also apply to countries that do not explicitly use that approach.[11] In our model, line ministries must make proposals on their priorities, on objectives to be reached, and on corresponding (quantifiable) targets.[12] The line ministry budget proposal is then negotiated with the MoF. However, we do not model the negotiation process. The contract comprises both:

- the required "output" to be produced by the line ministry (in terms of provision of public goods and services) and thus, implicitly, the "effort" required from the line ministry; and
- the line ministry "transfer", *i.e.* its budget appropriation.

A menu of possibilities can be included in the contract to take into account the general economic conditions or make relevant assumptions. For instance, it could be specified that, under a baseline scenario with realistic growth prospects, the line ministries are required to operate with their existing capacities; but, under a more optimistic assumption (the country receives more debt relief, or the economy experiences higher growth), the line ministries could make additional investments. In fact, this is increasingly happening in the context of poverty reduction strategy papers (PRSPs), which

often present a baseline scenario, plus a higher aid scenario based on the resource availability necessary to reach the millennium development goals.[13] We assume that, everything else being equal, the line ministry prefers being granted a large budget appropriation but dislikes the effort associated with the performance requirements.

2.2. Agency problems

The agency problem arises from the diverging interests of the MoF and the line ministry and the latter's informational advantage, both on its own actions and on the current state of nature. As standard in the principal-agent literature, the agent's effort is a necessary component of the production function, but entails some disutility. The agent may take unfair advantage of its superior information: if external conditions are favourable, the line ministry could exert little effort and produce a low output, while claiming that this low output is due to unfavourable external conditions. The MoF is not in a position to disentangle the two factors unless it uses some form of audit or supervision. There is thus a risk that the line ministry captures some rent at the expense of the MoF.[14] In the principal-agent literature, this cheating rent generally stems from lowering the level of effort *vis-à-vis* the compensation received. Rents, and possible reductions in public output, compared to what is economically efficient, constitute the agency costs.

In this article, we broaden the interpretation of corruption (generally referred to as the abuse of public office for private benefits) to include misgovernance stemming from the abuse of some information asymmetry. We consider the line ministry's effort in terms of a combination of factors that can be good and bad, including, on the one (good) hand, an efficient and equitable allocation of resources, fiscal transparency measures, and quality of services provided; and, on the other (bad) hand, corruption, consumption of perquisites, mismanagement, and nepotism in the choice of staff or suppliers. This allows us to interpret the cheating rent, not only in terms of reduced disutility from "productive" effort, but also as corruption or misgovernance. For example, if the state of nature is high (say, favourable weather conditions), the line ministry could allocate some resources to unproductive areas or divert monies, if it thinks that the MoF could be led to believe that the state of nature was low. In such cases, rent capture takes place and is possible because of the information asymmetry between the principal and its agent. This interpretation enables us to link our approach with the empirical literature on corruption. Indeed, the latter identifies various factors contributing to corruption, including the overall level of potential benefits from corrupt behaviour, the cost of bribery (including penalties and sanctions), and the bargaining power and extent of discretionary powers of the various actors (Chand and Moene, 1999). Moreover, while cheating (exerting a lower effort) is

probably costless for the agent, we argue in this article that cheating, in the sense of being corrupt, may entail some costs to be concealed. This enables us to make the link with the literature on collusion in organisations (*e.g.* Tirole, 1986) and, in Section 5, we interpret *ex ante* controls by the MoF as increasing the cost of cheating for the agent.

As already stated, the MoF has a number of instruments and strategies at its disposal to limit agency problems. First, it can use incentive schemes, designed solely on observable information, and promise to grant the line ministry a transfer equivalent to the sum of a suitable compensation for the line ministry's effort and an informational rent (which depends on incentive compatibility constraints) in case of high productivity.[15] If such a contract exists, it prevents the line ministry from exerting little effort – but at the expense (for the MoF) of a loss equivalent to the informational rent, in addition to a distortion created by requiring a lower level of effort in some occurrences of the productivity factor. Although commonly applied to models of the corporate world (*e.g.* granting board members bonuses or shares), this strategy is not always directly applicable in the public sector.[16] Alternatively, the MoF can supervise the line ministry using a number of instruments and can threaten it with appropriate sanctions if cheating is detected. The design of the appropriate control system must take a number of factors into account, for instance the choice between *ex ante* and *ex post* (or internal and external) controls, the type of variables to be monitored (input *versus* result indicators), and the choice between systematic or random audits. In our model, there are two unobservable variables (effort and state of nature). Supervision could thus turn either to the exogenous productivity factor, from the observation of which the agent's behaviour could be inferred (this relates, for instance, to public sector reforms aimed at improving the economic statistical data collection, or to audits targeted at assessing the programme design), or directly to the agent's effort. In this article, we assume that the MoF will audit the line ministry's effort.[17] The timing of the game is the same as in all principal-agent models (see Leruth and Paul, 2006, for more details).

3. The basic model

In this article, we will not develop the details of the model but concentrate instead on its main elements and results (for more details, refer to Leruth and Paul, 2006).

3.1. Main assumptions

The model developed here is close to the literature on supervision, as in Kofman and Lawarrée (1993) and Khalil and Lawarrée (2006). However, it differs in some assumptions so as to better reflect the features of PEM systems. The

added value of this article lies in the practical applications to PEM of the analysis, but also in those differences.

We model the agency relationship between the MoF and one line ministry, both assumed to be risk neutral.[18] The line ministry produces a level of output x, which depends on two variables: a random exogenous productivity factor, θ; and the line ministry actions or effort, e, such that $x = \alpha(\theta,e)$; with $\alpha_e > 0$; $\alpha_{ee} < 0$; $\alpha\theta > 0$. The realised output is public knowledge, but e and θ are the line ministry's private information. The external productivity can be either high or low: θ_i with $i \in \{H,L\}$ and $\Delta\theta = \theta_H - \theta_L > 0$. We also assume $\alpha(\theta_H,e) > \alpha(\theta_L,e)$; and $\alpha_e(\theta_H,e) > \alpha_e(\theta_L,e) > 0$. It is common knowledge that the MoF assigns *ex ante* probability q to the event that $i = H$ (and probability $[1 - q]$ to the event that $i = L$). When state i occurs, the line ministry exerts a certain effort level e_i, thus producing an output $x_i = \alpha(\theta_i,e_i)$.

The monetary equivalent of the line ministry's disutility from effort is represented by an increasing and strictly convex function $\psi(e)$, with $\psi_e > 0$ and $\psi_{ee} > 0$. To obtain strictly positive but bounded optimal efforts, we also assume that $\alpha(\theta,0) = 0$; $\psi(0) = 0$; $\lim_{e\to 0}\psi_e(e) = 0$; $\lim_{e\to 0}\alpha_e(\theta,e) = \infty$; $\lim_{e\to\infty}\psi_e(e) = \infty$; and $\lim_{e\to\infty}\alpha_e(\theta,e) = 0$. The line ministry's utility is given by $u = t - \psi(e)$, where t is the transfer (appropriation) it receives, and its reservation utility is normalised at zero. We also assume that $\Delta\theta$ is large enough so that the MoF is always better off in case of high output: $x_H - t_H > x_L - t_L$.

3.2. Perfect information benchmark

The MoF's problem is to choose the levels of effort required from, and transfers to be made to, the line ministry for each occurrence of the random factor, so as to maximise the expected output:

$$\underset{e_H,e_L,t_H,t_L}{Max}\ E(X) = q\left[\alpha(\theta_H,e_H) - t_H\right] + (1-q)\left[\alpha(\theta_L,e_L) - t_L\right] \qquad (P)$$

Subject to the line ministry's individual rationality *(IR)* or participation constraints under each occurrence:

$$t_H - \psi(e_H) \geq 0 \qquad IR(H)$$

$$t_L - \psi(e_L) \geq 0 \qquad IR(L)$$

Under perfect information, the MoF equates the line ministry's marginal cost of effort with the marginal value of its product: $\alpha_e(\theta_i,e_i^*) = \psi_e(e_i^*)$, with $i \in \{H,L\}$.[19] The transfers are such that both participation constraints are binding: $t_i^* = \psi(e_i^*)$. The MoF can therefore enforce first-best, efficient efforts, and the line ministry gets no rent. Note too that, according to our assumptions, $e_H^* > e_L^*$.[20]

3.3. Second-best solutions

Under imperfect information, effort is not observable. It cannot be directly enforced, but must be indirectly induced. Therefore, the MoF must provide the right incentives so that the line ministry produces the highest possible level of effort. The reason is that when one productivity level takes place, the line ministry could cheat by adjusting its effort so as to produce the output corresponding to the other productivity level. We define the effort level $\tilde{e}_L$ such that $\alpha(\theta_H, \tilde{e}_L) = \alpha(\theta_L, e_L)$. This means that, if $i = H$, the line ministry could exert a low effort $\tilde{e}_L$, and thus produce x_L, while claiming to receive t_L. The "cheating rent" that the line ministry can get in that case is thus equal to $\left[t_L - \psi(\tilde{e}_L)\right] - \left[t_H - \psi(e_H)\right] > 0$. To ensure that it is never optimal for the MoF to shut down the contract in case of low productivity, we also assume $(1-q)\alpha(\theta_L, e_L) > \psi(e_L) - q\psi(\tilde{e}_L)$.

