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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

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

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Opening Budgets to Public Understanding and Debate: Results from 36 Countries

by

Pamela Gomez with Joel Friedman and Isaac Shapiro*

As part of the global movement toward more open government, citizens have become increasingly concerned with obtaining access to accurate, comprehensive and timely information on the budgets of their countries. The International Budget Project developed the Open Budget Questionnaire, a measurement tool to evaluate public access to budget information from the perspective of civil society organisations. In early 2004, civil society researchers from 36 developing countries and transition economies completed the questionnaire. Other budget process issues were also included in the questionnaire, in order to explore ways of improving public understanding and involvement in the budget and to identify concrete steps that countries can take to improve their budget systems.

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1. Introduction

Consistent with the movement toward more open government, citizens around the world have become increasingly concerned with obtaining access to accurate, comprehensive, and timely information on their country's budget. The growing interest in access to budget information is unsurprising – a government's budget and reports issued throughout the year are key documents that should allow the public to evaluate a government's policy intentions, its policy priorities, and their implementation. Access to such budget information is essential to ensure government financial accountability, and for civil society's informed participation in budget debates.

The International Budget Project (IBP) of the Center on Budget and Policy Priorities was established in 1997 to assist non-governmental organisations (NGOs) and researchers in developing countries in their efforts to analyse budget policies, open budget processes, and strengthen budget-related institutions. The IBP's goal is to make budget systems more responsive to the needs of society and, accordingly, to make these systems more transparent and accountable to the public.

As such, the IBP worked for two years (2003-04) to develop the *Open Budget Questionnaire*, a comparative measurement tool to evaluate public access to budget information and budget processes across countries from the perspective of civil society organisations. The findings presented here are intended to contribute to the debate and discussion on budget transparency.

1.1. The rising global interest in budget transparency

Since the mid-1990s, a number of important global trends have spurred interest in budget transparency. These trends include an increasing focus on combating corruption, interest in ensuring accountability for the delivery of public services, the process of decentralising government, and increased emphasis on community-led development. The interest of some international donors in building the capacity of governments to administer development funds by providing direct budget support rather than through traditional project-specific support has also been a factor.

Meanwhile, civil society organisations (CSOs) with a broad range of mandates and interests have become increasingly concerned about the availability of budget information and opportunities for participation. These

CSOs include organisations with an emphasis on pro-poor budgeting, combating corruption, or monitoring a government's adherence to its commitments under the *International Covenant on Economic, Social and Cultural Rights*. Organisations with specialisation in sector-specific issues such as health or education have also recognised the importance of budget transparency to their work.

1.2. Development of international standards

Both multilateral organisations and civil society have become interested in promoting budget transparency by further defining those practices and procedures necessary to ensure transparency and accountability. Some efforts involve the development of codes of good or best practices, in conjunction with research to assess adherence to the guidelines developed. Other efforts have involved measuring perceptions through surveys or polls to determine how knowledgeable individuals in a country view adherence to a set of practices researchers have defined as necessary to budget transparency.

The International Monetary Fund adopted the *Code of Good Practices on Fiscal Transparency* in 1998 in the wake of the Asian financial crisis (IMF, 2001). The Asian financial crisis and a series of other financial collapses during the 1990s spurred a debate on the need to reform the global financial architecture. Although the debate on the global financial system is ongoing, it did contribute to a view within international financial institutions that good governance is central to achieving macroeconomic stability, and that fiscal transparency is a key aspect of good governance.

Subsequently, the OECD developed guidelines of what are considered to be best practices for transparency relating to budgets, the *OECD Best Practices for Budget Transparency* (OECD, 2001). The OECD best practices are focused on information that should be publicly available as part of a government's budget documents and during each stage of the budget process. The OECD best practices provide specific guidelines on the principal budget documents and reports that a government should produce. These include details relating to the disclosures to be contained in the reports, and practices for ensuring the quality and integrity of the reports. This focus differs in some respects from the IMF fiscal transparency code, which also contains valuable reporting guidelines intended to provide coverage of the entire public sector, including sub-national government.

1.3. Civil society research efforts

The *Open Budget Questionnaire* effort grows out of related recent civil society efforts. Budget transparency and participation have been topics of considerable interest to civil society budget groups and researchers for some time. They were

the subject of extensive discussion at the first international conference for non-governmental budget researchers hosted in 1997 by the IBP.

This led the IBP and the Institute for Democracy in South Africa (Idasa) to develop a methodology to assess budget transparency and participation in the budget process. The IBP hoped that the method would help budget groups to compare budget transparency in their own countries with other countries. Idasa was concerned with documenting the significant improvements in transparency in South Africa and establishing a yardstick for future improvements. Both organisations thought that the scorecard might eventually be used by broader civil society and legislatures in developing countries to pressure for greater transparency.

The IBP and Idasa also organised the second international conference of budget groups around the theme of transparency and participation in the budget process. At this February 1999 conference, the initial results from the South Africa study were presented. Several of the conference attendees decided to undertake open budget work in their own countries. These groups included Poland's Gdansk Institute for Market Economics, which produced a report on openness and transparency of public finances in 2001.

In December 2001, civil society research on budget transparency and participation took a significant step forward with the release of a study examining these dimensions in five Latin American countries. The researchers engaged in the study came from some of the leading academic and non-profit institutions in Latin America including: Poder Ciudadano in Argentina; the Brazilian Institute for Social and Economic Analysis (IBASE); the Economics Department at the University of Chile; in Mexico, the Center on Research and Teaching in Economics (CIDE) and the groups Fundar and Gender Equity; and the Research Center of the Pacific University in Peru. This regional effort was subsequently expanded to include ten Latin American countries, producing research that was released in November 2003.

In June 2002, a cross-country transparency civil society study was published that covered five African nations. The Africa study was co-ordinated by the Africa Budget Project at Idasa, which gathered the country researchers to refine the methodology and discuss preliminary results. The survey was based on a review of available documentation and personal interviews with experts drawn from civil society, the media, academia, the private sector, and members of the executive and legislative branches of government. The groups that conducted this study include Isodec in Ghana, Transparency International in Kenya, Integrity in Nigeria, Idasa in South Africa, and in Zambia the University of Zambia, Women for Change, and Catholic Commission for Justice and Peace. The Africa regional initiative was expanded to nine countries in 2003 and will also produce research.

Other civil society efforts have involved regional and local governments. In Russia, the group Strategia organised a series of conferences focusing in large part on budget transparency and participation and sparked considerable research in this area in 2001. Strategia conducted the research at the local level in Murmansk, Petrozavodsk, and Velikije Luki, and at the regional level in St. Petersburg, Novosibirsk, Pskov, Samara, and Yuzhno-Sakhalinsk oblast.

The current study profited greatly from these previous efforts. Those efforts helped sort through a variety of methodological issues and employed innovative techniques, from which we have learned. Many of the researchers were also directly involved in this study, as described in the next section.

1.4. The structure of this report

The next three sections of this report present the findings, first by examining the results by the three main categories in which the questions were placed, then by the subcategories within each category, and finally by specific questions. The last section examines the results from a questionnaire completed by the researchers on the distribution of budget documents in their respective countries. The report concludes by sketching out how the report and its findings might be of use to the governments studied as well as to civil society, and briefly discusses the IBP's future plans in this area.

2. Principal findings by major category

The study's principal findings are shown in Table 1 which presents the scores in three categories for the 36 participating countries. The average scores for the categories show that countries tend to do a better job of meeting best practice guidelines for the information presented in the executive's budget proposal than they do for providing information on the budget after it has been enacted, or taking steps to encourage public and legislative involvement in the budget process.

- **Executive budget documents:** The average score of 56% (out of a possible total of 100%) for the countries in the sample indicates that their practices are more positive than not with regard to the executive's budget proposal, but that much possible improvement remains. (A score of 67% implies that acceptable standards have been met, on average, for the questions in the category.)
- **Monitoring and evaluation reports:** This category includes questions regarding in-year, mid-year, year-end, and audit reports. The average score for this category drops to 44%, indicating that practices are mostly negative, and generally fall short of best practice for the countries in the sample.
- **Public and legislative involvement:** The average score for the final category is 40%, implying that current practices with regard to encouraging public and legislative involvement are weak for the countries in the sample.

Table 1. **Summary of Findings by Major Category**
(sorted by category score)

Country	Executive Budget Documents	Country	Monitoring and Evaluation Reports	Country	Public and Legislative Involvement
Czech Republic	86%	Slovenia	99%	Slovenia	86%
Slovenia	86%	Poland	97%	South Africa	77%
Botswana	84%	South Africa	82%	Czech Republic	65%
South Africa	83%	Czech Republic	76%	Poland	63%
Poland	79%	Russia	74%	Brazil	57%
Peru	77%	Mexico	70%	Uganda	54%
Kenya	72%	Kenya	64%	Indonesia	52%
Namibia	68%	Peru	64%	Romania	51%
Jordan	68%	Bulgaria	57%	Peru	49%
Ghana	64%	Romania	55%	Argentina	49%
Azerbaijan	64%	Georgia	53%	Burkina Faso	48%
Russia	63%	Croatia	51%	Mexico	48%
Mexico	62%	Brazil	49%	Kenya	46%
Brazil	61%	Uganda	48%	Costa Rica	46%
Argentina	61%	Jordan	46%	Russia	45%
Uganda	59%	Indonesia	45%	Bangladesh	40%
India	59%	El Salvador	44%	Colombia	38%
Bangladesh	58%	Burkina Faso	43%	India	37%
El Salvador	58%	Argentina	42%	El Salvador	37%
Colombia	57%	Botswana	42%	Croatia	36%
Costa Rica	56%	Bangladesh	40%	Botswana	36%
Nepal	56%	Kazakhstan	36%	Bulgaria	34%
Burkina Faso	56%	Colombia	36%	Malawi	33%
Malawi	52%	Nicaragua	34%	Namibia	33%
Georgia	52%	Ghana	34%	Ghana	33%
Romania	51%	Nepal	32%	Jordan	31%
Kazakhstan	48%	Costa Rica	31%	Kazakhstan	28%
Indonesia	47%	Zambia	31%	Azerbaijan	27%
Bulgaria	45%	India	30%	Honduras	25%
Honduras	43%	Ecuador	25%	Georgia	24%
Zambia	35%	Namibia	14%	Nicaragua	20%
Ecuador	31%	Bolivia	12%	Zambia	19%
Croatia	28%	Azerbaijan	10%	Mongolia	19%
Bolivia	21%	Honduras	7%	Bolivia	18%
Nicaragua	19%	Malawi	6%	Ecuador	14%
Mongolia	0%	Mongolia	0%	Nepal	7%
Average	56%	Average	44%	Average	40%

Note: The shading groups countries according to their average score. Scores of 67% or above generally indicate “positive” practices, and scores of 50% to 66% reflect “mostly positive” practices. In contrast, scores of 33% to 49% indicate “mostly negative” practices, and scores of less than 33% reflect “negative” practices.

Most countries in the sample follow this general trend – higher scores for executive’s budget proposal and lower scores for the other two categories. There are, however, some exceptions. Nine of the countries show higher scores for monitoring and evaluation reports than for the executive’s budget proposal. These are Bulgaria, Croatia, Georgia, Mexico, Nicaragua, Poland, Romania, Russia, and Slovenia. Further, Croatia, Indonesia, Mongolia, and Nicaragua have higher scores for public and legislative involvement than for the executive’s budget proposal category.

Box 1. Content of major categories

The questions were grouped into three major categories that describe the study’s principal findings. These include the executive budget documents, monitoring and evaluation reports, and public and legislative involvement.

Executive budget documents

This category includes 45 questions that cover information presented in the executive’s budget proposal as it is tabled in the legislature. The executive budget documents category also reflects information in any of the supporting documents that the executive may issue simultaneously as companion documents to facilitate understanding and interpretation of its main budget proposal. Many of the best practices assumed in the questions used in this category reflect the *OECD Best Practices for Budget Transparency*, and some of the guidelines contained in the *IMF Code of Good Practices on Fiscal Transparency*.

Monitoring and evaluation reports

This category includes 25 questions on reports that are used to monitor the budget’s execution during the fiscal year and to evaluate it after the year has concluded. These include: in-year reports on the budget’s execution, which the OECD recommends should be issued monthly; a mid-year review, which should provide a comprehensive report covering the first six months of the budget year; and a year-end report that should serve as the government’s key accountability document, which should be audited.

Public and legislative involvement

The third category is intended to capture those budget-related materials and aspects of the budget process that, if emphasised, can help to improve public understanding of the budget and contribute to increased involvement of the public and the legislature in the budget debate. This category includes 42 questions on budget documents that can enhance public debate and understanding, such as a pre-budget statement, and practices during the budget’s formulation and approval that can assist public involvement.

2.1. High scores

Only two countries – Slovenia and South Africa – score more than 67% in all three categories, and thus can be said to have strong practices in all of the major areas covered by the questionnaire. (A score of 67% implies that acceptable standards have been met, on average, for the questions in the category.) The Czech Republic and Poland were close to achieving this goal, scoring above 67% in the first two categories and just below 67% in the third category.

2.2. Low scores

Three countries – Bolivia, Ecuador, and Mongolia – score below 33% in all three categories, indicating serious deficiencies in terms of the openness of their national budget processes. Mongolia's score of zero in the first two categories is attributable to the fact that it makes none of the budget documents available to the public that are covered in the questionnaire. This includes the executive's budget proposal, which is not considered a public document. Five of the countries score below 33% in two of the three categories (Azerbaijan, Honduras, Nepal, Nicaragua, and Zambia).

3. Detailed findings by category and subcategory

This section of the report discusses in more detail the results from the 36 countries examined. The categories presented in the previous section are broken down into subcategories, and findings for each of these subcategories are presented below.

3.1. Executive budget documents

The countries on average receive the highest marks for information contained in the executive's budget proposal. The "executive budget documents" category averages a score of 56%, indicating that countries' performance on average is "mostly positive" in this category (see Table 2).

Countries on average tend to provide significant amounts of basic information on expenditures and revenues in the executive's budget proposal for the budget year and for past years, according to the subcategory scores. The subcategories that fare the best cover information for the budget year and beyond, and for the prior year and before. The two highest subcategory average scores are for the "budget year and beyond" at 65%, and "prior year and before" at 63%. Both are close to the level of 67% considered to be indicative of meeting acceptable standards on average for all questions in the subcategory.