Traditional principal-agent models rely on incentive-compatible schemes to prevent such cheating. The well-known results from this literature apply and can be summarised as follows. At equilibrium, the line ministry does not cheat and gets no rent when $i = L$. In order to induce it into exerting the right effort level when $i = H$, the line ministry must receive an informational rent equal to $\psi(e_L^{SB}) - \psi(\tilde{e}_L^{SB})$ (where superscript "SB" stands for "second best") in addition to its first-best transfer, where $\tilde{e}_L^{SB}$ is such that $\alpha(\theta_H, \tilde{e}_L^{SB}) = \alpha(\theta_L, e_L^{SB})$. While production is efficient when $i = H$, the line ministry underproduces (compared to the full information benchmark) in case of low productivity: $e_L^{SB} < e_L^*$. Requiring a lower level of effort when $i = L$ enables the principal to decrease the informational rent granted to the LM when $i = H$. This reflects the "rent extraction – economic efficiency" trade-off which characterises adverse selection problems. The MoF therefore incurs an agency cost equal to the difference in expected output between the first-best and the second-best solutions and caused by information asymmetry.

3.4. Introducing supervision

In order to avoid forgoing the informational rent, the principal can hire a supervisor and reduce the information asymmetry. Usually, this is combined with the threat of penalty if cheating is detected. In introducing supervision, we will, in some respects, diverge from the existing principal-agent literature, so as to better reflect PEM concerns.

In the context of PEM, supervision may take various forms. One can distinguish internal controls (*e.g.* MoF or line ministry agents responsible for ensuring that expenditures and procurement are performed according to the rules) and external controls (*e.g.* a court of audit reporting to parliament). Controls may take place *ex ante* (*e.g.* comptrollers issuing visas to allow expenditure, or automatic safeguards preventing line ministries from exceeding

budget appropriations)[21] or *ex post* (*e.g.* auditors checking the reliability of fiscal data or the performance of public spending). Different types of controls can be combined. For instance, going back to the example of PEM systems in Africa, it is worth noting that the so-called francophone system rests on the principle of separation between the person who initiates spending (the *ordonnateur*) and the person who pays it (the accountant or *comptable*). The system relies on centralised *ex ante* controls from the MoF, which take place at various stages of the expenditure process and mainly focus on the conformity of spending with regard to procedures and budget appropriation. Anglophone countries, on the other hand, have inherited a decentralised management system, where the line ministries' accounting officers are responsible for budget execution. *Ex ante* expenditure control is mainly exercised by the issue of periodic warrants by the MoF (cash management). The anglophone system relies on independent *ex post* controls by an auditor-general. In practice, however, notwithstanding those conceptual differences and institutional arrangements, both systems have proven to perform poorly (Bouley, Fournel and Leruth, 2002; Moussa, 2004; and Lienert, 2003).

In the next two sections, we introduce two types of supervision. We first study the case of *ex post* audits (Section 4) and explain how a standard principal-agent model with audit may be of interest for the design of PEM systems. We then move to *ex ante* controls (Section 5). In doing so, we assume that *ex ante* controls increase the cost of cheating for the line ministry, as is done in the literature on collusion.

4. *Ex post* audits

In this section, we introduce an *ex post* auditor, costing z whether or not it identifies cheating.[22] It could be an external or an internal auditor, in which case the audit cost may be interpreted as the opportunity cost of using MoF resources for controlling the line ministry instead of doing other tasks. The auditor observes an imperfect signal on the line ministry's effort (for instance, this may be done through a review of accounts to check if there has been corruption). We assume that the signal can take two values: "has complied" or "has cheated". The latter occurs only when the line ministry has indeed cheated, while the signal can report compliance by mistake. The monitoring function is such that σ denotes the probability of detecting actual cheating, in which case the line ministry is imposed an exogenous penalty *P*. With the introduction of supervision, the contract specifies not only the transfers and expected outputs (and thus, implicitly, the expected effort levels), but also the probability of audit. We assume that the MoF commits to audit with probability γ after x_L has been observed. When productivity is high, the line ministry may cheat with probability *m*. Given that output is low, the probability that the line ministry has cheated can be written as $\phi = qm/[(1 - q) + qm]$. We also assume

that the auditor is honest and does not collude with the line ministry.[23] An appealing interpretation is that developing countries are often subject to donors' external auditors, which are supposed to be honest (or not in a position to negotiate with the line ministry).

We discuss three possible regimes that the MoF can implement:[24] *i)* the "cheating-proof" regime, which corresponds to the optimal, incentive-compatible contract when commitment is credible; *ii)* the "cheating-inducing" regime, which is not optimal but, as we argue, matches the situation in some developing countries; and *iii)* a "no commitment" case, in which there is no formal commitment to audit at the time of offering the contract, which results in a mixed strategy equilibrium. In Subsection 4.4, we discuss some applications of the model in terms of public expenditure management and compare these regimes on the basis of their relative costs and benefits.

4.1. *The cheating-proof regime*

Traditional principal-agent models with credible commitment use the revelation principle to determine the optimal contract. The revelation principle asserts that, to find the optimal payoff of a problem with asymmetric information, one can, without loss of generality, restrict it to the incentive-compatible, individually rational scheme where every agent truthfully reveals his/her private information. To put it simply, this means that the principal can do no better than offer an incentive-compatible contract, which therefore **deters** cheating. Under these circumstances, the penalty is never imposed at equilibrium, but its existence out of the equilibrium path acts as a deterring threat and prevents cheating.[25]

This approach is only applicable to settings in which the principal is able to credibly commit to any outcome of the contract. In a PEM system, the existence of a court of audit may be viewed as a commitment tool, enabling the MoF to make the credible commitment, at the time of offering the contract, that it will audit the line ministry at the end of the fiscal year with a given probability, which can be either probability one (systematic audit) or below one (random audit).[26] Under this regime, there are conditions where the audit threat is such that it prevents the line ministries from cheating.

Formally, the MoF's problem is to choose the levels of transfers, required efforts and audit probability so as to maximise the expected output:[27]

$$\underset{e_H, e_L, t_H, t_L, \gamma}{Max} E(X) = q\left[\alpha(\theta_H, e_H) - t_H\right] + (1-q)\left[\alpha(\theta_L, e_L) - t_L - \gamma z\right]$$

Subject to *IR(L)*, *IR(H)*, and the following incentive compatibility *(IC)* constraint:[28]

$$t_H - \psi(e_H) \geq t_L - \psi(\tilde{e}_L) - \gamma\sigma P \qquad IC(H)$$

Note that the term $\gamma\sigma P$ relaxes the *IC(H)* constraint, compared to the second-best case. Hence, provided its cost is not too high, we obtain the intuitive result that audit benefits the principal.

As in Kofman and Lawarrée (1993), we find that the optimal contract exhibits qualitatively different types according to the value of the parameters (although the specific thresholds differ, as we have slightly different assumptions; see Leruth and Paul, 2006, for proof and complete results). These types are characterised by different rents, productive distortions and audit probabilities. The shift from one type to the other rests on a comparison between the expected benefits from audit (the penalty and reduction of rents and distortions) and its cost, with both the former and the latter depending on exogenous (country-specific) parameters. The shadow cost (Lagrange multiplier) of the *IC(H)* constraint is a crucial variable in determining the optimal institutional setting[29] and it is only when the benefits from audit exceed its cost, so that $q\sigma P > (1 - q)z$, that it is profitable to audit. In that case, the optimal probability of audit, rents and productive distortions vary, and three sub-types can be identified:[30]

- "**Rent extraction**" **(RE) scheme:** The MoF audits with probability one, the production distortion when $i = L$ corresponds to the second-best solution, and the line ministry gets a rent when $i = H$ (the rent is equal to that of the second-best solution reduced by the expected penalty).
- "**Effort adjustment**" **(EA) scheme:** The MoF still audits with probability one, but the line ministry no longer gets a rent, and the productive distortion is lower compared to the second-best solution (*i.e.* the effort level lies between the second-best and the first-best solutions).
- "**Random audit**" **(RA):** The MoF decreases the probability of audit (*i.e.* $0 < \gamma < 1$) and still deters cheating, while the productive distortion is smaller than in the second-best solution.[31]

In other words, if it is efficient, audit reduces the agency costs (distortions and rents) associated with the second-best contract, while still deterring cheating. When the expected penalty is relatively low, the MoF must concomitantly use other incentives to prevent cheating. For example, our model suggests that the line ministry could get a rent in case $i = H$, which would then lead to distorting production when $i = L$. Nevertheless, audit enables the MoF to reduce the rent granted to the line ministry compared to the second-best level (hence the label "rent extraction"). When the expected penalty rises, the threat increases for the line ministry so that the MoF can reduce the degree of mobilisation of other incentives. In our model, the line ministry can no longer get a rent, and so the productive distortion can be reduced. Audit thus increases the effort requested from the line ministry in case of low productivity (hence the label "effort adjustment"). Also, when the

expected penalty is large, the MoF can reduce the probability (thus the cost) of auditing (while still deterring cheating). Finally, there remains a production distortion when $i = L$, reflecting the trade-off between efficiency and the cost of audit.

As already mentioned, these results show that, when the expected penalty is relatively small, the MoF must concomitantly use other incentive tools, such as informational rents, in addition to audits to be able to prevent cheating. As the penalty threat increases, other incentives become less necessary. When the penalty is very high, even if the MoF reduces the probability of audit, the line ministry will not find it profitable to try to cheat. In developed countries, like France for instance, this principle is at the root of the "sampling" of expenditures and agencies to be audited.

Finally, note that this model may also be adapted to take into account other constraints faced by the MoF. For example, we could think of a situation where the MoF is obliged to comply with some minimum requirements in terms of output (for example, the "education for all initiative" or the provision of some basic health care package), so that it cannot tolerate that the line ministry produces below x_L^*. The MoF would still have to fulfill *IC(H)* at the lowest cost (considering the additional constraint), which could be done through a trade-off between granting the line ministry a higher rent when $i = H$ or raising the audit probability (if it is possible).

4.2. The cheating-inducing regime

When audit is not optimal, we have seen that the MoF should offer the second-best contract, which is characterised by an informational rent paid to the line ministry when the state of nature is high. However, in reality, there may be circumstances preventing the MoF from offering that contract. For instance, the MoF may not be in a position to grant an informational rent when the budgeting system is input-based (line item) or if it is confronted with a tight cash constraint. Besides, one fundamental difference between private sector operations (which have typically been used to illustrate the principal-agent theory) and public sector operations is often that output is easier to quantify when it is sold on the market. Public sector output often is not easy to quantify and must then be estimated at high cost and with uncertainty (how many children have actually learned to read and write, how many have been vaccinated).

There may also be political pressure or legal constraints forcing the MoF to use *ex post* controls by the court of audit, even if it is not efficient to do so. For instance, nearly all sub-Saharan African countries possess a court of audit. Yet, findings from country financial accountability assessments (CFAAs) show that these institutions often suffer from important weaknesses, ranging from

lack of independence to poor capacity (World Bank, 2004b), which impair their ability to deter cheating in a significant manner. The solution recommended by the principal-agent theory is to grant premiums to line ministries so as to induce them not to cheat. But this solution is hardly (if at all) observed in reality. Rather, one often observes the coexistence of a weak supreme audit institution and high levels of cheating (including corruption), with few positive incentives such as performance premiums.

To look into cases where there exists a court of audit which is not effective in deterring cheating, we now introduce a "cheating-inducing" regime: the MoF uses audit but is not able to deter cheating. We are aware that this regime is not optimal for the principal with respect to the constraints usually considered in the literature, as it could get the same output without incurring the cost of audit. However, we believe that it adequately reflects the situation of some developing countries (see Subsection 4.4 on that issue). Therefore, we consider the case in which the MoF audits, but the penalty and audit probability are such that $t_H - \psi(e_H) < t_L - \psi(\tilde{e}_L) - \gamma\sigma P$. In that case, it is always in the interest of the line ministry to cheat when feasible, and the actual output is always low. As audit takes place, penalties will be imposed at equilibrium, but they will not be a sufficient enough threat to deter cheating. To come back to the model, the cheating-inducing regime takes place when the MoF commits to audit with a probability $\gamma^{CI} < \left[\psi(e_L^*) - \psi(\tilde{e}_L^*)\right] / \sigma P$ (where the superscript "CI" stands for "cheating-inducing").

Characterising the cheating-inducing regime is interesting in that it helps understand the reasons why the MoF is unable to deter cheating. This happens in the following cases:

- The audit probability γ^{CI} is deliberately chosen at a level that is too low.
- The parameters preclude sufficient audit – in particular, if the expected penalty is low compared to the rent, the theoretical γ which would help deter cheating may turn out to be higher than unity, which is irrelevant; this case may also occur when the effectiveness of audit (σ) is too low.
- The MoF does not make use of concomitant incentives (*e.g.* rents and distortions).

Finally, note that if $z > q\sigma P$, audit increases the agency cost. The weight of this component could increase when the MoF supervises several line ministries. For instance, if some ministries are less critical than others, and could reasonably function with low production levels, agency costs could be reduced by offering cheating-inducing contracts, thus saving on auditing costs. The money saved could be used to provide the incentives to the priority line ministries and offer them a cheating-proof contract, thus ensuring high production (when $i = H$) in these sectors.

4.3. The case of "no commitment"[32]

So far, we have considered that the MoF could credibly commit, at the time of offering the contract, to audit the line ministry with a given probability once output is observed. However, commitment to audit suffers from a time inconsistency problem: the contract determined by the revelation principle is optimal *ex ante* but entails inefficiencies *ex post*. Indeed, as the contract deters cheating, the audit cost must be incurred without any compensation in terms of collected penalty. Moreover, as the contracted effort is not efficient when i = L, one obtains a Pareto improvement by renegotiating the contract once information has been revealed. This time inconsistency reduces the credibility of the commitment to audit, all the more if the MoF is facing a tight budget constraint.[33] Other reasons may also contribute to preclude the commitment to audit, for instance the difficulty of verifying whether the principal did indeed abide by its committed random audit strategy (Mookherjee and Png, 1989) or, in practice, the absence of adequate legal institutions. In particular, we have so far assumed that the existence of a court of audit in the country consisted in a commitment control. Yet, the inefficiency of the court of audit and related institutions may reduce the credibility of the commitment. Nevertheless, in such situations where the MoF cannot credibly commit to auditing, it can call upon some external auditors for specific tasks.

In this subsection, we drop the assumption that the MoF commits to auditing at the time of offering the contract. However, once output is observed, the MoF can decide to audit if it proves to be efficient *ex post*, *i.e.* if the MoF expects to get "value for money" out of the audit. Indeed, when the output is produced, it is too late to deter cheating – but the MoF can still earn a penalty if cheating is detected. The MoF will be willing to audit only if the expected penalty is at least equal to the audit cost. Moreover, the mere expectation that the MoF may audit will reduce the line ministry's incentive to cheat.

Formally, with no commitment, the revelation principle cannot be used and audit must be optimal *ex post* to justify its cost. Hence, cheating may occur in equilibrium (*i.e.* the probability of cheating is positive), and the MoF can expect to collect a penalty. The MoF's problem is to choose the levels of transfers, effort and audit probability so as to maximise its objective function:

$$\underset{e_H,e_L,t_H,t_L,\gamma}{Max} E(X) = q(1-m)\left[\alpha(\theta_H,e_H)-t_H\right]+\left[(1-q)+qm\right]\left[\alpha(\theta_L,e_L)-t_L+\gamma(\phi\sigma P-z)\right]$$

Subject to *IR(L)* and the following constraints:

$$(1-m)\left[t_H-\psi(e_H)\right]+m\left[t_L-\psi(\tilde{e}_L)-\gamma\sigma P\right]\geq 0 \qquad IR(H)$$

$$m\in\arg\max_{m'}(1-m')\left[t_H-\psi(e_H)\right]+m'\left[t_L-\psi(\tilde{e}_L)-\gamma\sigma P\right] \qquad IC(H)$$

$$\gamma\in\arg\max_{\gamma'}\left[\gamma'(\phi\sigma P-z)\right] \qquad IC(A)$$

Note that, compared to the previous cases, the MoF's objective function and the constraints now encompass the probability of cheating by the line

ministry (Subsections 4.1 and 4.2 correspond to corner solutions of this general problem). The two *IC* constraints consist of indifference conditions and determine the game, which is played simultaneously by the MoF and the line ministry. Indeed, the line ministry is indifferent between cheating and being honest when $t_H - \psi(e_H) = t_L - \psi(\tilde{e}_L) - \gamma\sigma P$. The MoF observes x_L, and is indifferent between auditing and not auditing when $\phi\sigma P = z$.

This problem yields a mixed-strategy equilibrium. Under this regime, production is efficient and the line ministry gets no rent. The equilibrium is obtained when the MoF audits with probability $\gamma = \left[\psi(e_L^*) - \psi(\tilde{e}_L^*)\right]/\sigma P$ and the line ministry cheats with probability $m = [z(1 - q)/(\sigma P - z)q]$. Note that penalties are collected at equilibrium and are exactly offset by the cost of audit. Moreover, as it entails no production distortion, the mixed-strategy equilibrium tends to the first-best when the penalty is very large or audit is free.[34]

To our knowledge, the literature has not attempted to directly compare regimes with and without commitment, because commitment to audit is usually considered desirable as it reduces the *ex ante* cost of inducing truthful reporting (Baron and Besanko, 1984). The limited commitment due to the possibility of renegotiating a contract is typically handled by using the renegotiation-proofness principle. The latter, which is somewhat similar to the revelation principle, says that one can, without loss of generality, restrict the set of possible contracts to the class of contracts that are not renegotiated. Renegotiation-proof constraints are thus added to the set of *IR*s and *IC*s (*e.g.* Bolton, 1990; Dewatripont and Maskin, 1990; but see also Aghion, Dewatripont and Rey, 1994). In practice, commitment may entail some costs, including those linked to the creation of an adequate institutional setting such as the creation of a court of audit. Our framework allows a comparison of the agency costs associated with each regime. For instance, one observes that the agency cost of our mixed-strategy equilibrium consists mainly of the loss of production (when $i = H$ and the agent cheats). However, when external audits are cheap, and/or the expected penalty is large, the cheating probability decreases and the mixed strategy becomes a better option. This could reduce the value of establishing a court of audit if it does not yet exist in the country.

4.4. *Applying the theoretical framework to PEM systems*

The sections above explain the different control regimes the MoF can implement, according (notably) to the audit probability it chooses. The optimality of these regimes depends on the value of exogenous, country-specific parameters such as the level of penalty, the quality of the supervision technique, the cost of audit, and the probability of high productivity. This suggests that the need to base the choice of the control design on a good analysis cannot be overemphasised and limits the applicability of "one-size-fits-all" solutions. In this respect, our model provides an analytical framework that can guide PEM reforms, as it allows

for comparing different institutional designs while taking into account the constraints faced by governments.

Generally speaking, the MoF should choose the audit regime associated with the lowest agency cost. Yet, the regimes vary with the institutional setting. The cheating-proof regime corresponds to a situation where the MoF can credibly commit *ex ante* to auditing with a given probability, for instance if a court of audit exists. This regime can be compared directly with the second-best contract, and the choice will depend on the ratio $q\sigma P/(1-q)z$. The mixed strategy relies on a different assumption: there is no commitment, but the MoF can choose *ex post* whether to resort to external auditors for specific tasks. To compare these two frameworks, one should add the fixed cost of setting up and running the institutions necessary to allow commitment (*e.g.* the cost of creating a court of audit) to the agency cost of the cheating-proof regime.