However, the "comprehensiveness" subcategory has an average score of 40%, indicating weak performance. This suggests that in many countries in

Table 2. **Executive Budget Documents**

Country	Budget Year and Beyond			Prior Year and Before			Compre- hensiveness	Category Total
	Budget year (BY)	Multi-year (BY+2)	Sub- category Total	Prior year (BY-1)	Historical (BY-2)	Sub- category Total	Sub- category Total	Executive Budget
Argentina	81%	100%	87%	39%	43%	41%	55%	61%
Azerbaijan	70%	50%	64%	85%	100%	91%	36%	64%
Bangladesh	81%	0%	56%	94%	86%	91%	28%	58%
Bolivia	59%	0%	41%	0%	0%	0%	21%	21%
Botswana	96%	0%	67%	100%	86%	94%	92%	84%
Brazil	96%	100%	97%	15%	14%	15%	71%	61%
Bulgaria	56%	0%	38%	55%	90%	69%	29%	45%
Burkina Faso	70%	0%	49%	48%	29%	41%	79%	56%
Colombia	81%	42%	69%	42%	76%	56%	48%	57%
Costa Rica	85%	8%	62%	55%	86%	67%	41%	56%
Croatia	70%	0%	49%	39%	0%	24%	12%	28%
Czech Republic	100%	50%	85%	100%	95%	98%	76%	86%
Ecuador	74%	0%	51%	55%	0%	33%	7%	31%
El Salvador	81%	0%	61%	85%	71%	80%	33%	58%
Georgia	78%	0%	54%	67%	76%	70%	31%	52%
Ghana	78%	100%	85%	76%	100%	85%	21%	64%
Honduras	70%	75%	72%	58%	14%	41%	15%	43%
India	78%	0%	54%	82%	90%	85%	38%	59%
Indonesia	85%	0%	59%	70%	0%	43%	38%	47%
Jordan	74%	0%	51%	82%	95%	87%	64%	68%
Kazakhstan	59%	58%	59%	64%	57%	61%	23%	48%
Kenya	70%	92%	77%	76%	95%	83%	55%	72%
Malawi	67%	67%	67%	48%	24%	39%	50%	52%
Mexico	96%	0%	67%	85%	71%	80%	39%	62%
Mongolia	0%	0%	0%	0%	0%	0%	0%	0%
Namibia	89%	100%	92%	70%	90%	78%	33%	68%
Nepal	81%	0%	56%	88%	100%	93%	19%	56%
Nicaragua	63%	0%	44%	0%	0%	0%	14%	19%
Peru	93%	92%	92%	73%	95%	81%	56%	77%
Poland	100%	50%	85%	88%	90%	89%	64%	79%
Romania	89%	50%	77%	48%	43%	46%	29%	51%
Russia	78%	58%	72%	76%	100%	85%	33%	63%
Slovenia	100%	8%	72%	100%	100%	100%	86%	86%
South Africa	100%	100%	100%	100%	100%	100%	49%	83%
Uganda	74%	67%	72%	85%	90%	87%	19%	59%
Zambia	59%	58%	59%	42%	0%	26%	21%	35%
Average	77%	37%	65%	64%	61%	63%	40%	56%

Note: The category scores reflect the average of the subcategory scores. The scores for the subcategories were calculated by averaging the scores of the individual questions within each subcategory.

the study there is insufficient information in the budget proposal to provide the full information necessary to allow the public to assess the government's fiscal position during the budget year or in future budget years. For example, in some countries important information on items such as expenditure arrears, contingent liabilities, or future liabilities is not disclosed to the public in budget documents.

Box 2. Subcategories of “executive budget documents”

Table 2 provides more detail on the “executive budget documents” category, presenting the subcategories of questions that comprise this category.

The first subcategory is **budget year and beyond** and it includes 13 questions that ask about expenditure, revenue, and debt information provided in the executive's budget for the budget year and for future years. This subcategory is divided into two groupings, one relating to information provided during the budget year, and a second for projections of expenditures and revenues for the two subsequent budget years labelled “multi-year”.

The second subcategory is **prior year and before**, with 18 questions that ask about the basic financial data in the budget for the year prior to the budget year and for years before that. Such prior year information is essential during budget debates for comparative purposes. This subcategory is divided into two groupings, one regarding expenditure and revenue information provided for the year preceding the budget year, and another for information two or more years prior to the budget year labelled “historical”.

The third subcategory is **comprehensiveness**, and it asks questions about assumptions and activities that can have a significant impact on the budget during the year or in future years. This subcategory's 14 questions seek to examine whether the budget discusses, for instance, the economic assumptions upon which the budget estimates are based, extra-budgetary funds, quasi-fiscal activities, contingent liabilities, and donor assistance.

3.1.1. Budget year and beyond

The questions in the “budget year and beyond” subcategory have been broken down in Table 2 to show further detail to distinguish between information available for the budget year and multi-year projections covering future years. What is notable in this subcategory is that although countries on average tend to provide significant information for the budget year in formats that are suitable for policy analysis, many fail to provide information for future years. This indicates that many have yet to adopt best practices in

budgeting that call for strengthened planning and transparency in regard to their programmatic and fiscal goals in future years, such as adoption of a medium-term expenditure framework. The average score of 77% for information presented for the budget year stands in marked contrast to the average score of 37% for multi-year projections for future years.

A total of 26 countries have positive scores (at least 67%) with regard to the basic budget data for the budget year provided in the executive's budget proposal. No country except Mongolia scores below 50% for this grouping. For information provided during the budget year, eight countries score above 90%, with four countries – Czech Republic, Poland, Slovenia, and South Africa – scoring 100%.

Regarding information presented for future budget years, five countries have scores of 100% on the questions dealing with multi-year projections. Argentina, Brazil, Ghana, Namibia, and South Africa have multi-year budgets that provide detailed expenditure and revenue estimates. Kenya and Peru also show strong performance in providing multi-year information. In contrast, 16 countries do not present multi-year budgets covering at least two years beyond the budget year. A further 12 countries present some limited multi-year information.

3.1.2. *Prior year and before*

In the “prior year and before” subcategory the scores for the presentation of data covering the prior year and those covering a longer historical period are about the same – 64% and 61% respectively. Slovenia and South Africa scored 100% on both provision of budget information for the year prior to the budget year and for previous years. Azerbaijan, Bangladesh, Botswana, Czech Republic, and Nepal also provide substantial information on previous budget years, all scoring above 90% in the “prior year and before” subcategory.

In sharp contrast, Bolivia and Nicaragua provide no prior year or historical data in their budgets. Mongolia does not make its budget available to public and, as such, also scores 0% for the prior year and before subcategory. In addition, four other countries – Croatia, Ecuador, Indonesia, and Zambia – include no historical data beyond the prior year.

3.1.3. *Comprehensiveness*

The responses to the questions in the “comprehensiveness” subcategory indicate especially weak performance. Fifteen countries have scores of less than 33%, indicating negative performance in disclosing information on such activities as tax expenditures, quasi-fiscal activities, non-financial assets held by government, and the future liabilities that government faces (such as civil service pensions). Only five countries – Botswana, Brazil, Burkina Faso, Czech

Republic, and Slovenia – have positive practices in this area, based on their scores of 67% or higher.

The “comprehensiveness” subcategory contains questions that attempt to assess whether **all** government activities that may have an impact on the budget are fully disclosed to the legislature and the public in budget documents. In some countries, for instance, entities outside central government (such as public corporations) undertake fiscal activities. Similarly, activities that can have a significant impact on the budget (such as payment arrears and contingent liabilities) are not properly captured by the regular modes of presenting expenditure, revenues, and debt. A lack of transparency and mismanagement of such activities have led to an enormous drain on government budgets in many countries.

3.2. Monitoring and evaluation reports

In contrast to the information contained in the executive’s budget proposal, the responses indicate that far fewer countries of the 36 countries examined have positive practices in terms of issuing to the public reports that monitor the budget while it is being implemented or that evaluate the budget once the fiscal year has been completed. The second major category in the study – “monitoring and evaluation reports” – receives an average score of 44%, indicating mostly negative performance on average (see Table 3).

This suggests that countries are doing a fairly poor job in both presenting in-year monitoring reports and end-of-year evaluation reports, with these subcategories showing scores of 45% and 43% respectively. The low scores for the executive’s year-end report is especially of concern because this document should serve as the government’s key accountability document, showing the executive’s compliance with levels of revenues and expenditures authorised by the legislature in the budget.

3.2.1. In-year monitoring

In the “in-year monitoring reports” subcategory, a total of 19 countries score below 50%, indicating that about half of the countries in the sample do a poor job of reporting their in-year budget activities. Only Slovenia scores 100% for both in-year reports and the mid-year review. Poland also receives substantially high scores on in-year reporting and for its mid-year review.

Significantly, a total of six countries provide no regular in-year reports monitoring the progress of the budget (Azerbaijan, Botswana, Ghana, Indonesia, Malawi, and Mongolia). An additional 11 countries score less than 50% in the “in-year monitoring reports” subcategory, providing scanty or delayed information on expenditures, revenues, and borrowing during the

Table 3. **Monitoring and Evaluation Reports**

Country	In-Year Monitoring Reports			End-of-Year Evaluation Reports			Category Total
	In-Year Reports	Mid-Year Review	Subcategory Total	Year-End Reports	Audit Reports	Subcategory Total	Monitoring and Evaluation Reports
Argentina	74%	0%	51%	48%	13%	33%	42%
Azerbaijan	0%	0%	0%	0%	47%	19%	10%
Bangladesh	74%	0%	51%	43%	7%	28%	40%
Bolivia	26%	0%	18%	0%	13%	6%	12%
Botswana	0%	0%	0%	76%	93%	83%	42%
Brazil	48%	50%	49%	24%	87%	50%	49%
Bulgaria	100%	0%	69%	57%	27%	44%	57%
Burkina Faso	52%	0%	36%	71%	20%	50%	43%
Colombia	33%	25%	31%	43%	40%	42%	36%
Costa Rica	19%	0%	13%	61%	33%	50%	31%
Croatia	74%	0%	51%	38%	67%	50%	51%
Czech Republic	81%	67%	77%	81%	67%	75%	76%
Ecuador	48%	0%	33%	29%	0%	17%	25%
El Salvador	63%	0%	44%	57%	27%	44%	44%
Georgia	70%	33%	59%	43%	53%	47%	53%
Ghana	0%	75%	23%	62%	20%	44%	34%
Honduras	4%	0%	3%	14%	7%	11%	7%
India	41%	50%	44%	0%	40%	17%	30%
Indonesia	0%	58%	18%	71%	73%	72%	45%
Jordan	81%	0%	56%	0%	87%	36%	46%
Kazakhstan	85%	0%	59%	19%	7%	14%	36%
Kenya	59%	83%	67%	62%	60%	61%	64%
Malawi	0%	0%	0%	0%	27%	11%	6%
Mexico	85%	58%	77%	71%	53%	64%	70%
Mongolia	0%	0%	0%	0%	0%	0%	0%
Namibia	11%	50%	23%	0%	13%	6%	14%
Nepal	37%	50%	41%	38%	0%	22%	32%
Nicaragua	74%	0%	51%	29%	0%	17%	34%
Peru	96%	0%	67%	76%	40%	61%	64%
Poland	96%	100%	97%	95%	100%	97%	97%
Romania	100%	0%	69%	52%	27%	42%	55%
Russia	81%	75%	79%	62%	80%	69%	74%
Slovenia	100%	100%	100%	100%	93%	97%	99%
South Africa	100%	83%	95%	76%	60%	69%	82%
Uganda	41%	33%	38%	62%	53%	58%	48%
Zambia	33%	8%	26%	38%	33%	36%	31%
Average	52%	28%	45%	44%	41%	43%	44%

Note: The category scores reflect the average of the subcategory scores. The scores for the subcategories were calculated by averaging the scores of the individual questions within each subcategory.

Box 3. Subcategories of “monitoring and evaluation reports”

Table 3 presents more details of the “monitoring and evaluation reports” category, which is comprised of the two subcategories described below.

The first examines **in-year monitoring reports**. The 13 questions in the in-year monitoring subcategory ask about the availability of in-year reports and the mid-year review that can be used to assess progress in implementation of the budget during the fiscal year. This subcategory is divided into two groups, one relating to regular periodic reports on the budget’s execution that the OECD recommends should be issued monthly, and a second grouping showing the country’s mid-year review.

The **end-of-year evaluation reports** subcategory consists of 12 questions that ask about the availability and content of a year-end report, and an audit report prepared by the supreme audit institution that can be used to assess the budget once the budget year has ended. This subcategory is divided into two groupings, one that shows a score for the country’s year-end report, and a second grouping for the audit of the year-end report.

fiscal year (Bolivia, Brazil, Colombia, Costa Rica, Ecuador, Honduras, India, Namibia, Nepal, Uganda and Zambia).

A total of 19 countries – slightly more than half the countries in the sample – do not produce mid-year reviews. This is of serious concern because the mid-year review is a highly significant document for tracking the progress of the budget during the fiscal year. This report should provide a comprehensive update on the budget’s implementation, and should disclose the impact of any changes to macroeconomic assumptions and of any government decisions or other circumstances that will significantly impact the budget for the remainder of the year.

3.2.2. End-of-year evaluation

In the “end-of-year evaluation reports” subcategory, 25 countries score 50% or below, implying notable weaknesses in this area. The year-end report is especially significant because it should serve to demonstrate the executive’s compliance with the levels of spending and revenue collections authorised by the legislature, as well as explain any deviation from these levels. The report should also include non-financial data to allow the public to evaluate the executive’s performance during the year.

Further, it is essential that an independent body audit the year-end report and issue a public report on its finding. This is a key function of a national

supreme audit institution. Yet the study finds that only Poland and Slovenia scored 90% or better for the provision of information in both their year-end reports and audit reports. Poland scores 100% for audit reports, while Slovenia receives a perfect score for year-end reports.

At the same time, ten countries – Azerbaijan, Bolivia, Ecuador, Honduras, India, Kazakhstan, Malawi, Mongolia, Namibia, and Nicaragua – had exceptionally low scores for both year-end reports and audit reports, with their scores for the end-of-year evaluation subcategory at 20% or lower.

3.3. Encouraging public and legislative involvement in the budget

The study finds that the weakest aspect of the budget process in nearly all of the countries has to do with efforts by the executive or the legislature to facilitate public discourse and understanding of the budget. Most executives fail to provide information to the public and to legislatures that can help make the budget and the policies it embodies more understandable. Without such information, a wider and informed debate on a nation's fiscal priorities is impossible. The study's third category – “encouraging public and legislative involvement in the budget” – receives an average score of 40%, the lowest average score of the three major categories (see Table 4).

3.3.1. Highlighting policy and performance goals

The lowest average score for any subcategory in the study relates to information provided to highlight policy and performance goals. The average score in this subcategory is 31%. The weakness of this average score is a concern because effective budgeting requires that policy goals be aligned with budget allocations, yet few countries are providing the necessary information to assess this essential aspect of their budgets. This includes providing non-financial data that would allow for evaluation of the effectiveness of spending programmes, such as the number of beneficiaries for a programme, other performance indicators or targets, and information on policies specifically intended to assist the poor.