In theory all the regimes discussed above could be implemented. In practice, however, additional constraints may restrain the choices available to the MoF, especially in developing countries. On the one hand, several factors may contribute to reducing the ratio $q\sigma P/(1-q)z$ which conditions the value of audit in those countries. When cheating is detected, the penalty faced by line ministries may be very small or rarely enforced (see, for example, Dia, 1996; Lienert, 2003; Moussa, 2004), all the more if discounted at a high rate (because of the time required for implementation) and if the supervision technology is not performing well (low σ, for instance due to poor fiscal data; see, for example, Bouley, Fournel and Leruth, 2002); the probability of high output may be low, compared to that expected in industrial countries; and the opportunity cost of audit may be high, considering the scarcity of competent human resources. Therefore, while the MoF can probably deter cheating through *ex post* audits in industrial countries, this may not be so easy in developing countries.

Practical constraints may also restrict the MoF's actions:

- A tight cash constraint and/or the framework of line-item budgeting may limit the availability of informational rents.[35]
- The government may have committed to provide a minimum package of services, which prevents production distortions below a certain level (the level obtained under the optimal contract).
- The MoF may be legally or politically obliged to resort to the court of audit, even if it is not working well.

Finally, if audit is not efficient [due to a low ratio $q\sigma P/(1-q)z$] and if the MoF cannot enforce the second-best contract (for practical reasons), it can only implement the cheating-inducing regime: the most unfavourable for the MoF, and a regime that is never optimal.

Note that our analytical framework may be extended to evaluate various reforms. One can think of reforms to increase the quality of audit, or to use signalling to help determine productivity (*e.g.* collecting economic information on the sector and/or auditing the quality of the approved programme design).

5. *Ex ante* controls[36]

We have so far considered that, notwithstanding the risk of being caught *ex post*, cheating is costless for the agent. This assumption is common in the literature because the cheating rent generally consists of a reduction in the effort made by the agent, which remains his/her private information. But the line ministry's effort may also comprise some negative actions (such as corruption), and this leads us to assume that cheating entails some costs to be concealed. This allows us to make the link with the economic literature on collusion in organisations.[37] The literature distinguishes two types of collusion costs, according to whether they are exogenous (*e.g.* negotiation costs, "physical" strategies to divert monies from their intended purposes) or endogenous (*e.g.* costs stemming from the risk of future detection; see Faure-Grimaud, Laffont and Martimort, 1999; Khalil and Lawarrée, 2006). Ways in which the principal can avoid corruption include: *i)* create incentive payments; *ii)* decrease the stake of collusion; and *iii)* increase the transaction cost of collusion (Laffont and Rochet, 1997). In this section, we introduce an exogenous cost of cheating and explain how it affects the constraints of the MoF's problem. In a second step, we interpret *ex ante* controls, undertaken by the MoF before the commitment and/or the payment of the line ministry's expenditures, as increasing the cost of cheating. We then discuss the relative value of *ex post* and *ex ante* controls.

5.1. *Exogenous cost of cheating*

We assume that the line ministry incurs a certain cost $\eta \geq 0$ when it cheats. That cost decreases the expected benefits from cheating. If we first consider a model without *ex post* audit, the MoF's problem can be written as:

$$\underset{e_H, e_L, t_H, t_L}{Max} E(X) = q(1-m)\left[\alpha(\theta_H, e_H) - t_H\right] + (1-q+qm)\left[\alpha(\theta_L, e_L) - t_L\right]$$

Subject to *IR(L)* and:

$$(1-m)\left[t_H - \psi(e_H)\right] + m\left[t_L - \psi(\tilde{e}_L) - \eta\right] \geq 0 \qquad \textit{IR(H)}$$

$$m \in \arg\max_{m'} (1-m')\left[t_H - \psi(e_H)\right] + m'\left[t_L - \psi(\tilde{e}_L) - \eta\right] \qquad \textit{IC(H)}$$

We observe that *IC(H)* is relaxed by the cost of cheating. If $t_H - \psi(e_H) < t_L - \psi(\tilde{e}_L) - \eta$, the line ministry will always cheat ($m = 1$) unless appropriate incentives are provided. For instance, the second-best contract in this case would also entail a rent when $i = H$ and a productive distortion when $i = L$, but these would be reduced by the cheating cost. If the cost of cheating is high enough and $t_H - \psi(e_H) > t_L - \psi(\tilde{e}_L) - \eta$, the line ministry will not cheat

($m = 0$) and the MoF will reach the first-best solution [no rent and efficient production, as *IC(H)* is not binding]. It is thus in the MoF's interest to increase the cost of cheating. This is discussed further in the next subsection.

5.2. Ex ante *controls as increasing the cost of cheating*

Most traditional principal-agent models consider monitoring at the *ex post* stage.[38] Deterring cheating (or collusion) *ex ante* is done by granting rewards and/or through a threat of future punishment. For their part, PEM systems also include a series of controls designed to prevent agents from cheating *ex ante*. For example, automatic tools, such as computer-based systems that check the budget appropriations before allowing spending, are designed for that purpose, and a similar role is played by the financial comptrollers placed by the MoF within line ministries. Such controls are particularly extensive in the francophone treasury system (Bouley, Fournel and Leruth, 2002) but also exist in the anglophone system (Diamond, 2002). As observation suggests, however, these control techniques are not perfect, partly because agents are very active in trying to bypass them (Lienert, 2003; Moussa, 2004).

We hereafter interpret setting up *ex ante* controls implemented by the MoF as increasing the line ministry's cost of cheating.[39] We endogenise the cost of cheating as a decision variable of the MoF and first consider a model without *ex post* audit.

Assume that c represents the cost of the *ex ante* controls. It may be interpreted as the cost of implementing and running controls, but also as the economic cost (sometimes heavy) of procedures that may complicate the expenditure process and reduce the line ministry's absorptive capacity.[40] The line ministry's cost of cheating $\eta(c)$ is now endogenous and depends on the controls implemented by the MoF. We assume $\eta_c > 0$, $\eta_{cc} < 0$, $\eta(0) = 0$, and $\lim_{c\to\infty} \eta(c) = \infty$.[41] We limit our analysis to the specification of incentive-compatible schemes (thus, where the MoF deters cheating). The MoF will decide on the levels of *ex ante* control, transfer and effort so as to maximise its expected output, as follows:

$$\underset{e_H, e_L, t_H, t_L, c}{Max} \; E(X) = q\left[\alpha(\theta_H, e_H) - t_H\right] + (1-q)\left[\alpha(\theta_L, e_L) - t_L\right] - c$$

Subject to *IR(L)*, *IR(H)* [which now has the form: $t_H - \psi(e_H) \geq 0$] and

$$t_H - \psi(e_H) \geq t_L - \psi(\tilde{e}_L) - \eta(c) \qquad \textit{IC(H)}$$

Relying on *ex ante* controls is different from *ex post* audits because: *i)* the performance of *ex ante* controls is "intrinsic" (depending on η), and does not depend on external factors like the level of penalty; *ii)* the cost of controls is incurred *ex ante*, whatever the state of nature, while the cost of audit is incurred, if at all, only when a low output is observed; and *iii)* the decision parameter of the MoF is bounded in the case of *ex post* audits while, in theory,

the MoF could increase *ex ante* controls infinitely (although it would not be efficient to do so).

The results and proofs related to this discussion are presented in Leruth and Paul (2006). Once again, the problem remains to respect *IC(H)* at the lowest cost, hence the importance of the shadow cost (Lagrance multiplier) of that constraint. We first show that it is not efficient to increase controls above a certain point where $[1/\eta_c(c)] \geq q$. If the cost of deterring cheating by controls alone is too high (*i.e.* when the minimum level of control that would be necessary to deter cheating, $\eta(c) = t_L - \psi(\tilde{e}_L)$, would be such that $[1/\eta_c(c)] > q$), the MoF must also use other means to deter cheating, including rents and productive distortions. For instance, the line ministry could be granted a rent when $i = H$ (the level of this rent decreases with the amount of control by the MoF) and be required to produce the second-best level of effort when $i = L$. In that case, the MoF's expected output corresponds to the second-best solution.

When *ex ante* controls are sufficiently effective to allow the MoF to deter cheating by raising controls (until a point such that $[1/\eta_c(c)] < q$), the line ministry gets no rent. However, it may be profitable for the MoF to distort the required effort, if it can save by reducing the level of controls. The MoF would then choose the level of control and the effort required when $i = L$ by comparing their cost, *i.e.* so as to relax *IC(H)* at the lowest cost. The trade-off here is between increased efficiency and the cost of control.

The results do not fundamentally differ from the cheating-proof regime with *ex post* audits. Both types of control are assessed with regard to their ability to deter cheating, and if their cost is too high relative to their benefits, the MoF has to use other means (rents and distortions). Yet, one can compare the relative value of both types of controls on the basis of the shadow cost of each problem's *IC(H)* constraint, *i.e.* the Lagrange multiplier of those constraints at equilibrium. Both indeed measure the difficulty of deterring cheating, and determine the agency costs (cost of control, rents and production distortions) associated with each regime. For instance, it is not profitable for the MoF to increase the level of *ex ante* controls when $[1/\eta_c(c)] > q$, nor to use *ex post* audits when $[(1 - q)z + \lambda\gamma]/\sigma P > q$. An analysis of shadow costs reveals that both thresholds depend on the probability that $i = H$. It also reveals that the higher the probability of high output, the higher the incentive to use controls to guarantee it. Second, the effect of *ex post* audits on relaxing the constraint *IC(H)* is mitigated by the size of the expected penalty. As already mentioned, penalties are low and/or not enforced in developing countries, and *ex post* audits may not be able to deter cheating, making *ex ante* controls more effective. Third, if penalties are a credible threat, *ex post* audits may prove to be effective because their cost is incurred only when the principal observes a low output (*i.e.* with probability $[1 - q]$ under a cheating-proof regime) contrary to *ex ante* controls which are imposed in a nondiscriminatory manner.