Only three countries – Czech Republic, Slovenia, and South Africa – have scores above 67% in this subcategory, indicating the common availability of this policy and performance information. Notably, a total of 19 countries have scores below 33%, and ten of these countries – Bolivia, Croatia, Ecuador, El Salvador, Georgia, Honduras, Kazakhstan, Mongolia, Nepal, and Nicaragua – have exceptionally low scores at 10% or lower.

3.3.2. Involvement of the legislature

The involvement of the legislature in the budget process is, on average, slightly weak in the 36 countries answering the questionnaire, with an

Table 4. **Encouraging Public and Legislative Involvement in the Budget**

	Highlighting Policy and Performance Goals	Involvement of the Legislature			Facilitating Public Discourse and Understanding			Category Total
Country	Subcategory Total	Approving Budgets	Engaging with the Budget	Subcategory Total	Supple- mentary Materials and Explanations	Encouraging Budget Debate	Subcategory Total	Encouraging Public and Legislative Involvement
Argentina	54%	61%	48%	54%	37%	43%	40%	49%
Azerbaijan	18%	40%	52%	47%	19%	14%	17%	27%
Bangladesh	54%	44%	24%	33%	30%	38%	33%	40%
Bolivia	0%	39%	33%	36%	11%	24%	17%	18%
Botswana	25%	56%	67%	62%	26%	14%	21%	36%
Brazil	44%	83%	62%	72%	30%	90%	56%	57%
Bulgaria	21%	50%	33%	41%	19%	71%	42%	34%
Burkina Faso	15%	56%	76%	67%	52%	76%	63%	48%
Colombia	31%	50%	29%	38%	41%	48%	44%	38%
Costa Rica	41%	72%	52%	62%	30%	43%	35%	46%
Croatia	0%	56%	52%	54%	37%	76%	54%	36%
Czech Republic	85%	72%	38%	54%	67%	43%	56%	65%
Ecuador	3%	28%	24%	26%	0%	29%	13%	14%
El Salvador	8%	83%	52%	67%	44%	24%	35%	37%
Georgia	10%	44%	33%	38%	19%	29%	23%	24%
Ghana	46%	44%	43%	44%	11%	5%	8%	33%
Honduras	8%	83%	29%	54%	15%	14%	15%	25%
India	23%	56%	33%	44%	70%	10%	44%	37%
Indonesia	49%	89%	38%	62%	26%	71%	46%	52%
Jordan	33%	33%	33%	33%	26%	29%	27%	31%
Kazakhstan	8%	61%	33%	46%	30%	33%	31%	28%
Kenya	46%	44%	52%	49%	41%	48%	44%	46%
Malawi	46%	40%	29%	33%	22%	14%	19%	33%
Mexico	49%	53%	43%	47%	33%	62%	48%	48%
Mongolia	0%	61%	29%	44%	0%	29%	13%	19%
Namibia	31%	72%	29%	49%	19%	19%	19%	33%
Nepal	8%	0%	0%	0%	19%	10%	15%	7%
Nicaragua	10%	22%	24%	23%	26%	29%	27%	20%
Peru	33%	67%	48%	56%	63%	52%	58%	49%
Poland	38%	61%	86%	74%	59%	95%	75%	63%
Romania	56%	83%	24%	51%	59%	29%	46%	51%
Russia	13%	56%	76%	67%	33%	76%	55%	45%
Slovenia	87%	94%	76%	85%	81%	90%	85%	86%
South Africa	72%	83%	81%	82%	71%	81%	76%	77%
Uganda	51%	50%	33%	41%	67%	76%	71%	54%
Zambia	15%	39%	24%	31%	4%	19%	10%	19%
Average	31%	56%	43%	49%	34%	43%	38%	40%

Note: The category scores are the average of the subcategory scores. The scores for the subcategories were calculated by averaging the scores of the individual questions within each subcategory.

average score of 49%. The countries, on average, show somewhat better practices, scoring 56%, on the questions related to the legislative approval of the budget. A total of 11 countries score 67% or above in this area, and these higher scores indicate the extent to which the executive consults with the legislature during the budget's formulation, the legislature's legal powers to amend the budget, and the legislature's role in approving supplemental budgets and contingency funds.

However, the group of questions labelled “engaging with the budget” receives substantially lower scores than does the previous grouping related to legislative approval of the budget. These questions ask, for instance, whether the legislature is holding public hearings on the budget, an essential step if the legislature is to review and understand the budget in detail. Another question asks how far in advance of the start of the fiscal year the legislature receives the budget, giving an indication of the amount of time available for the legislature to debate the budget. These questions show an average score of 43%, with 10 countries scoring less than 33%. Nepal scores zero for this subcategory of questions on the legislature because the authorities dissolved the legislature in 2002 due to a civil conflict.

3.3.3. Facilitating public discourse and understanding

Under the “facilitating public discourse and understanding” subcategory, both groupings of questions (supplementary materials and explanations, and encouraging budget debate) show low scores. In particular, the 34% average score for the questions involving the provision of supplementary materials and explanations is quite low. In total, 20 countries have scores of less than 33% on these questions, and ten of these countries have scores below 20%. Such scores indicate that governments are not taking steps to provide non-technical descriptions of the budget – for instance, in the form of a “citizens’ budget” – or other information that can help the public better understand the budget and the budget process.

Although somewhat higher at 43%, the average score for the questions examining whether the executive is taking steps to encourage budget debate is still fairly low. This reflects in large part the fact that few countries release a comprehensive pre-budget statement in advance of the budget to outline the budget and stimulate discussion; 17 countries (or slightly less than half of the total) do not release any pre-budget statement to the public. In other countries, the release date of the budget is not known far enough in advance to give the legislature and interested civil society groups sufficient time to prepare for its release and provide input on budget policies.

Box 4. Subcategories of “encouraging public and legislative involvement in the budget”

The results for the category “encouraging public and legislative involvement in the budget” are presented in Table 4. The category is divided into the three subcategories discussed below.

The **highlighting policy and performance goals** subcategory has 13 questions that ask whether the budget discusses specific policy proposals separately from ongoing activities. They also ask whether the budget (and year-end reports) includes non-financial data or other information that help assess the performance of government programmes.

The **involvement of the legislature** subcategory asks 13 questions about the role of the legislature in approving the budget, including supplemental budgets, and actions it takes to examine the budget, such as holding public hearings. This subcategory is divided into two groupings, the first relating to the approval of budgets, which deals with the extent to which the executive consults with the legislature during the budget’s formulation, the legislature’s legal powers to amend the budget, and the legislature’s role in approving supplemental budgets and contingency funds. The second grouping, engaging with the budget, examines how far in advance of the budget year the legislature receives the budget proposal, whether legislative committees hold hearings on the budget’s macroeconomic framework, and hearings on the individual budgets of administrative units such as ministries or agencies.

The third subcategory is **facilitating public discourse and understanding**. These 16 questions examine a range of activities that the executive could undertake to help promote wider debates on the budget. The subcategory is split into two parts. The first group of questions examines whether the executive is providing supplementary materials and explanations that can assist the legislature and the public to better understand the technical aspects of the budget and the context in which the budget debate occurs. The second group of questions looks at steps the executive could take to encourage more budget debate, such as releasing a pre-budget statement and clarifying its release timetable for the executive’s budget proposal.

4. Responses to specific questions

This section of the report examines country responses to the individual questions contained in the *Open Budget Questionnaire*. Examining the responses to individual questions highlights specific ways in which countries in the sample typically engage in positive and negative budget practices.

The findings of this section are similar to those discussed above relating to the category and subcategory averages. For instance, the individual questions in the “encouraging public and legislative involvement in the budget” category fare worse than questions in the “executive budget documents” category. There are, however, identifiable specific budget practices – such as issuing citizens’ budgets, monitoring extra-budgetary funds, tracking policies to benefit the poor, and describing the conditions of international aid, to name a few – where examining the responses to individual questions is more informative than the category or subcategory scores.

The score for a particular question reflects the average of the 36 country responses to the question. Those questions with an average score of 67% or above indicate that the practices assessed are at least mostly fulfilled in the countries examined. Questions with an average score of less than 33% indicate that the practices, on average, are used only to a small degree across the countries.

As Table 5 indicates:

- There were 21 questions for which the average score was 67% or more, indicating positive practices. The highest score was on the issue of whether the executive’s budget documents provided information on interest payments for the budget year; all the survey countries but Mongolia provide such information, yielding a score of 97% for this question.
- There were 34 questions for which the average score was less than 33%, indicating negative practices. The lowest score applied to whether the legislature held hearings on departmental budgets that included testimony from the public. The vast majority of countries fail to hold such hearings, yielding the meagre score of 10%. Few of the countries examined provide an official forum for the public to comment on this key feature of a budget proposal.
- There were 57 questions for which the answers scored from 33% to 67%; that is, the scores to just over half of the questions indicate practices that are mostly positive (50% to 66%) or mostly negative (33% to 49%). In all these cases, the scores suggest room for improvement.

Table 5. Answers to the 112 individual questions

	Number in category	Percent of questions
Positive practices (67% or more)	21	19%
Negative practices (less than 33%)	34	30%
Other (between 33% and 67%)	57	51%

For a complete list of the individual questions and their scores, see the IBP website at www.internationalbudget.org/openbudgets/index.htm.

4.1. Positive practices

Out of the 21 questions with scores of 67% or above, 16 relate to the provision of budget year or prior year information in the executive budget documents. These include the seven questions with the highest scores. This result reinforces the report's conclusion that most of the countries examined provide significant basic budget information. In cases where a country fails to provide such information, however, its budget documents are falling short in a fundamental fashion.

- For the budget year, countries typically are quite good at presenting information in the executive's budget proposal on interest payments on the debt (a 97% score), sources of tax revenue (93%), sources of non-tax revenue (88%), expenditures classified by administrative unit (85%), and expenditures by economic classification (75%).
- For the year prior to the budget year, countries also generally meet the standards when it comes to providing sources of tax revenue (78%) and non-tax revenue (74%). Note the drop-off, however; countries provide less information about revenues for the prior year than they do for the upcoming budget year.

Of the remaining five questions with high scores, three relate to the role of the legislature. Two of the questions are worth noting. The expenditure budget approved by the legislature tends to include a reasonable amount of detail. The average score on this question was 74%. More than a third of the countries provide full programme-level detail, while the large majority of the remaining countries provide at least expenditures by administrative unit or functional classification. Since it is the budget that is approved by the legislature that is the one to be implemented, the provision of adequate details is essential to ensure proper oversight.

Also of importance, the executive branch of most of the countries tends to comply with legislative requests for more detailed budget information; the average score here was 73%. Positive practices in this area are vital to the legislature's ability to fulfill its oversight responsibilities.

4.2. Negative practices

Significantly more questions received scores below 33% than scores of 67% or above. The large majority of the 34 questions that received scores indicating negative practice fell into the following four subcategories:

- **Nine of the 13 questions in the area of "highlighting policy and performance goals" received scores below 33%.** As examples, most countries failed to design performance targets that enable one to assess

whether progress is being made toward meeting policy goals (the score on this question was just 19%); to provide non-financial data useful for assessing how an expenditure programme is performing (22%); or to use performance indicators (26%). The low scores on these and other performance or policy indicators make it difficult to assess whether government budgets are aligned with policy priorities. Further, even when key policy connections are described in the executive's budget, whether or not the implemented budget achieves these connections frequently is not assessed. For instance, while all but seven countries provide at least some information in the executive budget on how policies benefit directly their most impoverished populations, 19 countries fail to provide any information on how actual spending levels on programmes to assist the nation's poor differed from enacted levels. Because of the frequently large gap between the amount of funds enacted to be spent on a programme and the amount of funds that is actually spent, the absence of information on this gap is troubling.

- **Seven of the 14 questions in the area of the “comprehensiveness” of the executive’s budget had scores of less than 33%.** In their budgets, most countries provided little or no information about non-financial assets (scoring 21%), quasi-fiscal activities (23%), future liabilities (23%), tax expenditures (27%), financial assets (28%), expenditure arrears (30%), and the impact of different macroeconomic assumptions (31%). The poor practices in the first six of these questions point towards a common deficiency in the budget documents of many countries. Even though a large share of budget activities are carried out through activities or mechanisms that are not captured in the standard presentations of revenue and expenditure, information concerning these activities or mechanisms is typically absent.
- **Five of the 16 questions relating to “facilitating public discourse and understanding” scored less than 33%.** Only six countries – Colombia, El Salvador, India, Slovenia, South Africa, and Uganda – have a “citizens’ budget” that provides a non-technical presentation of the budget designed for a broad audience; the remaining 30 countries examined do not. In another example, only five countries – Argentina, Costa Rica, Peru, Poland, and Slovenia – provide significant information about the distribution of tax burdens.
- **Four of the 13 questions concerning the “involvement of the legislature” did poorly.** There were several questions which indicated room for substantial improvement. Three of these questions relate to legislative hearings. Legislatures in 17 countries do not hold public hearings on the macroeconomic and fiscal framework, while 14 countries hold quite limited hearings in this area. In 27 countries, the legislature does not release any type of public report on its hearings. In 28 countries, the hearings on the individual budgets of the government’s administrative units do not include testimony from the public, so only the government’s view is represented.

The poor practices in this area indicate that most countries are failing to develop one of the most direct forums for encouraging broader understanding of and debate over the budget.

4.3. Other observations

Macroeconomic forecasts lack sensitivity analyses. While 23 countries present a fairly detailed macroeconomic forecast upon which budget projections are based, only 12 countries include a detailed analysis of the effects of alternative economic assumptions, such as different rates of inflation or economic growth. Such a sensitivity analysis is important, because modest changes in macroeconomic assumptions can lead to substantial variations in expected budget outcomes, such as the amount of the deficit.

Multi-year budgets contain insufficient detail. About half of the countries surveyed provide aggregate levels for estimated expenditures and revenues for a multi-year period. Yet only about one-quarter of the countries provide disaggregated information for expenditures and revenues for a multi-year period. Detailed multi-year projections are necessary to understand the anticipated path of expenditures on particular programmes or the collection of certain revenues.

All four of the questions related to the mid-year review received scores of less than 33%. Only Kenya, Poland, Russia, and Slovenia fared well on all four questions and release a comprehensive mid-year review that discusses changes in the economic outlook and provides updated expenditure and revenue estimates. This finding further documents the limited use of this potentially helpful report. When done properly, it provides an important mid-year snapshot of how the budget is being implemented.

Information on the conditions associated with International Financial Institution (IFI) and donor assistance is sorely absent. Some 23 countries provide no budgetary information explaining conditions associated with assistance from donor countries; 20 countries provide no information about conditions associated with IFI aid. Just four countries – Burkina Faso, Poland, Slovenia, and Uganda – provide fully comprehensive information about donor country aid conditions; the same four countries are the only ones that provide fully comprehensive information about conditions applying to IFI assistance. Since these conditionalities can play an important role in shaping government's budget policy choices, it is clear many countries should place a higher priority on making them known to the public.