5.3. *Integrating* ex ante *and* ex post *controls*

We now briefly consider (without explicitly solving) the case in which the MoF can deter cheating through a combination of *ex ante* controls and *ex post* audits. Limiting ourselves to incentive-compatible schemes, the MoF's problem is to maximise the expected output:

$$\underset{e_H, e_L, t_H, t_L, \gamma, c}{Max} E(X) = q\left[\alpha(\theta_H, e_H) - t_H\right] + (1-q)\left[\alpha(\theta_L, e_L) - t_L - \gamma z\right] - c$$

Subject to *IR(L)*, *IR(H)* and:

$$t_H - \psi(e_H) \geq t_L - \psi(\tilde{e}_L) - \eta(c) - \gamma\sigma P \qquad IC(H)$$

Under a combined approach, the most interesting case occurs when the MoF simultaneously uses both types of controls. This may only take place when $\lambda = 1/\eta_c(c) = [(1-q)z + \lambda\gamma]/\sigma P \leq q$. This may be interpreted as linking the cost-effectiveness of each type of control and comparing their costs (resp. c and $[(1-q)z + \lambda\gamma]$) to their effectiveness in deterring cheating (which depends on η and σP). When the MoF uses both audits and controls in combination, it will thus equate the relative contribution of each type of control. Finally, the optimal level of *ex ante* controls and probability of *ex post* audits, as well as the production distortion when $i = L$ and the possible rent when $i = H$, will be determined simultaneously, so as to satisfy the constraint *IC(H)* at the lowest cost.

6. Conclusion

We have argued that the principal-agent theory offers a powerful analytical framework to better understand PEM systems and guide their design in developing countries. The model discussed in this article equally applies to "managerial" systems relying on *ex post* audits (in the British tradition) and to systems relying more on *ex ante* controls (in many francophone African countries). It allows for comparisons between institutional settings (*e.g.* depending on whether or not the MoF is able to commit to a certain audit probability) and types of control (*e.g.* comparing the effectiveness of *ex post* audits and *ex ante* controls) by examining the cost-effectiveness of various tools available to the principal to deter cheating. However, this often entails some productive distortions, which result from a trade-off between economic efficiency, on the one hand, and the cost of control and/or an informational rent, on the other hand. Finally, we have interpreted corruption and the lack of governance as "rents" captured by the line ministries at the expense of their principal as a result of the informational advantage. By assuming that the agent's effort encompasses productive effort, as well as negative actions such as those related to corruption, we have linked the model to the literature on collusion in organisations.

The model shows that several regimes can exist and that their optimality depends on country-specific parameters, hence the importance of basing the choice of a PEM system on a detailed analysis. Nevertheless, it is possible to draw a few general lessons that can help PEM advisors address some important issues:

- ***Ex post* controls** (which we mostly assimilate to a court of audit in this article) should be used up to the point where their marginal cost is equal to their return in terms of improved economic efficiency. This will depend on several parameters such as arbitrarily low or ineffective penalties (often the result of social pressure or a weak judicial system in developing countries). Rather than setting up a court of audit (they do not exist in all countries), it may then be profitable to rely on other tools such as external, private audit firms, which increase the cost of cheating for the line ministries. In certain conditions, we also stress the importance of setting up a court of audit so as to make the commitment assumption credible and, in conjunction with better funding, increase its activities, thereby increasing the deterring aspect of the threat of punishment.
- The effectiveness of **internal** controls is similarly determined by cost-benefit considerations, but money spent on internal controls tends to be more effective than money spent on *ex post* controls in developing countries. An important parameter is the extent to which these controls can be bypassed, for example through the use of extraordinary procedures. The cost of internal controls should be assessed carefully, taking into account not only the cost of additional controllers or systems, but also the economic cost due to the resulting slowdown of the expenditure process.
- In countries where the efficiency of both internal and external controls is dubious, theory recommends that the line ministry should be granted an "**informational rent**" in the form of a transfer above the compensation for the effort made. However, in practice, and beyond the difficulty of implementing such schemes in a public sector context in many countries, the efficiency of informational rents may be reduced if appropriate performance measures on which to base the contract between the MoF and the line ministry are unreliable or even unavailable.
- The model may also help **sequence reforms**, although we do not develop this aspect in the article. As causes for the poor performance of the PEM system are identified, it is possible to decide what measures should take priority. For instance, if the MoF is not in a position to deter cheating by introducing internal controls, nor to grant informational rents, it is trapped in the so-called cheating-inducing regime. A first step could be to announce that private audit firms will be hired. In our model, this would relate to implementing a mixed-strategy equilibrium, which tends to be an easily

implementable and cheaper solution (as it incurs no fixed cost) to reduce the extent of cheating. If the country lacks reliable fiscal data, *ex post* audits are not very effective, and the priority should be to reinforce the accounting system before reinvigorating the court of audit.

Finally, although the principal-agent theory provides very interesting insights for the design of PEM systems, we have only considered a few aspects and many more are worth exploring. For instance, a principal-agent analysis could be applied to the allocation of resources for control purposes between different line ministries (for example because they have different probabilities of cheating). Future research could also focus on the dynamic aspects of PEM design and take into account the repeated interactions between the MoF and line ministries at the time the contract is prepared. Although not easily tractable, the realities of the negotiation process between the MoF and the line ministries are very complex, with some line ministries being better informed than others.

Notes

1. However, there is a growing literature on performance, programme and output budgeting, which basically aims to improve the information available on the effectiveness of public expenditure, and hence helps improve performance through enhanced accountability.
2. This assessment was initiated in 2002 and recently updated (see IDA/IMF, 2002 and 2005).
3. More recently, several bilateral donors and multilateral institutions have set up the public expenditure and financial accountability (PEFA) programme. It aims to build a strategic and collaborative approach to assessing and reforming partner countries' public expenditure, procurement and financial accountability systems, and identifies a set of performance indicators and benchmarks in order to help address developmental and fiduciary objectives. It has developed a public financial management (PFM) performance measurement system, and assesses PFM systems against six critical objectives: budget realism; comprehensive, policy-based budget; fiscal management; information; control; accountability and transparency. The sixteen criteria are presented in Appendix I of Leruth and Paul (2006).
4. This interpretation is consistent with that of political and social sciences, which refer to the broader notion of "rent capture" rather than corruption.
5. In some countries, such as Belgium and Lebanon, the court of audit may also perform some *ex ante* control. In this article, we restrict our attention to the functions of *ex ante* in contrast to *ex post* controls, irrespective of the institution performing them.
6. The "*mise en débêt*" is a tool to make public accountants personally responsible for financial wrongdoings discovered in their management of public funds by the court of audit or similar body.
7. Note that assuming a strict agency relationship between the MoF and the line ministry is a simplification of realities. A powerful line ministry could often play a

very important role in budget negotiations, simply because it has more knowledge about requirements in its own area than the MoF. This could be particularly true at the time of budget preparation, where the line ministry could consider itself as an equal partner to the MoF.

8. Potter and Diamond (1999) and Bouley, Fournel and Leruth (2002) discuss several of these constraints.

9. This is in line with the approach adopted, for instance, in the Australian budgeting system, where so-called service and resource allocation agreements are prepared and implemented (New South Wales Treasury, 2000).

10. For example, if the health system in a country does not perform well, say in terms of vaccination ratios, it can be because the health ministry focuses on other things (and could do those efficiently). It could also be because the money appropriated for the purchase of vaccines gets "lost" in the system. A weak PEM system would generally refer to the latter. See, for example, Gupta and Verhoeven (2001).

11. To quote a very practical definition from the New South Wales Treasury: "Output budgeting involves the Executive Government explicitly 'purchasing' outputs from program and service delivery agencies (the 'providers') in order to achieve desired Government outcomes [...]. With performance budgeting, the Executive Government funds (or 'purchases') an agency's program and delivery plan (a set of program and delivery strategies) which the agency has developed in order to achieved desired Government outcomes" (New South Wales Treasury, 2000, p. 13).

12. Ideally, these objectives are defined in the context of a medium-term (three-year) framework and based on a comprehensive macroeconomic model. A multi-year budget framework has the potential to improve incentives, for instance by allowing the introduction of intertemporal competition across agents (Ahmad and Martinez, 2004). Although we will not address this issue in the context of the article, it is important to note that the lack of a proper framework for medium-term budgeting has also been identified by the IMF and the World Bank as an area that requires substantial strengthening.

13. The PRSP approach was launched in 1999 in the context of the HIPC initiative. A PRSP describes a country's macroeconomic, structural and social policies and programmes to promote growth and reduce poverty, as well as associated external financing needs. Its preparation and implementation now often condition the release of aid funds and debt relief.

14. Hereafter we use the term "**informational** rent" when referring to the supplementary premium that the line ministry is deliberately granted as an incentive to exert high effort. We use the term "**cheating** rent" to refer to the amount illegally diverted, notably through corruption.

15. In this article, we use indifferently "performance payment" (contingent on observable/verifiable results) and "informational rent" although the latter is, in principle, more general (the difference between the expected utility of an agent with private information and his/her reservation utility).

16. Incentive schemes may be used in public companies (see, for instance, the regulation theory following Laffont and Tirole, 1993) and also, to some extent, in customs administrations (on the theoretical side, see, for instance, Besley and McLaren, 1993).