5. The public availability of budget documents

This section of the report examines the public availability of various documents linked to the formulation, approval, execution, and monitoring of the budget in the respondent countries. Making these documents publicly

available is one of the first and most important steps to cultivate an open and accountable budget process.

The information for this section is taken from the “distribution of budget reports” chart at the end of each country’s questionnaire (see IBP website) and is not included in the scores discussed elsewhere in this study. The information provided in these charts shows that the countries surveyed have an uneven approach to making budget-related documents available to the public. Further, in a number of countries, documents were prepared but not released to the public; rather, they were used only by the executive or the legislature for internal purposes. In these countries, the openness of their budget processes could be improved simply by making these documents available to the public.

5.1. Publicly available information essential for an open budget process

The *Open Budget Questionnaire* pays particular attention to the information that is made available to the public, from the executive’s proposed budget to the final audit reports released after the budget year has been completed. Although information that the executive may have but does not make public can assist the executive with its task of managing the budget, information available only for internal purposes does not help to inform the public about the budget. Only information that is available to the public can help deepen the public’s understanding of the budget and ultimately facilitate a more inclusive and accountable budget process (see Box 5 for an explanation of when a document is “released to the public”).

This analysis specifically examines whether a country follows the recommendations contained in the *OECD Best Practices for Budget Transparency* with regard to issuing six key budget documents – the pre-budget statement, the executive’s budget proposal, in-year monitoring reports, a mid-year review, year-end evaluation reports, and independent audit reports. In addition, the questionnaire asks whether the executive releases a “citizens’ budget” – that is, a non-technical discussion of its budget proposals intended to reach a wide audience.

To be of significant value to the public, bolstering its role in the budget process, documents provided to the public must be comprehensive, understandable, and timely. Other parts of the questionnaire examine these crucial questions in more detail. This section of the report focuses only on the most basic question: Is a particular document made available to the public? This is the first crucial step in making a budget process more open. Once a document is made public, its comprehensiveness, clarity, and timeliness can always be improved. In fact, the more a document is subject to public scrutiny and use, the more likely feedback will improve its contents over time. So making it public is an essential first step.

Box 5. What is meant by “public document”?

The questionnaire focuses on documents released to the public. Budget documents and reports that are produced by the executive or other entities such as the supreme audit institution may fall into three categories:

- those that are produced for internal purposes only and are not made available to the public;
- those that are made available to the public either free of charge or for a minimal fee, but only if the public requests the particular documents from the executive; and
- those that are distributed to the public either free of charge or for a minimal fee, such that the public can access the documents through means other than requesting them directly from the executive (for instance, on the Internet or from a public library).

A document is considered as “released to the public” in either the second or third categories above. A document must be available to any member of the public who requests it to meet the conditions of the second category.

5.2. Budget documents made available to the public

Table 6 shows that two-thirds or more of the 36 countries examined make available to the public four of the six documents recommended by the OECD: the executive’s budget proposal, in-year reports, year-end reports, and audit reports. About half of the countries provide the other two documents: the pre-budget statement and the mid-year review. Only a relatively small number of countries release a citizens’ budget. Only four countries – Colombia, Slovenia, South Africa, and Uganda – provide all seven documents to the public.

Table 6. **Budget documents made available to the public**
(out of 36 countries completing the questionnaire)

	Number of countries	Percent of total
Pre-budget statement	19	53%
Executive’s budget proposal	35	97%
Citizens’ budget	6	17%
In-year monitoring reports *	27	75%
Mid-year review	17	47%
Year-end evaluation reports	29	81%
Audit reports	24	67%

* Results for in-year expenditure reports only.

The most prevalent public document is the executive's budget proposal, which is publicly available in 35 of the 36 countries examined. Of all the budget documents, the executive's budget typically is the most detailed and it receives the most attention in the media and by the public. Only in Mongolia, where the executive provides the budget just to the legislature (which is not allowed to distribute it), is the document not available to the public. A high percentage of countries provide in-year reports monitoring expenditure (75% of the countries), year-end evaluation reports (81%), and audit reports (67%) to the public. These reports are essential for assessing the execution of the budget and the extent to which the financial and policy goals embodied in the budget have been met.

As noted, about half of the countries examined make available to the public a pre-budget statement and a mid-year review. Some might argue that these documents are less important than the others. But their value should not be underestimated, particularly when it comes to facilitating public discourse and understanding. Both documents tend to be less technical than other reports, typically putting the budget information into the context of larger fiscal and economic circumstances. A pre-budget statement can be particularly important in countries where the legislature has only a short time to debate the budget.

The fewest number of countries provide a citizens' budget. Here again, some may try to make the case that this document is not essential, as it is simply repeating information that is already presented in the main executive budget document. Further, a citizens' budget could be prepared by a group outside the executive with the information provided in the budget, raising issues as to whether such a document is a responsibility of the executive. But the questionnaire asks about the executive providing a citizens' budget in part to gauge the executive's efforts at providing information to the public that is clearer and more accessible than the budget document, whose presentation is often fairly technical. In general, the questionnaire seeks to assess the extent to which the executive has made the extra effort to clarify to the public the policy goals and funding priorities embodied in the budget. The citizens' budget is an important component of such an effort.

5.3. Budget documents that are not made available to the public

In many cases, documents that are not made available to the public are in fact prepared, but are only used by the executive or the legislature for their internal purposes.

- Although one-quarter of the 36 countries examined do not release to the public in-year reports monitoring expenditures and one-fifth do not release year-end evaluation reports, all of these countries except one – Namibia –

prepare these reports for internal purposes. That is, the executive collects the relevant information, but uses it only for its own management purposes.

- Similarly, one-third of the countries do not make audit reports available to the public, but all of these countries except one – Nicaragua – have a regular audit process, and audit reports are prepared for the use of the executive or the legislature. Even in the case of pre-budget statements, more than two-thirds of the countries that do not release this report to the public prepare it for internal purposes.
- Only in the case of the mid-year review are there few instances of it being prepared for internal purposes. (In the case of the citizens' budget, it would make no sense for the executive to prepare it for internal purposes.)

Unlike other parts of the study, which are based on the assessments of public documents made by non-governmental researchers, the findings in this section are more difficult to verify because they involve documents that are not publicly available. Even if a non-governmental researcher can confirm the existence of a document prepared by the executive for internal purposes, it can be very difficult for the researcher to assess the contents of the document to determine if it meets the desired standards. Nevertheless, the findings still seem to point to the existence of a significant amount of information that is prepared for internal purposes but not released to the public, even though international organisations such as the OECD recommend that such information be disclosed to the public.

To improve the openness of the budget process in a country, therefore, more of these documents prepared for internal purposes should be made available to the public. The most difficult step in providing budget information to the public is actually collecting the information and putting it into reports. This can sometimes involve developing complicated collection processes and databases. Thus a call to make certain information public could require a significant undertaking on the part of the executive. But in many of these cases, the country has already undertaken the difficult step of collecting the information and preparing the report. Therefore making these documents available to the public is an easier next step for these governments to take to make their budget processes more open.

5.4. Making budget documents more widely available

The executive can take any number of steps to make budget documents and budget information more accessible to the public. For instance, it can announce in advance when documents will be released, so that the media and the public can be better prepared to engage in a discussion of their contents. Documents can be written in plainer, less technical language or, in some countries, translated into multiple languages to accommodate more diverse

Table 7. **Budget documents not available to the public**
(number of countries, out of 36 countries completing the questionnaire)

	Reports prepared for internal use	Reports not prepared at all	Total, not available to the public
Pre-budget statement	13	4	17
Executive's budget proposal	1	0	1
Citizens' budget	n.a.	30	30
In-year monitoring reports*	8	1	9
Mid-year review	11	8	19
Year-end evaluation reports	6	1	7
Audit reports	11	1	12

* Results for in-year expenditure reports only.

populations. The executive can more actively promote the budget with the media and the public, making itself more available for public discussions.

Budget documents can also be distributed more widely. Often, public documents are available only if requested or are available only to a narrow group of technicians in the capital city. Narrower distribution may be appropriate for a technical report, but broader access is surely more desirable for other budget documents. Making documents available in a timely manner at a wide range of locations, from the public library to the Internet, can greatly increase the potential for public access.

5.5. Many countries post documents on the Internet

Posting budget documents on the Internet is becoming increasingly more common. Of the 36 countries examined, all but three – Honduras, Kenya, and Zambia – post at least one budget document on the Internet. Colombia, Slovenia, and South Africa post all seven of the documents, from the pre-budget statement to audit reports, on the Internet. Brazil, Mexico, and Russia post all of the documents recommended by the OECD (i.e. all but the citizens' budget, which they do not produce). Internet links to budget documents available on line are provided in the “list of budget documents” chart for each country (see IBP website).

Although making budget documents available on line is a practice that should be encouraged, it is not without its limitations. The biggest problem in poorer countries is that only a limited segment of the population has Internet access. Sometimes budget documents are quite large, potentially making them difficult and costly to download. Nevertheless, even when such problems exist, interested parties – such as non-governmental organisations, international institutions, and academic researchers – still have much easier access to

documents available on line, and these groups in turn can further the dissemination process.

Information is most valuable when it is made available in a timely fashion. While availability of a document on the Internet can be a sign of timeliness, it is no guarantee. In some cases, documents are only posted some time after a “hard copy” of the document has been released to the media or the public. For instance, in some cases researchers provided links to government websites, but noted that the documents on these websites were out of date and that, for all practical purposes, the executive was not making relevant documents available on line. Governments should commit themselves to keeping websites up-to-date and using the Internet as a way to make budget information more accessible in a timely manner.

6. Conclusions: taking open budget work forward

In the near term, we hope that this study as well as the detailed questionnaires for each country found on the IBP website will be of use to countries that are interested in opening up their budget systems. The information here is designed to assist civil society organisations around the world in their own assessments of their budget systems and how they might be improved. A few of the lessons that emerge are discussed below.

- **Progress on budget transparency is feasible and sometimes can be achieved within a short period.** The development of budget systems that are open in a wide range of ways in a relatively short time period has been accomplished already in the Czech Republic, Poland, Slovenia, and South Africa.
- **Concrete steps towards improvements are readily identifiable.** We believe each of the completed *Open Budget Questionnaires* for the countries in this study suggests concrete steps that a government may take to improve its performance. As examples, in some instances this may be through the adoption of a multi-year budget. In other cases, it will necessitate strengthening the comprehensiveness of the budget by improving the quality of information disclosed regarding extra-budgetary funds, quasi-fiscal activities, tax expenditures, and contingent liabilities. For many countries, in-year reporting and year-end reporting are in significant need of improvement.
- **Facilitate public and legislative involvement.** This study indicates that countries should take much larger steps to further open national budget processes to broader citizen participation. In some countries, the executive could greatly increase information available during the formulation phase by issuing a pre-budget statement that discloses the macroeconomic assumptions and revenue and expenditure parameters with which it will

formulate the budget. In other countries, opening the budget process will require making the legislature's involvement in budget deliberations more meaningful by providing sufficient time prior to the start of the budget year for legislative debate. And in many others, legislative hearings open to the public on the budget would greatly increase public understanding of the government's handling of important policy issues.

- **Make budget documents available to the public.** Public access to budget documents is vital to ensuring government financial accountability, and for the public's informed participation in budget debates. Yet in many cases essential documents are already produced by governments for internal use but are not released to the public. Many countries could improve their budget processes simply by releasing documents that they already routinely prepare.

These are just a sampling of the policy implications that flow from the study. We are eager to hear from the governments in the countries examined about their assessments of our findings, and would be glad to engage in discussions about them.

More generally, we hope that this questionnaire and this study will be a useful departure point for civil society researchers around the globe interested in opening up the budget processes in their countries. We encourage new researchers to use the survey instrument in their own countries, believing that its use will both help them to improve their understanding of their own budget systems and to develop a reform agenda.

Further, the questionnaire may offer a starting point for wider efforts researchers might undertake to examine the budget systems of their countries. The questionnaire can complement analysis of other issues – such as the relationship between national and sub-national budget policies or the operations of natural resource funds – essential to understanding the impact of budget policies in certain countries.

Here at the International Budget Project we intend to distribute this study widely, partly to receive comments on how our method and analysis can be improved. We also see this study as one part of our broad array of efforts to encourage budget transparency worldwide. The current intent is also to issue another study in the future, replicating, with necessary amendments, our current methodology and including more countries. A potential series of cross-country studies would help track progress on opening budget processes over time.

In many ways, and in many countries, how to make budgets more open, accountable, and participatory is a discussion in its infancy. We hope this cross-country study helps deepen this discussion. And, with our colleagues around the world, the IBP remains committed to working to continue to strengthen our open budgets initiative in an attempt to further advance

progress on issues so essential to ensuring the accountability of the single most important piece of legislation enacted by governments on an annual basis: the budget.

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Budgeting in Switzerland

by

Dirk-Jan Kraan and Michael Ruffner*

The Swiss budgeting system is characterised by three special features: the political environment; the debt containment rule; and the nature of the federal budget as a transfer budget. Prominent features of the political environment are direct democracy, consensus and federalism. The debt containment rule requires a balanced cyclically adjusted general government budget (zero deficit). The nature of the federal budget as a transfer budget implies among other things that around a quarter of total federal expenditure is spent by the federal government, the rest being transferred – mainly to sub-national government and social security funds. Various elements of the Swiss budgeting system are described: the development of the central government sector and the fiscal balance; the development of taxation and financial liabilities; the budget formulation timetable in the federal government and in Parliament; financial planning, accounting, auditing, and internal control; and financial relations between levels of government, including the tax equalisation system.

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1. Introduction

1.1. The central government sector

Switzerland came into existence as a national State in the first half of the 19th century as a consequence of a process of political integration of 25 regional communities known as “cantons”. This process culminated in the establishment of the first federal constitution in 1848. This constitution was based on a compromise between a liberal Protestant majority, mostly living in a small number of populous cantons, and a Catholic conservative minority, mostly living in a large number of thinly populated cantons. The rights of the minority were protected through constitutional provisions that guarantee the competences of the cantons and limit the responsibilities of the Federation and through cantonal representation in the federal political system, particularly in the Council of States (the upper chamber of Parliament).

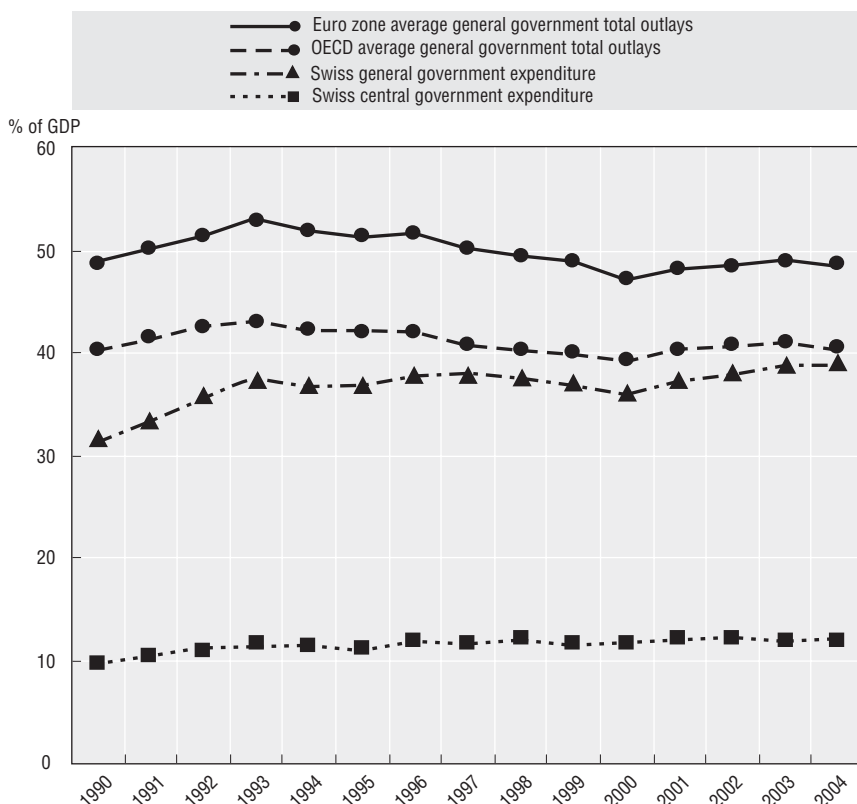
The strongly federalist nature of the Swiss State is reflected in the relatively small size of its central government sector. Expenditures of the central government as a percentage of GDP amount to 11.9% only. This value is among the lowest in the OECD area. On the other hand, expenditures of the general government as a percentage of GDP amount to 39.1% in 2004, which is close to the OECD average (Figure 1). However, this percentage does not take into account all expenditures for the compulsory national health care scheme. When these expenditures – which in most other OECD countries are covered by public social insurance – are added to the ratio of general government outlays as a percentage of GDP, the ratio is some three percentage points higher.

The evolution of this ratio – expenditure of general government as a percentage of GDP – since 1990 has been atypical. Whereas many OECD countries reduced their expenditure ratios in this period, Switzerland experienced an increase of 7 percentage points in the period 1990-2002, which is the highest increase in the OECD area. On average, this ratio remained stable in the OECD area in this period.

1.2. The fiscal balance

As far as the fiscal balance is concerned, Switzerland compares favourably with other OECD countries since 1990, in particular with European countries (Figure 2). Until 1999, the actual deficit of general government was

Figure 1. **Central and general government expenditure as percentage of GDP**

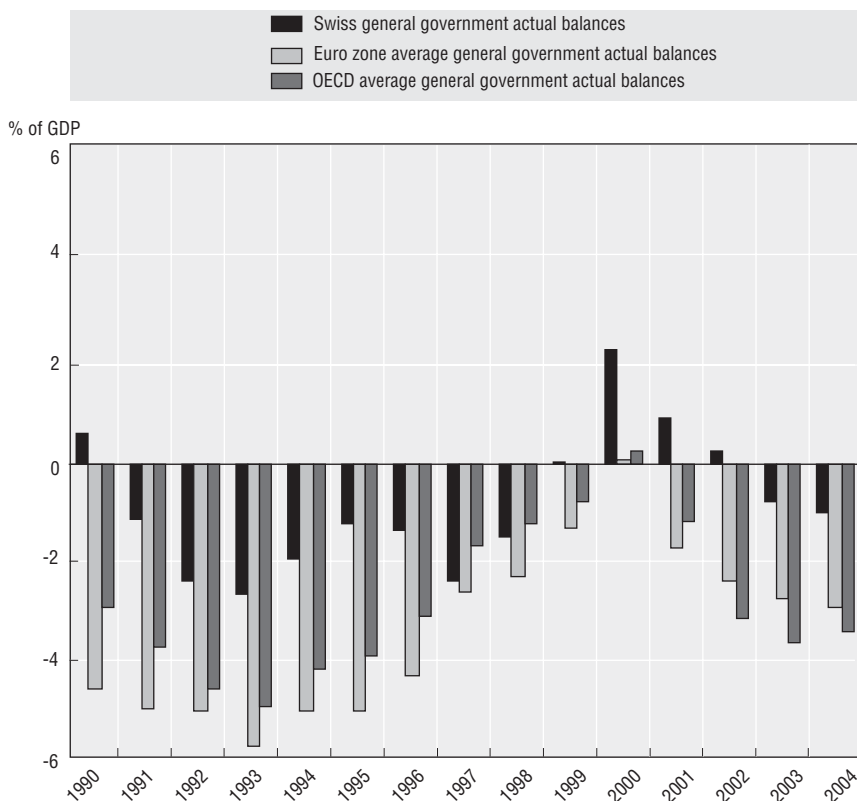


Sources: OECD Economic Outlook 74; Swiss Federal Finance Administration FS 01.02.2005.

consistently lower than that of countries in the euro area. In 2000 and 2001, there was a surplus in Switzerland, whereas the euro area showed a smaller average surplus in 2000 and, on average, a deficit in 2001. Although Switzerland has moved into deficits since then, its deficits have been lower than on average in the euro area.¹ Up to 1998, the general government deficits were for a large part due to deficits at the cantonal level. From 1999 to 2003, the cantons were in surplus. The public social security funds have shown a surplus over the entire period until 2002.

The firm control of the nominal deficit in Switzerland is all the more remarkable because real economic growth has trailed behind other OECD and European countries since the early 1980s. Between 1980 and 2002, the annual growth differential vis-à-vis the euro area averaged 0.75 percentage

Figure 2. **General government actual fiscal balances as percentage of GDP**



Source: OECD Analytical Database.

point. Moreover, this differential has gradually widened, reaching one percentage point on average in the 1990s. It has been noted, however, that the traditional measure of GDP does not take into account the considerable improvement in the terms of trade that has taken place in this period in favour of the Swiss economy (37% over the period 1980-2002). Due to the high quality of Swiss products and the strong appreciation of the Swiss franc, Switzerland is able to import ever more foreign goods and services in exchange for its exports. This effect is not fully reflected in the traditional (national accounts) concept of GDP. However, even if the improvement in the terms of trade is taken into account, the performance of the Swiss economy remains relatively weak in comparison to other OECD countries, especially in the 1990s (OECD, 2004).

Table 1. **Real growth of gross domestic product (annual growth rates)**
USD constant prices and constant exchange rates

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Switzerland	3.8%	-0.8%	0.0%	-0.2%	1.1%	0.4%	0.5%	1.9%	2.8%	1.3%	3.6%	1.0%	0.3%	-0.4%
Euro area	3.7%	2.7%	1.5%	-0.8%	2.4%	2.3%	1.5%	2.4%	2.9%	2.8%	3.5%	1.6%	0.9%	0.6%
OECD total	3.1%	1.4%	2.1%	1.3%	3.1%	2.4%	3.1%	3.4%	2.5%	3.1%	3.7%	1.1%	1.4%	2.2%

Source: OECD Statistics Department.

1.3. Level of taxation

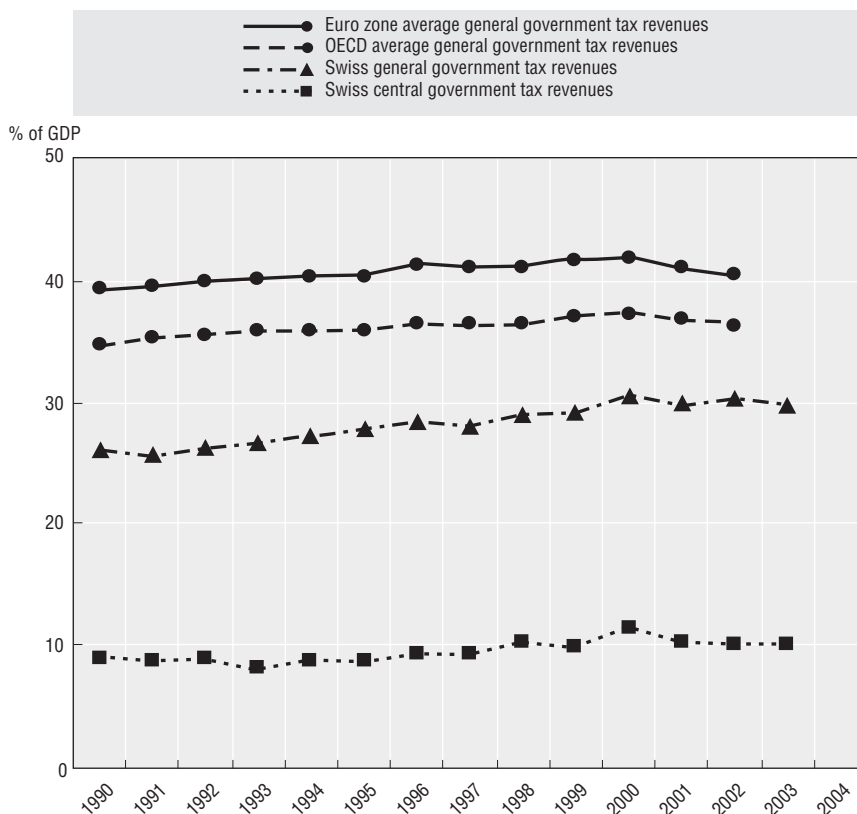
Tax revenue as a percentage of GDP in Switzerland was 29.6 in 2003, which is among the lowest in OECD countries (only above Austria, Ireland, Japan, Korea, Mexico and the United States). However, this was previously not the case and appeared only after a statistical revision in the calculation of total tax revenue in 2002 whereby a number of receipts were reclassified as not being tax revenue in order to meet a definition closer in line with international practice. Consequently, the size of non-tax revenues in Switzerland is among the highest in the OECD area² and many of those are fees which cannot be classified as tax revenue because they are paid in exchange for a concrete performance but in reality cannot be easily avoided – for instance various kinds of environmental fees. Furthermore, as noted before, premiums to private companies which manage the compulsory health insurance scheme are not reflected in the fiscal rate. If these obligatory insurance premiums are included, total tax revenue as a percentage of GDP amounts to 35.6% in 2003, which is close to the OECD average (Figure 3).

In line with the strong growth of expenditures as a percentage of GDP since the early 1990s, tax revenues have also grown substantially. Switzerland increased its tax level as a percentage of GDP in the period 1990-2002 by 5 percentage points. This is one of the highest increases in the OECD area (lower only than Greece, Iceland, Korea, Portugal and Turkey, where tax levels were previously low). The average increase was 2 percentage points of GDP in the OECD area over the whole period.

1.4. Financial liabilities

Although expenditures and revenues have moved more or less in line and deficits have generally been under control, general government gross financial liabilities have increased considerably in relation to GDP in the period since 1990 (Figure 4). This has partially been due to the improvement of accounting procedures aimed at a clearer separation of public enterprises, pension funds and general government, and partially due to the slow growth of the Swiss economy over these years. Whereas gross financial liabilities of Switzerland were among the lowest in the OECD area in the early 1990s (but partially as a

Figure 3. **Central and general government tax revenues as percentage of GDP**



Source: OECD Revenues Statistics Database.

consequence of inappropriate accounting procedures), Switzerland is now close to the median position (but still considerably below the OECD average, which is strongly affected by the very high debt rates of a few large countries).

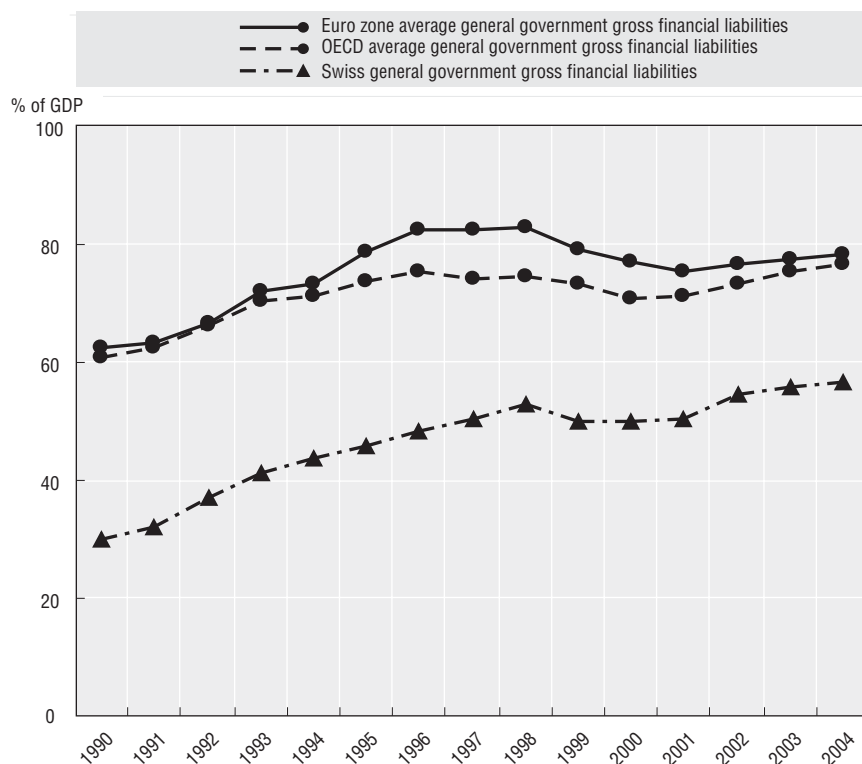
2. Budget formulation

2.1. Key characteristics of the Swiss budgeting system

The Swiss budgeting system is characterised by three special features that differentiate it from most other OECD countries:

- the political environment, characterised by direct democracy (referendums), federalism and a tradition/system of achieving consensus;

Figure 4. **General government gross financial liabilities as percentage of GDP**



Sources: OECD Economic Outlook 74; Swiss Federal Finance Administration FS 01.02.2005.

- the debt containment rule, which is a constitutional provision mandating a balanced budget over a business cycle (structural balance);
- the nature of the Swiss federal budget as a transfer budget.

Each of these features is briefly discussed below.

2.1.1. Political environment

The Swiss political system has several distinct features. These include direct democracy, federalism, and a tradition/system of achieving consensus (*concordance*). Direct democracy means that Swiss citizens can decide by popular vote on matters of public policy and institutional arrangement. Federalism means that the Swiss constitution guarantees a high degree of autonomy to the cantons (and the municipalities). Consensus (*concordance*) means the participation of all important political groupings in the public

decision making process and the resolution of conflict through negotiation and compromise.