17. A model close to ours, which combines adverse selection and moral hazard, predicts that monitoring the agent's action is strictly preferable to auditing private information (Kessler, 2000).

18. In practice, the MoF would try to maximise the joint output of several line ministries. By restricting the model to one line ministry, we assume that the MoF treats all line ministries equally. The case of several line ministries is indirectly handled when the probability of audit is below one (notably in the mixed strategy equilibrium), which may be interpreted as follows: the MoF can possibly audit only a certain number of line ministries, and each line ministry chooses its cheating level considering that probability of being audited.

19. Superscript "$*$" stands for first-best values.

20. This could be interpreted as an absorptive capacity constraint: when the state of nature is high, the line ministry must work harder to absorb a larger appropriation.

21. For example, if a government is not allowed to use an overdraft facility with the Central Bank, the rule can be interpreted as a safeguard.

22. Assuming the auditor is paid only when reporting cheating is not relevant in a PEM system, although there are many instances where a bonus is given when cheating is detected (for example, customs employees detecting a fraud have a right to a portion of the tax recovered in many countries).

23. Note that this assumption is also made by Kofman and Lawarrée (1993) in their regime with one costly truthful auditor, as well as in Khalil (1997), for example.

24. We use a terminology similar to that of Eskeland and Thiele (1999) who refer to collusion-proof and collusion-inducing regimes, as we refer to cheating-proof and cheating-inducing regimes.

25. This may seem a little remote from reality. However, the revelation principle characterises the optimal payoffs and can be seen as the "truth-telling map" of a complex mechanism where cheating and punishments occur (Kofman and Lawarrée, 1993, p. 648).

26. If there are several line ministries, the latter situation could correspond to the case where the MoF announces it will audit a certain number of line ministries – so that each line ministry knows, *ex ante*, with which probability it will be audited at the end of the year.

27. The probability of cheating and the expected penalty do not enter the principal's objective function as, under this regime, cheating is deterred. However, the expected penalty appears in the *IC* constraint.

28. To be complete, one should also introduce an *IC(L)* constraint, aimed at preventing the line ministry from producing the high output when productivity is low. This would take the form $t_L - \psi(e_L) \geq t_H - \psi(\tilde{e}_H)$. But, as is common in the literature, that constraint is redundant with the others and is therefore not relevant. Note also that, as we use the revelation principle and deter cheating, the optimal solution exhibits no cheating. The penalty is not collected in equilibrium and hence it does not enter the MoF's objective function (although it is present in the constraints).

29. Note that, from the specification of that Lagrange multiplier, one observes that the higher the cost of audit and/or the probability of low productivity, and the lower the penalty, the harder it is to deter cheating.

30. Our results are consistent with the analysis of Kofman and Lawarrée (1993) with a truthful auditor. There are some slight differences, however.

31. The random audit case may be interpreted in a context with several line ministries, where γ represents the probability, for each line ministry, to be audited in the framework of the general auditing policy of the MoF.

32. Mixed-strategy equilibriums have generally been used in the literature on collusion. The latter suggests that, instead of trying to systematically deter (or induce) collusion, it may be efficient to allow it to some extent (*e.g.* Kofman and Lawarrée, 1996; Khalil, 1997; Khalil and Lawarrée, 2006). This may be the case, for example, if there is a positive probability that the agent and the supervisor are honest, so that it may be too costly to provide incentives to systematically deter collusion. We hereafter apply a similar approach to cheating (corruption). We do not model it; but, in a context with several line ministries, the mixed-strategy equilibrium could also yield the optimal contract when some line ministries are honest while others are corrupt, because preventing cheating as if all line ministries were corrupt would be too costly.

33. This argument holds in one-period games. However, in the context of repeated relationships, it is probably in the MoF's interest not to backtrack on its promise to audit with the announced probability, in order to preserve its reputation.

34. Our results are quite intuitive. Both the probability of audit and the probability of cheating are decreasing functions of the expected penalty. The more cheating rent the line ministry can capture, the more the MoF audits. The more expensive the audit, the more the line ministry cheats. The cheating probability is also influenced by the relative probabilities of the productivity occurrences: to keep the MoF indifferent between auditing and not auditing, cheating is increasing with the probability of low productivity. The agency cost decreases with the expected penalty and increases with the probability of low productivity. It is also higher when the difference of production between $i = H$ and $i = L$ is higher.

35. Informational rents could be envisaged in a system of performance budgeting, as they consist of rewarding the line ministry for good performance (above the compensation of its effort).

36. This section deals with an issue not often discussed in principal-agent papers where the focus tends to be on controls run *ex post*.

37. Following Tirole (1986), that branch of the literature studies the potential for side-contracting between a privately informed, cheating agent and the supervisor hired by the principal to control him or her.

38. As an exception to this statement, Strausz (2006) compares the value of monitoring *versus* auditing – but our analysis differs from Strausz's in that we do not assume that *ex post* audit and *ex ante* controls rely on the same technology.

39. The literature on collusion adopts a similar approach when it acknowledges that hiring a collusive auditor is still useful, because it makes shirking costly for the agent, as he/she will have to pay a bribe to falsify the report (*e.g.* Kofman and Lawarrée, 1996).

40. For instance, in Senegal, the procedures for disbursing the Health Decentralization Fund are such that it takes on average ten months for the resources to be at the disposal of the providers. This leaves only two months to the facility to absorb those resources (World Bank, 2004a).

41. The more effective the controls, the higher $\eta(c)$ for any $c > 0$.

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Performance Budgeting in Australia

by
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This article describes how the principles of management for results have worked in practice over the past two decades in Australia. The current performance information framework involves, among other things, the accrual-based outcomes and outputs policy, performance agreements between heads of agencies and their responsible ministers, and regular review and assessment, particularly at agency level.

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1. Description of the performance system

Financial management in Australia has been shaped by the principles of "management for results" since the introduction of the Financial Management Improvement Program (FMIP) in 1983 as part of a wide-ranging public sector reform strategy (Parliament of the Commonwealth of Australia, 1990).

Financial management's focus on results has evolved considerably over the two decades since the FMIP established rudimentary programme-based planning and reporting on cash movements. Today the information gathered includes comprehensive and detailed accrual-based reporting on plans and actual results for each outcome, output and administered activity in each department and agency across the general government sector.

The nature of performance information in Australia's financial management framework may have changed, but the essential objectives remain very much the same: to improve both the cost-effectiveness of resource use and public accountability while devolving financial management responsibility and flexibility to those who deliver policies and programmes.

1.1. Background

Australia's current arrangements arose from budgetary reforms associated with the *National Commission of Audit 1996*, an independent review commissioned by the then incoming Australian government (Commonwealth of Australia, 1996). That review considered aspects of the management and financial activities of the Australian government and how they were recorded. The commission's main recommendations were that:

- government management skills and government finances operate on a more business-like footing;
- the transparency of government finances be further improved;
- the culture and operations of the Australian public service reflect a more businesslike approach.

Between 1996 and 1999, legislative and administrative changes were introduced that reflected the principles espoused by the National Commission of Audit:

- The Audit Act 1901 was replaced in 1997 by new financial legislation for government departments, agencies, authorities and companies. The

legislation comprised the Financial Management and Accountability Act 1997 (FMA Act) and the Commonwealth Authorities and Companies Act 1997 (CAC Act), as well as the Auditor-General Act 1997.

- Financial management moved to a principles-based framework, with clear lines of accountability.
- The Charter of Budget Honesty Act 1998 (the Charter) was introduced in response to a specific recommendation of the *National Commission of Audit 1996*. The Charter provides a framework for a more transparent conduct of fiscal policy. *Inter alia*, it requires:
  - ❖ governments to disclose their fiscal strategy and to base that strategy on principles of sound fiscal management. The principles are identified in the Charter;
  - ❖ reporting on the fiscal strategy at budget time (including a statement of risks), half-year, and end-of-year. Prior to an election, a fiscal outlook statement is also required;
  - ❖ specific guidelines governing the costing of election commitments by the government and the opposition, and release of the information.

Other key reforms were implemented in 1999/2000 in addition to the legislative changes. These included: the move to accrual budgeting (including accrual appropriations); an outcomes and outputs resource management and performance framework; and increased flexibility and responsibility for agency chief executives (also reflected in the Public Service Act 1999).

The financial management and public administration legislation that replaced the Audit Act 1901 eliminated detailed legislation, mandatory requirements and directives relating to authority and action on public funds. Those arrangements were replaced by more general provisions that give chief executives the authority to set their own internal operating procedures and delegations, subject to general principles of efficient, effective and ethical use of resources.

The new arrangements also established performance agreements between chief executives and their ministers. The agreements generally cover the key goals and objectives for the CEO and their agencies.

The reforms of the 1990s aimed to establish clear responsibility and accountability for financial and non-financial performance. They sought to hold agency heads responsible for performance. The requirements for central controls on comprehensive evaluation plans were relaxed; at the same time, greater emphasis was placed on the development of precise and measurable performance information.

Until 1996, agencies were required to submit formal portfolio evaluation plans each year, assessing all programmes within their area of responsibility over a five-year period. Experience with the variable quality of evaluations and their usefulness or lack thereof for decision making suggested that a more focused and balanced approach to evaluation and performance measurement might yield better overall results. In 1996, agencies were encouraged to use new evaluation and performance monitoring techniques in ways that contributed most to efficient, effective and ethical management. The Department of Finance and Administration ("Finance"), in co-operation with the Australian National Audit Office, released a set of good practice principles for performance information (ANAO and Department of Finance and Administration, 1996).