Direct democracy is the most conspicuous aspect of the Swiss political process. This takes several forms. For example, all proposed changes to the constitution are subject to mandatory referendum. Citizens may also seek a referendum on an amendment that they want to make to the constitution. For such an initiative to be organised, the signatures of 100 000 voters must be collected within 18 months. Citizens can also seek a referendum to in effect veto parliamentary decisions, i.e. enacted laws. In this case, a popular ballot is held if 50 000 citizens so request. The signatures must be collected within 100 days of publication of the relevant parliamentary decision. For referendums on constitutional change, a double majority is needed for adoption: first, a popular majority by which is meant a majority of the valid votes cast throughout the country; second, a majority of the cantons, i.e. a majority of cantons in which the voters adopted the proposal.³ Referendums on parliamentary decisions require only a popular majority. The Swiss take great pride in these rights and, according to surveys, popular rights are the most valued political institutions. At the same time they place high demands on the citizens. On average about 40% of the voters actually go to the ballot box and only 25% of eligible citizens vote on a regular basis. The apparent paradox between the high value placed on popular rights and the low turnout at actual votes may be explained by the fact that participation is now seen more as an individual right that places constraints on the behaviour of other parts of the political system, such as Parliaments, than as a civic duty. With respect to the budget process, it is important to note that the federal constitution defines the maximum rates of the two most important taxes which implies that these rates can only be increased by referendum.⁴ This requirement serves as a formidable obstacle to budgetary expansion.

The Swiss State came into existence in 1848 by a voluntary act of association of independent cantons. From the beginning, the cantons have seen to it that their autonomy was guaranteed in the constitution. Many areas of public policy that in other countries belong to the domain of central government are attributed to the cantons in Switzerland. Each canton has its own educational system, its own system of social services (apart from some federal social security laws) and its own system of judicial courts. Although the development of the welfare State in the period after the Second World War has shifted the balance somewhat to the federal level, in particular as far as public expenditures are concerned, Switzerland still is the most decentralised country in the OECD area. Since the competences of the cantons are guaranteed in the constitution and since constitutional change not only requires a majority of the popular vote but also a majority of the cantonal votes, the autonomy of the cantons cannot easily be infringed upon.

The tradition/system of consensus (*concordance*) can be seen as an extension of the principle of minority protection that characterises the Swiss constitution. There are a number of important social and socio-economic differences in Switzerland. This is best exemplified by the fact that Switzerland has four official languages – German, French, Italian and Romansh. The German-speaking part of Switzerland is the largest comprising three-quarters of the population, followed by the French-speaking part with less than 20%. Consensus (*concordance*) is based on proportional representation of all groups, without exclusion of minorities. This applies not only to Parliament but also to the Federal Council (the federal cabinet), in which all the major parties participate. The federal administration consists of only seven departments (ministries) and a number of agencies with some degree of autonomy. Accordingly, the Federal Council consists of only seven ministers.⁵ Switzerland is not the only OECD country with a strong tradition of consensus, but the Swiss system is more entrenched in the constitutional structure. Indeed, direct democracy and federalism strongly support this system because lack of consensus may easily trigger popular votes or cantonal vetoes. The budget process is strongly affected by the system of consensus. In general, it fosters continuity and gradual adjustment and hampers fundamental reform or far-reaching reallocation or retrenchment.

2.1.2. *The debt containment rule*

The debt containment rule is a fiscal rule. It has a double objective:

- to ensure a balanced budget in structural terms;
- to permit the automatic stabilisers to function.

Regarding the first objective, it implies that the debt in absolute terms remains unchanged over a business cycle. To let automatic stabilisers function implies deficits in periods of recessions and surpluses in economic upturns. The debt containment rule applies to the federal budget only.

The debt containment rule is inscribed in the Swiss constitution. It was adopted by Parliament in June 2001 and ratified by referendum in December 2001. It went into effect with the budget for 2003. This rule operationalises a long-standing provision of the Swiss constitution which prescribes that the Confederation has to balance its expenditures and revenues in the long term and in particular to pay off debt which was not covered by assets. In doing so, the overall situation of the economy had to be taken into account. This provision had not prevented the accumulation of considerable debts in the past decades, as indicated above. The debt containment rule was preceded by a transitory rule which stipulated a maximum deficit for the year 2001. There was a need for a new fiscal rule that would be less susceptible to asymmetric policies in bad and good times (more expenditures in bad times to stabilise the

economy; more expenditures in good times as well because the resources are available). The Swiss answer to this challenge is the debt containment rule.

The debt containment rule puts a ceiling on the maximum admissible expenditures. According to the rule, the expenditures are a function of expected revenues and the economic situation. It prescribes that total federal expenditures must equal expected revenues multiplied by expected trend GDP divided by expected actual GDP, plus an adjustment factor that takes account of past deviations of budget outturns from the norm laid down by the rule. The rule implies that if trend GDP exceeds actual GDP, expenditures can be somewhat higher than expected revenues, whereas the reverse applies when expected trend GDP remains behind expected actual GDP.⁶ There is an underlying hypothesis of a unitary GDP elasticity of revenues.

The maximum expenditures are calculated twice: first, when the budget is established; second, when the final accounts for the fiscal year are presented. In case of overspending, the amounts have to be carried forward on a separate account and eventually be compensated for with cuts in spending in the future. Differences between the budget and the final accounts can happen in the case of forecasting errors in revenue estimates or in the trend GDP. If the total deviations exceed 6% of total expenditures, the necessary adjustments have to take place. The adjustments have to be realised within three years.

The debt containment rule aims at budget balance over the economic cycle and will thus stabilise the nominal public debt. The Swiss authorities consider this aim as both ambitious and realistic. It is deemed ambitious in view of the fact that public debt has continuously increased in the last decades at a rapid rate, both in nominal terms and as a share of GDP. It is also ambitious in view of the fact that some economists consider an increasing nominal public debt that remains constant as a share of GDP as sustainable. The rule is deemed realistic because it does not prescribe the reduction of the public debt in absolute terms.

The debt containment rule aims not only to correct the asymmetry of expenditure policy in good times and bad times, but also to correct the institutional asymmetry of decision making for expenditures and taxation as embedded in the Swiss constitution. The latter asymmetry is due to the fact that the expenditure increases are decided by Parliament whereas tax increases, in so far as they require adjustment of the maximum rates, have to be decided by constitutional amendment and are thus subject to a compulsory referendum. The rule assures that new expenditures can only be proposed if they are financed by previously adopted tax proposals and that tax reductions can only be proposed if expenditure reductions are proposed simultaneously.

The debt containment rule aims at macroeconomic stabilisation by allowing deficits during macroeconomic downturns and requiring surpluses during upswings. As with all structural deficit rules, this requires the calculation of a cyclical factor, in the Swiss case specified as expected trend GDP divided by expected actual GDP. It is well known that the calculation of trend GDP is a fairly complex exercise in which arbitrary elements cannot entirely be avoided. In general, there are two approaches: statistical methods based on past realisations including, sometimes, forecasts for the medium term; and output gap methods based on forecasts derived from macroeconomic production functions. The EU and the OECD use output gap methods. Switzerland uses a statistical method which entails the construction of a smooth trend line on the basis of past realisations through a Hodrick-Prescott filter.⁷ The method was revised during the budget preparation of 2004 mainly because the calculation method of the cyclical factor was re-examined in view of its weak reaction upon the considerable downwards adjustment of the GDP forecasts in 2003.⁸

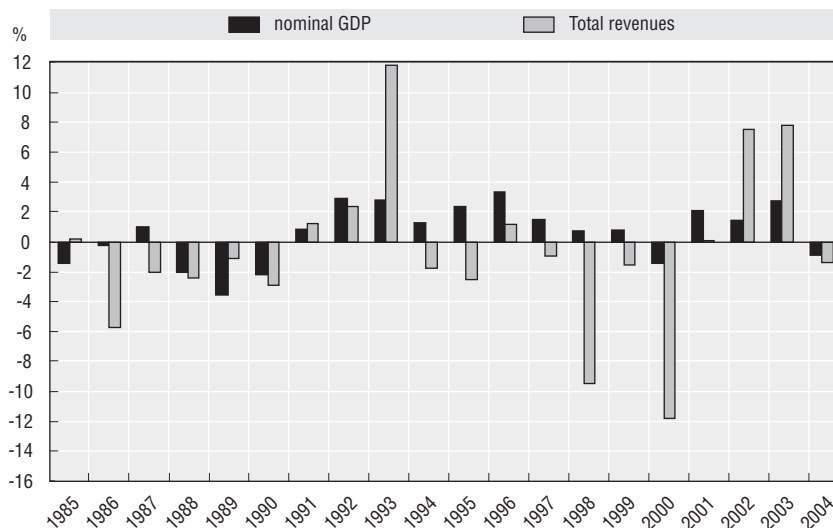
The OECD has noted in previous reports that the effectiveness of the debt containment rule is limited by the relatively small size of the federal budget compared to general government expenditure, in combination with the lack of coordination of fiscal policy with the cantons (OECD, 2002 and 2004).

Perhaps the largest challenge to the rule, however, noted both in previous OECD reports and by the Swiss authorities themselves, is the lack of correspondence between the macroeconomic cycle and the financial assets cycle (OECD, 2004). Indeed, according to official estimates, the considerable deterioration of the budget balance that occurred between 2000 and 2003 (4.5% of GDP) was for the largest part (2.5 percentage points) not due to the slow economic recovery, but rather to revenue shortfalls originating in the bursting of the bubble in the financial markets (inducing a sharp decline in proceeds from the withholding tax and stamp duty). Figure 5 shows the prediction errors in nominal GDP and total revenues since 1985. In view of the structure of the debt containment rule, revenue volatility induced by the financial markets leads to volatility of the structural deficit, which in principle has to be compensated by fiscal policy. This might put considerable pressure on the budget process, as has indeed been the case during the last three years.⁹ This problem is avoided at the moment by using trend forecasts for the withholding tax. Short-term fluctuations that are not linked to the economic cycle are thus not represented in the forecast of these revenue components.

Another generally acknowledged problem of the debt containment rule is that it was implemented at a moment (budget year 2003) when, retrospectively, the structural deficit appeared to deviate from zero. Since the rule requires compensation of structural deficits, a considerable consolidation effort was necessary from 2004 onward, when revenue estimates for previous

Figure 5. **Prediction errors of nominal GDP and total revenues¹ in the budget since 1985**

Percentage point differences between real and estimated values



1. Less actions Swisscom sales (98.02) and licences UMTS (01).

Sources: Federal Administration of Switzerland and OECD Analytical Database.

years had to be adjusted downwards. Full compensation was widely perceived to be hardly possible technically within the budgeting process, as well as procyclical and therefore undesirable. For this reason the Swiss authorities have decided to temporise the reduction of the structural deficit and to allow an overshoot of the structural deficit of CHF 3 billion in 2004 (0.75% of GDP), CHF 2 billion in 2005 (0.5% of GDP) and CHF 1 billion in 2006 (0.25% of GDP). Simultaneously, an ambitious consolidation plan was presented in the budget for 2004.

2.1.3. *The character of the federal budget as a transfer budget*

Hardly one-third of the total expenditures of the Federation is used for the tasks of the Federation. More than two-thirds consist of transfers to sub-national government (cantons and municipalities), the social security funds (old age and war victim pensions, disability insurance) and other semi-autonomous public institutions. This characterises the Swiss federal budget as a transfer budget. Transfers are generally based on entitlement law and contracts, which diminishes the flexibility of the budget in the short term.

Table 2. Expenditures of the Swiss Federation according to economic character

(in percentage of total federal expenditure, 2002)

Consumptive expenditures, <i>of which:</i>	18
Personnel	9
Goods and services other than defense	6
Defense	3
Direct investment	1
Interest	8
Current transfers, <i>of which:</i>	60
Revenue sharing with sub-national government	11.0
Indemnities to sub-national government	0.1
Contributions to social insurance funds	25.0
Agricultural subsidies	7.0
Public transport subsidies	4.0
Subsidies for vocational training and fundamental research	7.0
Development aid	2.0
Road maintenance subsidies	2.0
Other subsidies	2.0
Capital transfers	13
Total	100

Source: Swiss Federal Finance Administration.

Apart from the debt containment rule, the Swiss constitution also contains an expenditure containment rule. This rule prescribes that transfers as well as authorisations to incur obligations resulting in new expenditures of more than CHF 20 million (approximately EUR 13 million), or new recurrent expenditure of more than CHF 2 million annually, require special authorisation of Parliament by qualified majority of all members in each chamber. The expenditure containment rule is explained by the large share of transfers in the Swiss budget, but it has not proved to be a very effective barrier. Perhaps other approaches, such as further integration in the revenue sharing system for sub-national governments, would be more effective (see Section 5).

Another characteristic of the Swiss federal budget which is related to its transfer character is the relatively large share of earmarked revenues (roughly a quarter of the budget). Important earmarked revenues include the revenue-sharing parts of the income tax, the obligatory contributions from the revenues of the value-added tax, and the tax on mineral oils to the Railway Fund and road infrastructure. This restricts the flexibility of the budget process and may hamper allocative efficiency.

2.2. Annual budget process

This section outlines the major events in the annual budget formulation process in Switzerland. This process is subject to an organic budget law and its executive decree. These regulations prescribe, among other things, the accounts structure of the budget, the mode of application of the debt containment rule and the procedures for the ordinary and supplementary budget proposals, and the establishment of multi-annual estimates. The budget in Switzerland is not enacted as a (set of) formal laws as in many other OECD countries, but is a proposal *sui generis* to be approved by Parliament and defined by the constitution and the organic budget law.

The budget consists of proposals for budget authorisations at the account level with explanations. The budget authorisations can be distinguished in annual credits (cash authorisations) and commitment credits (authorisations to incur obligations). The budget is submitted to Parliament with an explanatory report. The budget is accompanied by an updated multi-year financial plan, a report on the financial plan, and multi-year estimates at the account level. The financial plan and the multi-year estimates are not authorised by Parliament; Parliament discusses them and takes note.

Central responsibility for budgetary affairs lies with the Federal Finance Administration (FFA), an agency of the Federal Department of Finance. The FFA has a total staff of around 240.

The executive budget process starts in January with the development of budgetary targets and guidelines for the preparation of the budget. These targets and guidelines are based on a provisional assessment of the macroeconomic situation and the requirement of the debt containment rule.

Within the administration, the macroeconomic forecasts are made by a Committee of Economic Experts in which participate experts from the State Secretariat for Economic Affairs, the Federal Statistical Office and the Central Bank as well as experts from the Federal Finance Administration (FFA).

Tax revenues are estimated by the FFA, the Federal Tax Administration and the Federal Customs Administration. Two approaches are used in the process of revenue forecasting. A top-down approach starts from the updated macroeconomic assessment and assumes a unitary GDP elasticity. A bottom-up approach starts from developments in the tax base of the separate tax laws. The most important federal taxes are the value-added tax, the income tax (with distinct regimes for private households and legal corporations), a tax on mineral oil, a stamp duty (on emission and transactions of bonds, equities and issuance of insurances), a withholding tax, a tobacco tax and customs duties. In the recent past, revenue estimates have sometimes been considerably off the mark, mainly for the stamp duty and the withholding tax (interest income

Box 1. Budget formulation timetable

Fiscal year = calendar year

January-February: Guidelines and expenditure targets are developed by the Federal Finance Administration.

February: Federal Council decides on guidelines and targets.

March-April: Budget proposals are prepared by line departments.

May: Line departments submit proposals to the FFA.

May-June: Departmental proposals are examined by the FFA and discussed with line departments.

June: Federal Council decides about the totals and required expenditure reductions in the light of updated macroeconomic assumptions and new revenue forecasts.

July-August: Line departments adjust budget proposals.

August: Federal Council takes final decisions regarding expenditures and revenues.

September: The FFA elaborates the budget (financial account and results account) and the financial plan.

End of September – beginning of October: Federal Council finalises the budget message and the report on the financial plan and submits the budget and the financial plan to Parliament.

and dividends) due to erratic movements in the financial markets (see Figure 5).

Following their approval by the Federal Council, the targets and guidelines are sent to the departments and their associated agencies, some one hundred in total, at the beginning of March. The targets are also submitted to the Finance Committees of Parliament to be discussed at their spring meetings (March-May).

During March and April, the various departments and agencies establish their budgetary requests in accordance with the ceilings established in the guidelines. They are also requested to provide estimates for the non-tax revenues accruing in their respective areas. In the beginning of May, the requests have to be submitted to the FFA, properly justified in accordance with the guidelines.

The requests submitted by the agencies do not always respect the ceilings contained in the guidelines. Furthermore, additional savings are often

required to attain the budgetary targets. These subjects are discussed between the agencies and the FFA in the course of May and June. In this stage, the outlines of the budget are also discussed in meetings with the secretaries-general of the line departments (see Box 1).

Before the summer break end June, the Federal Council is informed about the progress with developing the budget and makes decisions about outstanding issues that have not been resolved at the administrative level. The room for manoeuvre at this stage is usually restricted, as 80% of expenditures is inflexible in the short run for legal reasons and contractual obligations. Even for the remaining 20% (mainly investments and material expenses) the margin of flexibility is usually small and amounts to a few hundred million Swiss francs.

When additional savings are necessary, the FFA follows by and large three strategies. It can try to identify itself the measures that are least painful to citizens and politicians; it can leave the decision of where to save to the departments; or it can propose cuts across the board. The first strategy usually raises the most resistance. If departments are to propose the cuts themselves, they tend to propose cuts that have a high probability of being reversed by Parliament. Cuts across the board have proved to be an effective and efficient instrument, if the necessary savings do not exceed a certain threshold amount.

In July and August, the agencies adjust their requests in accordance with the decisions of the Federal Council. At the end of August, the Federal Council receives an updated budget and financial plan. The Federal Council *de facto* decides on the budget, i.e. revenues and expenditures at the level of accounts (line items) in view of the requirements of the debt containment rule.

In September, the FFA prepares the budget proposal that will be submitted to Parliament. This proposal is made up of a report (on both a cash basis and an accrual basis) and budget line items with explanations and financial statistics. The FFA also prepares the financial plan, which contains multi-annual estimates for the three years following the next budget year and a comment regarding further development of expenditures in the various policy areas.

At the end of September or at the beginning of October, the Federal Council approves the budget message and the report on the financial plan and sends them to Parliament. Parliament has expressed its desire to receive the budget earlier. With the introduction of full accrual budgeting and accounting in 2007, Parliament has obliged the Federal Council to submit the budget one month earlier, i.e. at the end of August.

The Swiss budgeting system is quite input based. Performance measures and evaluations are generally not used in the budget process and are used

Box 2. **Budget formulation in line departments**

Line departments have financial divisions that are responsible for budget formulation and execution. Each department has several agencies that usually have their own financial division. Departments are sometimes also involved in the financial affairs of independent, autonomous institutions in the policy area of the department.

The departmental budgets are prepared in two stages, corresponding to the timetable of the federal budget process. In March, the departments prepare their budget requests. For that purpose the financial division sends out guidelines to the agencies of the department and the relevant independent, autonomous institutions in accordance with the guidelines of the Federal Finance Administration (FFA). They have roughly five weeks to prepare their budgets. The departmental requests are usually prepared by a financial committee or a board in which the directors of the various agencies and the head of the department's financial division participate and which is chaired by the secretary-general of the department. In May and June, the requests are discussed with officials of the FFA. In the second stage, from June to August, the departmental budgets have to be adjusted to the decisions of the Federal Council. This process is usually strongly co-ordinated by the central financial division in each department in order to make sure that the decisions of the Federal Council are adhered to and that the priorities of the minister are respected.

After the start of the budget year, there are two opportunities for supplementary budget proposals. In principle all shifts of expenditures between accounts require supplementary budget authorisations, but Parliament may allow certain shifts without supplementary authorisation. Various departments have indicated that major new policy initiatives often have more chance of success when they are proposed by way of supplementary authorisation rather than when they are proposed in the regular budget process. This may be due to the fact that during budget execution there is sometimes less fiscal stress than during budget formulation due to windfalls and that, moreover, proposals in particular policy areas may get more attention when they are proposed by way of supplementary authorisations.

only in a limited way in programme management. It is typically the line department that generates performance measures and performs evaluations.

It should be noted that in the last few years the Swiss federal budget formulation process has to a large extent been dominated by the necessity to find savings. This necessity had its roots in sluggish macroeconomic performance,

endogenous growth of major expenditure programmes based on entitlement legislation (social security, education, health) and the introduction of the debt containment rule in 2003. In order to meet this challenge, the Swiss authorities have not only relied on the regular budget formulation process but also on some special devices, in particular the central imposition of consolidation packages inside or outside the regular budget process and the use of cash ceilings.

When in the course of 2002 the revenue estimates decreased rapidly (mainly in reaction to the deterioration of the financial markets), the Federal Council submitted a new budget for 2003 to Parliament although the previously submitted budget for 2003 had already been approved. A few months later, the Federal Council proposed a savings package of CHF 3 billion in 2006 (increasing from 0.8 billion in 2004, to 2.1 billion in 2005, and to 3.0 billion in 2006). Similarly, the Federal Council proposed an additional savings package in 2004 amounting to CHF 2 billion in 2008 (increasing from 0.5 billion in 2004, to 1.0 billion in 2005, to 1.1 billion in 2006, to 1.8 billion in 2007 and to 2.0 billion in 2008).

In December 2002, Parliament renewed a law that permits a certain percentage of allocated funds in the ordinary budget to not be spent (blocked). Certain expenditures are not subject to this law, including interest payments, contributions to the social security and health care funds, the contribution to the Railway Fund, and the transfer of tax proceeds by virtue of tax-sharing systems. Since the introduction of the law, Parliament has each year imposed restrictions of 1% or 2% on all susceptible accounts or on specific groups of accounts. In this way, savings can be achieved of circa CHF 250 million. These cuts can be waived by the Federal Council in case of legal or contractual obligations towards recipients of benefits. The cuts can also be waived due to severe economic recessions but this must be approved by Parliament.

2.3. Financial planning

The chambers of the Swiss Parliament are elected for a period of four years. At the beginning of each legislative period, the Federal Council presents a report to Parliament on the main features of its policy. It looks back at the previous legislative period and provides a complete picture of the new tasks the Federal Council wants to undertake and the goals it wants to achieve. This report is accompanied by a financial plan for the legislative period which establishes targets for the main budgetary aggregates (total federal expenditures and revenues, deficit and debt development) from year to year.

The financial plan is updated from year to year in the annual budget process. Each year new projections are added at the end of the planning period to maintain a quadri-annual perspective (the budget year plus three subsequent years). The financial plan is the Federal Council's instrument to

gain insight into the mid-term perspective. Parliament takes notice and its endorsement or rejection is not legally binding according to current legislation (ParlG).

During the annual budget formulation process, the planning numbers of the financial plan are the point of departure. However, in view of the requirements of the debt containment rule or in view of unexpected developments or new policy initiatives, the budgetary targets and multi-annual estimates may already be changed at the beginning of the budget formulation process (i.e. in the guidelines sent out in March). In the course of the budget process further changes are likely.

In spite of this annual process of updating, the quadri-annual perspective is maintained from year to year. This implies that the agencies have to provide multi-annual estimates from year to year and that these estimates have to satisfy the macro-budgetary planning numbers for the next four years as established by the updated financial plan and the financial perspectives. This multi-annual approach to the budget formulation process makes it possible to decide on consolidation measures or new policy initiatives well in advance. With respect to consolidation efforts this makes it possible to phase in the required measures gradually, facilitating the implementation of such measures and enhancing their political acceptability. It should also be noted in this context that saving measures are always stated in relation to the previous multi-annual estimate. Consequently a saving measure does not necessarily imply a nominal decrease compared to the prevailing budget estimate; it may rather imply a less rapid growth than foreseen in previous multi-annual estimates. The consolidation packages of 2003 and 2004 were implemented in this way.

Although the financial plans and perspectives provide a certain degree of stability to the budget process, the annual revisions required by the debt containment rule may have an opposite effect. In an earlier OECD report, it was noted that the implementation of the debt containment rule was marked by errors in predicting the structural budget balance required for implementing the rule and that the inaccuracy of the structural balance estimates raises doubts about using this type of indicator as a guide for federal policy. Also, it has been noted that the rule leads to year-by-year fiscal management in view of the instability of estimates and the frequent revision of estimates once made. In this connection, a better incorporation of the rule in medium-term financial management has been recommended (OECD, 2004). The changes in the revenue forecasting process that accompany the current implementation of the debt containment rule (see above) have yet to prove their effectiveness in reducing short-term volatility of expenditures and thus increasing stability in the future.

The question arises whether a better incorporation in medium-term financial management is possible while maintaining the rule as it is presently

worded in the constitution and the organic budget law. In this respect, the approaches of the Netherlands, Sweden and the United Kingdom towards medium-term financial management may be relevant. These countries too aim for a zero balance over the economic cycle (in the United Kingdom, only current expenditure) or a gradual reduction of the structural deficit, but they avoid the annual adjustment of fiscal policy in the light of the most recent estimates of trend GDP or structural tax revenues. They rather determine a medium-term expenditure path on the basis of the expected medium-term GDP development which maintains the structural budget balance at zero, or gradually reduces the structural budget balance to zero, and then stick to that expenditure path for a number of years.¹⁰ This policy has roughly the same stabilisation effects as the Swiss debt containment rule.¹¹ However, the main differences with the Swiss debt containment rule are that: trend GDP estimates for the budget year and the next few years (let alone for the previous years) are not changed from year to year; and all non-structural revenue fluctuations are seen as cyclical (and not just those that are induced by cyclical GDP fluctuations). The advantage of this approach is mainly that it brings multi-annual tranquility to the expenditure estimates and a better basis for policy making in the line departments. An emergency brake remains necessary if the medium-term GDP estimates appear too optimistic. Such a brake could take the form of an upper bound for the allowable fluctuation of the nominal deficit. The risk that the emergency brake has to be applied could be reduced by the use of conservative estimation of medium-term GDP development or the use of a prudence margin between the trend GDP estimates used for the determination of the medium-term expenditure path and the official estimates. Such an approach would on first sight not be incompatible with the debt containment rule as worded in the Swiss constitution although it might require some adjustments in the organic budget law.¹²

2.4. Conclusion

The general government nominal deficit in Switzerland is firmly under control. This is all the more remarkable in view of the comparatively low growth of the Swiss economy in the last two decades. This achievement is due to consistent and intensive efforts on the part of the Swiss authorities including the introduction of the debt containment rule, a strict budgetary policy and large consolidation programmes in 2003 and 2004.

At this point, general government liabilities in Switzerland are not a reason for concern, given that the relatively rapid growth is due, for a substantial part, to better accounting procedures, although a bias towards budget deficits has also emerged during the last decade.

The debt containment rule is respected by the major players in the Swiss budget process and has contributed to the control of the federal deficit. However, the rule also has some problematic effects, the most important of which is that it tends to disturb the financial planning process through frequent adjustments of budgetary targets. This problem is avoided at the moment by using trend forecasts for the withholding tax. Short-term fluctuations that are not linked to the economic cycle are thus not represented in the forecast of these revenue components. This change in the revenue forecasting process has yet to prove its effectiveness in reducing short-term volatility of expenditures and thus increasing stability in the future. The Swiss authorities might consider further adjustments of the rule so that it becomes better integrated into the medium-term financial planning process.

The Swiss federal budget is largely a transfer budget. Moreover, it is characterised by a relatively high share of earmarked revenues. So far, the limitation of the growth of transfer expenditures has not been very effective. The Swiss authorities might consider other ways to restrict the growth of subsidies, for instance the further integration of transfers in the system of revenue sharing with sub-national governments (cantons and municipalities). In order to increase the flexibility of the budget, the Swiss authorities might also consider possibilities for reducing the use of earmarked revenue.

3. The role of Parliament

The Swiss Parliament is, relative to other OECD countries, a powerful body regarding its potential effect on the budget process. This means that Parliament has full and unlimited amendment rights over the State budget as introduced, and has used this power in the past.

According to the federal constitution, all expenditures must be approved by both chambers of the Swiss Parliament. In general, Members of Parliament have full rights to amendments. Parliament's only constraint is the debt containment rule, which puts a cap on overall expenditure. Yet Parliament is free to make changes within this limit among the different policy areas.

3.1. The Swiss parliamentary budget process

Parliamentary involvement in the budget process starts in March when the Finance Committees are notified of the Federal Council's decision on major directions for the upcoming budget. At present this is an informational release, as it does not require action by Parliament. It is only the Finance Committees that receive the guidelines for the budget. At this point, the Finance Committee can discuss the guidelines, send letters of request to the Federal Council or use the instrument of a motion for a change in the

Box 3. The Swiss Parliament

Parliament consists of two equal chambers: the National Council which provides proportional representation, and the Council of States which represents the cantons equally (although six former cantons which are now divided receive one vote each instead of the usual two). There are 200 members of the National Council and 46 members of the Council of States.

Parliament meets four times a year for a period of three weeks, i.e. for 12 weeks during the course of a year. Members of Parliament are not “professional” politicians, but rather assume their parliamentary duties in addition to their regular occupations.

The budget is dealt with in December. As a rule, committees meet outside of the four parliamentary sessions. Each chamber has a Finance Committee made up of sub-committees to deal with issues of each department. In addition, there is a joint committee – the Financial Delegation – made up of representatives from both chambers, which sits all year and has limited ability to act on behalf of Parliament.

There are currently 13 parties represented in the National Council and five parties with over ten members. There are four parties represented in the Council of States. A unique feature of the Swiss system is that there is no singular executive authority. There is a seven-person Federal Council of equals drawn from the major parties. This means that coalitions must come together to pass a budget.

guidelines. However, according to the constitution, the budget draft is the exclusive domain of the Federal Council whereas the budget bill that is voted in December is the exclusive right of Parliament. There is an ongoing debate on whether to strengthen the role of Parliament in the context of these guidelines.