While there have been benefits from the reforms of the mid to late 1990s, the Australian government has recognised the need for regular review and assessment of the reforms. This was undertaken most recently in 2002, when the Australian government initiated the Budget Estimates and Framework Review. The review was primarily aimed at ensuring greater timeliness and accuracy of budget estimates information, including cash data, and ensuring that the public service was adequately equipped to deliver the improvements. The major themes of the review report were:

- a greater focus on programme information;
- more detailed and timely reporting of financial information;
- strengthened processes to monitor agency financial performance, cash flows and estimates construction;
- ensuring that systems are capable of capturing and recording increased information requirements;
- increasing the number of professional staff in Finance and line agencies with the necessary financial and analytical skills.

The recommendations of the review were accepted by the government in November 2002. This included confirmation of accrual budgeting and Finance's power to amend agency financial estimates to ensure that the quality and timeliness of the whole-of-government estimates meet the best achievable standard.

In retrospect, the accrual-based outcome and outputs policy changes initiated in 1999/2000 were a significant challenge for the government, parliament, the budget, management and technical staff of central and line agencies, and information technology systems. The full impact of those changes was not obvious to the planners or to those working within the system in the early years of operation. This highlights the importance of monitoring and refining reform initiatives, especially when they are complex, wide-ranging and ambitious.

1.2. Institutional framework

Australia operates within a three-tier federal structure. National, provincial and local governments are elected independently and have the autonomy to make decisions on matters within the scope of their responsibilities. The major public services are delivered through state and territory governments – for example, most areas of health, education, infrastructure, utilities, law and order, and community services. The funding for those services is collected mainly at the national level and transferred to states, territories and local governments through direct payments. A minor proportion of the transfers are provided for specific purposes under conditions set by the national government.

Under the devolved financial framework at the national level, performance management (including performance measures and programme evaluation) is generally the responsibility of individual ministers and their departments and agencies, although outcomes must be agreed with the Minister for Finance and Administration.

The Australian government's outcomes policy requires every department and agency within the general government sector, including statutory bodies, to identify comprehensive and explicit outcomes, outputs and performance measures for the quantity, quality, price and effectiveness of their activities. They are required to report on those items and any major evaluations in their budget plans (portfolio budget statements) and their end-of-year results (in annual reports). Further details of performance measurement arrangements are provided in Box 1.

Major and whole-of-government initiatives may require cross-portfolio agreement on evaluation and review strategies; this may include the departments and agencies involved in implementing the policies as well as Finance and/or the Department of the Prime Minister and Cabinet.

Users of performance information published by departments and agencies are primarily parliamentary committees which scrutinise budget estimates and annual reports. The main users in parliament are the Joint Committee of Public Accounts and Audit (JCPAA) and the Senate Standing Committee on Finance and Public Administration (SCFPA).

In relation to reporting in agency annual reports (which are signed by agency heads), the JCPAA approves requirements for reporting performance information in annual reports that are issued each year by the Department of the Prime Minister and Cabinet; these requirements must be adhered to by all FMA Act agencies. All CAC agencies must comply with reporting requirements specified in the CAC Act. The requirements do not change much from year to year other than to reflect changes in the components, such as adoption of Australian equivalents of international financial reporting standards and more detail on governance and corporate intentions.

Box 1. **Overview of the Australian government's outcomes framework**

The purpose of the outcomes framework is outlined in the following extract from Finance's policy guidance, first published in November 2000 and updated in 2003:

"The outcomes and outputs framework is intended to be dynamic and flexible. It works as a decision hierarchy:

- Government (through its ministers and with the assistance of relevant agencies) specifies the outcomes it is seeking to achieve in a given area.
- These outcomes are specified in terms of the impact government is aiming to have on some aspect of society (*e.g.* education), the economy (*e.g.* exports) or the national interest (*e.g.* defence).
- Parliament appropriates funds to allow the government to achieve these outcomes through administered items and departmental outputs.
- Items such as grants, transfers and benefit payments are administered on the government's behalf by agencies, with a view to maximising their contribution to the specified outcomes.
- Agencies specify and manage their outputs to maximise their contribution to the achievement of the government's desired outcomes.
- Performance indicators are developed to allow scrutiny of effectiveness (*i.e.* the impact of the outputs and administered items on outcomes) and efficiency (especially in terms of the application of administered items and the price, quality and quantity of outputs) and to enable the system to be further developed to improve performance and accountability for results."

The framework applies to all agencies and authorities in the general government sector, and the agency or authority is the basic unit of organisation* – that is, outcome statements are agency statements but must be agreed by the portfolio minister and the Minister for Finance and Administration. Performance measures and targets are set by each minister for their areas of responsibility, taking account of the conditions under which they operate, including the available budget.

The framework is intended to serve a number of objectives:

- a strategic objective: to guide overall resource allocation (budget measure) decisions by the government in the budget context;
- as the basis for parliament to appropriate money in the annual appropriation acts. In practice, neither departmental outputs (18% of total expenses) nor administered programmes appropriated by special or standing appropriations (73% of total expenses) are appropriated against outcomes; only administered programmes included in the annual appropriation acts (9% of total appropriations) are appropriated by outcome;

Box 1. **Overview of the Australian government's outcomes framework** *(cont.)*

- an agency management objective: departmental outputs and administered programmes are directed to the achievement of the results or impacts specified in the relevant agency's outcome statement;
- accountability and transparency to parliament and other stakeholders, achieved by reporting on the agency's performance in producing the government's intended outcomes through the departmental outputs it delivers and the programmes it administers on behalf of the government.

* Department of Finance and Administration, 1998, p. 9.

The Auditor-General has authority, under the Auditor-General Act 1997, to initiate financial and performance audits of agencies and programmes to inform parliament; however, he/she does not audit budget material. The Auditor-General has undertaken many performance audit reports examining the quality, coverage and information systems associated with performance information.[1]

The Department of Finance and Administration (Finance) is responsible for providing guidance on performance management policies relating to budget-funded bodies and requirements for government statutory authorities and companies. Finance issues guidelines to agencies on the level of performance reporting, to be provided in agencies' statements to parliament as part of the information on the annual budget.

Finance also has responsibility for providing the government with advice on whole-of-government expenditure priorities. In this context, Finance provides advice to the cabinet and ministers on the performance of agencies and programmes, including when assessing new policy proposals in the annual budget process. Proposals for changes to the budget and medium-term estimates in the budget process, including new policies and savings, must identify the outcome they are intended to contribute to as well as key milestones for implementation and the agency's strategy for monitoring results.

Finance is responsible for developing policies on the review of expenditure initiatives; individual departments and agencies have ongoing responsibility for monitoring performance and undertaking evaluations of their own programmes. However, in October 2006 Finance established a strategic review unit (the Unit) that provides advice to senior ministers on matters warranting major (strategic) review as part of the budget process. The Unit co-ordinates cross-agency consultation on strategic reviews and administers those reviews approved by ministers. The strategic reviews will typically cover high-priority,

large, complex, cross-agency initiatives, and are intended to assist the government in improving the efficiency, effectiveness and appropriateness of expenditure programmes (including tax expenditure).

2. Measurement and assessment of results

The Australian government's performance information frame workplaces a strong emphasis on agency-level outcomes as the foundation for assessment. Outcomes are defined as the results, impacts or consequences of actions by the Australian government for the Australian community. Outputs are the goods and services produced by the individual department or agency on behalf of the government that contribute to outcomes for external organisations or individuals. Outcomes are decided by the responsible ministers in consultation with the Minister for Finance and Administration. Individual ministers are responsible for choosing outputs, which are decided at a broad level by cabinet in the budget process. The emphasis on explicit measures of results is crucial to the usefulness of the framework as a tool for performance assessment and evaluation.

Performance information in Australia is meant to contribute to financial management and budgeting at three levels: internal agency management; whole-of-government resource management; and external accountability.

Agencies are expected to undertake their own performance assessment and evaluation as part of normal internal management practice. At a minimum, agencies are required to identify outcomes, administered items and outputs covering all expenditure within their area of responsibility. They are required to identify, measure and report publicly on key performance indicators for the quality and quantity of outputs and effectiveness indicators that assist in measuring the success of their contribution to identified outcomes. Published performance information on agency plans is provided at budget time (in portfolio budget statements), and after the end of the year the results are published in their annual reports.

It is widespread practice for agencies to monitor and report on a range of key indicators on a regular basis throughout the year. Practices vary from sophisticated reporting techniques such as balanced scorecards, performance dashboards or traffic light reports, to providing a list of progress against key indicators, showing variances from plans, as a supplement to the financial progress reports or to meet public reporting obligations.

There are no specific whole-of-government outcomes at the national level in Australia. Most state and territory governments have high-level targets or objectives that agencies are expected to consider in their planning and operations. The main mechanisms for using performance information for

whole-of-government resource management are budget process review requirements and specific cabinet-directed reviews of important programmes or budget measures. These arrangements are explained in Section 3 below.

A particular challenge to the development of performance information at the national level is that most public services are delivered through state and territory governments. Consequently, the Australian government does not control the use of resources and has limited influence on performance. One exception is for specific-purpose payments from the Australian government to states and territories, which generally require performance reporting and achievement of targets or performance conditions. For example, specific performance benchmarks are set for literacy, numeracy and participation in schools, the quantity and quality of housing for disadvantaged people, and a range of health services delivered through cross-jurisdictional agreements by state and territory governments.

Portfolio budget statements contain details of the origin and uses of resources available to each general government sector agency. Uses of funds are disaggregated by outcome and within each outcome, by departmental (controlled) and administered resources. Performance indicators and measures are reported for each outcome in terms of effectiveness and output quantity, and quality. Differences between plans and actual results on performance measures are not routinely used directly in budget formulation. However, they are sometimes used by agencies and Finance to support arguments for revision to programmes or to identify options for budget savings.

The Australian National Audit Office (ANAO) and parliamentary committees have expressed concerns about the overall quality of information in published reports, particularly in relation to outcomes.[2] The government's Budget Estimates and Framework Review also identified the need to examine agency outcomes information to ensure that it is consistent with the policy framework and appropriate to the needs of the government and parliament.

The review of outcomes is currently being undertaken by Finance in consultation with all other general government sector agencies. The focus of the review is on improving the specification of outcomes, to ensure that they refer to explicit impacts rather than outputs or objectives, and to strengthen the measures and methodology for assessing individual agency contributions to outcomes.

Finance has developed a list of questions to assist in diagnosing the quality of performance information; the list is also useful as a framework for monitoring improvement over time. The questions are used by Finance as a basis for dialogue with agencies about the quality of their performance information. Agencies and the ANAO have used the questions as a reference for their own purposes in designing and assessing performance information.

The basic outcomes review is expected to be completed in 2007/08. However, it will be important for continued monitoring and support to achieve sustained improvements in quality of information and behaviour in agencies. Improvements in the quality of performance information are expected to make it more useful in supporting management and policy decisions on programmes.

3. Integrating and using performance information in the budget process

The effect of performance information on decision making and resource allocation in the budget process is mixed.

The outcomes policy has resulted in the development and reporting of performance information by all agencies in the general government sector. This offers considerable scope for that information to be used in budget and management decision-making processes. At present, the potential for using the information has not been fully realised. There are initiatives to increase the emphasis on performance information and reviews, for example through revisions to the format of new policy proposals and by launching a study to assess budget review arrangements and propose options for reform.

The format of new policy proposals was reviewed and revised by Finance and the Department of the Prime Minister and Cabinet in late 2004. The changes require departments and agencies to identify the key benefits, risks and milestones for each proposal, as well as related implementation issues, to inform cabinet's consideration of the proposal. These changes provide the basis for realising new policies to manage the implementation process, track progress and inform evaluation.

Expenditure and programme reviews are a central feature of the Australian budget process, and the area where performance information is used to inform budget decision making. The Australian government revised review arrangements in October 2006 to achieve a more co-ordinated strategic process better linked to budget planning and resource allocation. The new arrangements involve Finance administration of procedures for identifying and managing reviews, in co-operation with other departments. Decisions on which major areas of public expenditure should be reviewed in any given year are made by senior ministers in the budget process. The results of the reviews are considered at the beginning of the following budget process by the senior ministers setting priorities.

A small number of strategic reviews will be undertaken each year on major programmes and cross-agency themes, including tax expenditures and taking account of intergenerational considerations.

The new arrangements supplement rather than replace agency performance measurement and evaluation activities. Wider independent review and evaluation activity relating to government policies and programmes also continues, for example through parliamentary inquiries, independent commissions, eminent persons and non-governmental organisations.

4. Reporting of performance information

Every year, as part of the budget-related documentation, each portfolio (*i.e.* a collection of related agencies under the responsibility of a minister of state) provides an extensive report on the plans for the budget and the forward estimates period for each of its constituent agencies. These portfolio budget statements[3] include details of all sources and uses of funds by outcome.

Financial information on outcomes is supplemented by information on the administered items and outputs that contribute to each outcome. Also included is an extensive set of performance indicators, measures and targets for planned results and details of future evaluations. The portfolio budget statements also include a full set of budgeted financial statements for the agency covering four future years, as well as the estimated actual result for the current year.

The portfolio budget statements are a primary source of information for Senate committees during the budget scrutiny hearings following the presentation of the budget. Statements incorporating similar information are also provided in relation to other appropriation bills during the year.

The use of the information found in portfolio budget statements by Senate committees varies across agencies, from situations where there are many questions on achievements against indicators to situations where there are relatively few. Finance is working to improve the usefulness of these statements to parliament and other stakeholders, including in relation to the type and quantity of performance information they contain. The format and content of the statements will be reviewed in depth in 2007, as part of the Australian government's initiative to reduce red tape within the administration.

Aligned to portfolio budget statements are agency annual reports, which are published within four months of the end of each financial year. They contain audited financial statements and an explanation of agency performance during the financial year in question. They also publish actual results against individual performance measures for outcomes and outputs and the implications of evaluations finalised during the year.

The quality of performance reporting in annual reports has improved significantly since the introduction of accrual-based budgeting. For example, it is increasingly common for agencies to report portfolio budget statement targets in the same table as results, followed by a commentary on the reasons for major discrepancies and how agencies intend to respond to disappointing results.

There remains a wide variation in the quality of reports and the information contained in them.[4] In an effort to encourage improvement, Finance and the ANAO jointly published a better practice guide for performance information in annual reports (ANAO and Department of Finance and Administration, 2004). The guide contains practical advice on the main areas for improvement, including the performance reporting framework, data management and measurement, and explanation of results. The guide also contains a large number of good practice examples for agencies to consider and emulate where appropriate.

Published performance information is only one of many types of information used by the cabinet and ministers to assess revenue and expenditure proposals in a budget decision-making context. Ministers rely on analysis and information in new policy proposals and reviews contained in confidential cabinet submissions and portfolio budget submissions prepared by the proposing agency. This information is often not publicly available. In addition, ministers rely heavily on policy and financial advice from Finance, which provides a policy and financial assessment of all expenditure proposals under consideration in the annual budget process.

5. Key challenges

A key challenge with current arrangements is to ensure that the links between programmes, outputs and outcomes are clear and measured effectively. The benefits of programme and outcome performance information relate primarily to agency efficiency and effectiveness. Finance is seeking to encourage improvement in the quality and precision of performance information and evaluation in agencies. The aim is to develop skills, systems and a culture in agencies to raise the standard and usefulness of performance information for internal planning and for constructive dialogue with external stakeholders.

A further challenge is to ensure that the government has better access to performance information by better integrating it into the decision-making phase of the budget. The government's decision to adopt a more centrally co-ordinated strategic review framework and its initiatives for review of the quality of agency information on outcomes will help overcome some of the variability of agency performance information and improve its overall usefulness.

Continuing pressure for improving the effectiveness and sustainability of government expenditure is a perennial challenge. Over the last six years, from 2000/01 to 2005/06, annual government expenditure increased by AUD 50 billion. Both new policy spending and growth in expenditure for the existing stock of government programmes have driven this increase.

New policy spending accounted for around 48% (or AUD 24 billion) of the total increase. A large part of this spending has been in high-priority areas for the government, in particular national security and defence, health, and social

security and welfare. These areas will remain sources of spending pressure over the medium term. While they are high priority, it is acknowledged that they also should be subject to review.

Expenditure on continuing programmes accounted for 52% (or around AUD 26 billion) of the overall government expenditure increase between 2000/01 and 2005/06. This group includes large programmes in high-priority spending areas, as well as a large number of small to medium-sized programmes.

The new strategic review arrangements are intended to ensure that an integrated and systematic framework is in place to allow ministers to:

- focus on the allocation of government expenditures;
- identify appropriate areas for review;
- ensure that programmes and outcomes remain aligned with policy priorities, are effective, and are managed efficiently.

6. Solutions

Better integration of performance information into agency management processes and information systems will lead to better-informed decisions and better policy outcomes. Improving the relevance and quality of information available for the decision-making phases of the budget process is a long-term challenge that will require sustained effort from Finance and agencies.

Finance's current focus is on establishing the new strategic review framework, simplifying policies and procedures to meet financial management requirements, and improving the quality of financial and non-financial reporting. The aims are to improve financial management compliance and accountability while making existing and new programmes more coherent, more effective and better targeted to current government priorities.

7. Lessons learned and impact

Australia's approach to incorporating a focus on performance has been a long-term, iterative process. This has provided many benefits, not least the opportunity to learn from experience before proceeding with further reforms. This has also been important because of the interrelationship between performance and other aspects of the financial, accountability, political and management environment. The complexity of interactions and incentives is difficult to comprehend in isolation from practical experience, making "big bang" changes potentially high risk.

The iterative approach to improvement has allowed Australia to proceed with care, making refinements as unanticipated or unintended effects occur, and keeping to a long-term path of management for results.

Supplementary guidance, training and advice are being developed as part of continuing efforts to achieve better performance information. These efforts will continue alongside further research and sharing of good practices within and outside Australia.

Australia has faced two recurring themes in establishing good performance information:

- the quality of performance information in relation to agency contributions to outcomes and outputs;
- the limited use of the performance information for decision making in the budget context.

Outcomes and outputs will remain essential parts of Australia's budgeting and management framework. However, it is important to ensure that links between programmes, outputs and outcomes are clear and are measured effectively, particularly if this performance information is to be relied on for budget decision making.

As with other aspects of financial management reforms associated with the devolution of responsibility, it is crucial that new policies and practices are well understood by people in line agencies and that these people have the skills, capacity, resources and authority to implement the initiatives effectively. Implementation is much slower and more uneven if those responsible for data and measurement are incapable or unable to make the necessary changes.

With respect to enhancing the utility of performance information for budget decision making, a major challenge in introducing a systematic approach to programme reviews will be to ensure that such reviews add value to government considerations, use agency resources efficiently, and do not become a mechanical exercise.

Notes

1. For a list of performance reports by the Australian National Audit Office, see *www.anao.gov.au*.
2. For example, see JCPAA, 2002; SCFPA, 1999, 2000 and 2007; and ANAO, 2003 and 2007.
3. Portfolio budget statements are available on each department's website or can be accessed through the Australian government budget portal at *www.budget.gov.au*.
4. For further information on the quality of performance information in annual reports, refer to ANAO, 2003 and 2007.

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