The Finance Committees have a first round of discussions once the Federal Council has made its last decisions. The real engagement, however, starts in October when the Federal Council submits its budget and financial plan to Parliament. The Federal Council is bound by law to send the budget two months prior to the winter (December) session. This is a new legal requirement but in effect it has always been practice.

The Finance Committees first have plenary sessions on the budget as a whole, and then the examination is broken down to sub-committees. The National Council has seven sub-committees – one for each department – and

the State Council four to take account of the smaller size of this chamber and thus the more limited resources. The Finance Committees are by mandate the sole bodies to review the budget. Sectoral committees play no formal role in the examination and approval process. Sectoral committees may send letters on an *ad hoc* basis with views and estimates for the process, but these are not sought and not required.

The full Finance Committees can give the sub-committees instructions on their work. For example, if the full Committee decides to reduce spending, it is the sub-committee which is tasked with achieving the reductions. The sub-committee then reports back on recommendations and the cuts in spending required to achieve the reduction goal.

Ministers (who are members of the Federal Council, the collective executive body) appear before the plenary Committee to discuss their budgets in the presence of the finance minister. There are no restrictions on Parliament for questioning the minister. When examination of the budget moves to the sub-committees, it is generally the secretary-general of the department and directors of the various agencies who come to explain and defend the budget. The sub-committee examination generally lasts a full day for each department. The schedule is well known in advance to all participants in the budget process. The sessions of all parliamentary committees, including the Finance Committee and its sub-committees, are set in the spring (March-May) by the administrative offices of the two chambers. The Financial Delegation by contrast is free to set its own schedule as necessity dictates.

In December, after the work of the Finance Committees, the budget bill is sent to the full chambers for decision. What follows is a timed process. The budget bill is sent back and forth between the two chambers three times. Finally, if there are still differences between the two chambers, the budget is sent to a “reconciliation committee” comprising members from both chambers. If the two chambers cannot agree on a particular figure of a budgetary item, the lower figure counts. Thus, the procedure is set up to ensure a budget by the end of the year. In principle, though, in the case of extreme differences, Parliament has the option of sending the budget back to the Federal Council for revision. In practice, this has not happened.

However, prior to development of the budget, Parliament can pass a “motion”: a parliamentary instrument that broadly directs the Federal Council on development of government policy. In the area of budget policy, Parliament in recent years has promoted strong fiscal discipline. For example, a recent motion charged the Federal Council with developing an annual budget and a three-year financial plan so that supplemental requests will not exceed CHF 3 million for the 2004 budget. Motions like this set out expectations and political limits prior to the formal work on the details of the budget by Parliament.

Box 4. Parliamentary budget timetable

February: Federal Council decides budget guidelines and targets. The Finance Committees receive them for information.

August: Federal Council informs the Finance Committees of its decisions regarding the budget and the financial plan.

September/October: Budget transmitted to Parliament.

October/November: Finance Committees and their sub-committees examine the budget proposal.

December parliamentary session: Chambers take action on budget.

Mid December: Final vote on budget.

In plenary parliamentary sessions, individual MPs in both the Council of States and the National Council represent themselves and their constituents. Moreover, political party discipline is not strong by international standards. Individual rights and weak party discipline enhance the potential influence of Parliament in the budget process.

While parliamentarians have full rights to amend the budget, the reality is that not much is changed by the end of the process. Despite the large number of amendments that are submitted, one estimate is that there are perhaps 30 amendments per year passed by Parliament. Of these 30 amendments, most come in areas that are annually contested: foreign development assistance, agricultural policy, railroads, road infrastructure, defense and the like. This inability to substantially change the budget and reallocate spending is largely due to a number of factors including: the collective process of the Federal Council, general agreement on the role of the State in society, the debt containment rule (whereby being fiscally irresponsible is not politically feasible) and the fact that up to 80% of spending is entitlement spending or effectively outside the control of Parliament in the short run. On average, deviations between the budget proposal and the budget bill approved by Parliament amount to plus or minus CHF 250 million.

Parliament only approves the annual budget. There is no formal vote on the multi-year estimates known as the financial plan. There is the possibility of a motion, as was mentioned earlier, directing the Federal Council to take certain actions – either with respect to aggregate spending or specific budget functions. By and large, the debate on the budget is limited to single items of spending, and amendments to the budget are limited to minor items. There are no legal sanctions should Parliament not respect the fiscal rule enshrined in the constitution. There is no recourse for court action if Parliament

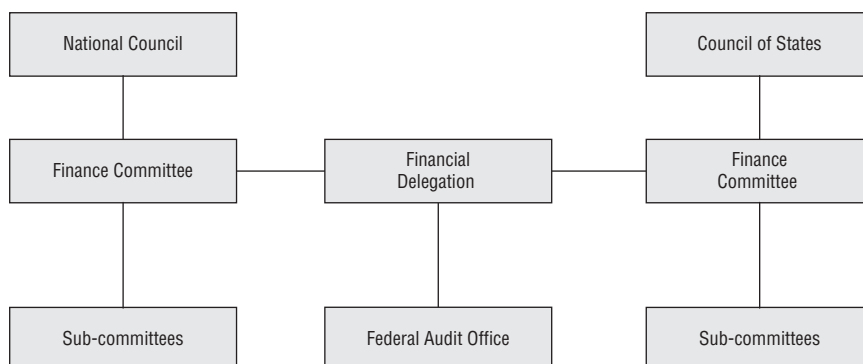
approves a budget over the spending limits decided by the Federal Council. There is an informal political limit on parliamentary budgetary action that limits the appetite for overspending. Practically, this means that any proposals for increased spending must be met with a proposed cut elsewhere. Moreover, proposed cuts in other functional areas are also difficult practically, further limiting the room for parliamentary action.

However, since all major parties are represented in the Federal Council, and the Federal Council acts by majority vote, it is more likely that the budget proposed by the government already reflects the priorities of a majority of parliamentarians.¹³

In general, there are two supplementary budget bills presented by the Federal Council each year. In principle, departments must try to compensate additional spending within their own budgets. If this is not possible, the supplemental request is decided by the Federal Council. After Federal Council approval, it is sent to the Finance Committee for review, which then passes it to the full Parliament for decision. There is also the possibility for Parliament to approve “additional credits” which are granted for new programme spending in the middle of the year. These bills are debated and amended like any normal bill.

Parliament also approves the financial accounts of government. In most countries this is a routine event with little discussion of the documents; after all, the spending has already occurred and there is no spending that can be called back. This is more or less true for Switzerland, except that it is a signalling device and the financial accounts receive a real hearing in Parliament. The most important example is the rejection of the accounts of the Federal Pension Fund in the 1990s. With the support of the Federal Audit Office, Parliament did not approve the final accounts of the Confederation’s pension insurance (EVK) until changes were finally made to the accounting treatment of pension liabilities in 1997.

Figure 6. **Parliamentary system of oversight**



3.2. The Finance Committees

The Finance Committees have three main functions: oversight of the budget process (including the long-term fiscal situation,) examination of the budget and supplemental spending, and reviews of the financial accounts of the State. It is the responsibility of the Finance Committees to put forth the annual budget law and any supplemental appropriation bills to the full Parliament. On the details of the budget, the work of the Committees is done in sub-committees following a *rapporteur* approach. The *rapporteur* writes the majority opinion of the sub-committee on the budget proposal. Individual members or groups of members may support different proposals or advice. These accompany the *rapporteur's* report.

3.3. The Financial Delegation

Because Parliament sits part time, there is a special Financial Delegation made up of members of the Council of States and the National Council. The Delegation meets through the year according to necessity, but at least once every two months. There are three members from each Finance Committee with the presidency of the Delegation changing every year. The Delegation is given special responsibilities to oversee and examine the totality of financial administration of the Confederation. This responsibility includes both the budget as well as execution and accounting of federal funds. The work plan of the Delegation is unlimited and is up to the decision of the Delegation. The Finance Committees can charge the Delegation with particular tasks related to the budget, or the Delegation can ask the full Committees to take up tasks as well.

The Financial Delegation is given special responsibility on behalf of Parliament to deal with emergency or special budget requests during the year. While there are formal supplemental laws during the year that are considered and debated in the usual method, the Delegation has the right to act on the behalf of Parliament and approve emergency appropriations with no ceiling on amounts granted. A vote is scheduled in Parliament to limit such emergency spending to CHF 250 million.

In addition, individual Members of Parliament must ask the Financial Delegation to request certain investigations or audits by the Federal Audit Office. It is the Financial Delegation that requests, receives and uses the audit reports. Approximately 10% of the work performed by the National Audit Office is based on requests from the Financial Delegation.

3.4. Secretariat

The Finance Committees and the Financial Delegation share a permanent secretariat. Administratively, the secretariat is attached to Parliament. Like the

head of the Federal Audit Office, the head of the secretariat is named by the Federal Council and ratified by Parliament. The secretary is then subordinated to the presidents of the Finance Committees and Financial Delegation. The secretary is afforded the same rights to documentation and information from the government as the Federal Audit Office. At present in each chamber of Parliament there are about five professional analysts supported by three to four assistants that comprise the secretariat.

3.5. Conclusion

Switzerland's parliamentary budget process is performing very well. In many respects, this performance is due to a strong political consensus. While in many countries Parliament measures its success in changing or increasing detailed spending items, the Swiss Parliament has seen its effect in restraining spending and calling for further reductions in personnel and expenditures. The parliamentary procedures have been developed over a long period and work well in their context.

Many OECD countries have moved to a two-stage budget process. In Switzerland for now the financial plan and the preliminary aggregates are given to Parliament for information purposes only. There are efforts underway to make the review more formal. These efforts deserve a full hearing.

4. Accounting and auditing

4.1. Accounting

Accounting in Switzerland is regulated by public laws and regulations. Because of the sovereignty of the cantons, federal laws do not apply and the cantons are free to develop their own rules and accounting systems. Even though each canton is different, it is fair to say that in general the cantons follow more private sector practices and operate more technically sophisticated systems than the federal level. The introduction of accruals in the federal budget and federal financial reporting will be adopted in law in June 2005. Adoption of accruals at the federal level was aided by the use of accruals at the sub-national level. While in many countries the adoption of accruals has been hampered or blocked by ministries or Parliaments, it is seen as a natural extension of current practice in Switzerland.

Traditionally, the federal budget and financial statements have been on a cash basis. Political decision making has thus been on cash expenditures. The debt containment rule applies to a cash perspective as well.

Up until recently, the accounting procedures were highly decentralised and each department had its own system and procedures, albeit generally on a cash basis. The Federal Council decided to adopt a standard accounting

system that will be ready by the end of 2005, and a new federal budget and accounting system approved in 2001 will be ready by 2007.

The new system is designed to be closely aligned with the framework of international public sector accounting standards (IPSAS). There are some important deviations from IPSAS because of constitutional reasons – the constitution foresees a balanced budget on a cash basis – and for procedural reasons – the debt containment rule links expenditure to revenues.

Other deviations from IPSAS were made for practical reasons emanating from work done by a steering committee. For example, defense investments will not be capitalised according to long-standing political reasons and immediately written down to zero. A second example of a difference is that the balance sheet will distinguish between financial and administrative assets according to a Swiss solution that is shared between the central and local levels. Administrative assets are defined as assets that are designated to fulfil publicly fixed functions. Financial assets are assets that can be sold without legal or public obligation. Despite the decision to deviate from many of the IPSAS rules, each deviation will be described in the footnotes to the financial reports.

4.2. Auditing

The Swiss Federal Audit Office (SFAO) is the supreme financial supervisory organ of the Swiss Confederation. In its auditing activity it is bound only by the federal constitution and the law. It is not an independent parliamentary body like is the case in most OECD countries, but for administrative purposes the SFAO is assigned to the Federal Department of Finance. This is a model similar to the Scandinavian system although in recent years in countries like Finland and Sweden the audit offices have been made offices of Parliament. This integration into the administration, though, is only technical and the office is functionally independent of the Federal Council and executive branch. Parliament directly decides the budget of the SFAO with no oversight by the Federal Department of Finance. All reports are sent directly to the concerned office. The office's responses, as well as the original report, are then sent to the Financial Delegation of Parliament, and the summary is sent to the minister concerned by the audit findings. The audit of the annual accounts is a special report that is sent directly to the Finance Committees of Parliament.

The SFAO operates as a traditional audit office and produces about 200 reports per year. It has incorporated most of the INTOSAI "Lima Declaration" guidelines (INTOSAI, 1977) into its operating programme. Of the annual workload, about half of the plan is derived from its legal audit mission of State or semi-State organisations and the other half comes from the audit

priorities based on risk analyses. There is a risk assessment process by which those programmes considered high risk are audited annually and lower risk programmes are in general audited once every five years.

There are approximately 100 staff persons working for the SFAO. About 80% are analysts while the remaining 20% consist of administrative staff. Most analysts have backgrounds in auditing and accounting. The head of the SFAO is nominated by the Federal Council and approved by Parliament. The term of the director is six years with the possibility of unrestricted re-election; removal can only be for cases of material breach of duties. The director in turn is responsible for the appointment of the audit staff.

The annual audit programme is determined autonomously and submitted simultaneously to the Federal Council and the Parliament Financial Delegation. They do not approve it, but only take note. The official programme is annual; however, the SFAO also creates an internal four-year plan. In addition to the plan, there is flexibility to do unplanned audits during the year. The unplanned audits can be generated by both the Federal Council and Parliament. The SFAO can be assisted in its work by private firms or by contracting out altogether.

The SFAO is responsible for all federal spending including Swiss companies that are majority owned by the Confederation (like Swiss Federal Railways and Swisscom). In practice, the majority owned private companies are audited by private firms and the SFAO only does special audits.

After a report is finished, the findings (supported facts) and opinions (recommendations) are presented first to the concerned office. The findings are first presented orally, and then followed up with a written report. The office then responds in a written statement, and the audit report and response are sent to the Financial Delegation of Parliament (which is charged with general oversight of spending through the year). A summary of the report is also given to the head of the department concerned by the audit findings.

Normally, the audited office accepts the findings of the SFAO and makes the necessary changes. The SFAO can issue a binding directive in the case of regularity or legality problems. There are three levels of findings: binding, where the office must comply because of legality or regularity issues; discretionary, where the correction is strongly urged; and recommendation, where the finding is a suggestion. The audited office must indicate who on its staff is responsible for implementing the audit report conclusions. The audit reports and recommendations are summarised and published in an annual report.

In 1994, the SFAO extended the audit function to include effectiveness and efficiency audits. Annually, the audit office conducts between six and eight efficiency evaluations which represent about 10% of the workload. The

audit office has two main tasks where about 40% of the work is on accounting audits (more internal control checks) and 40% is on financial audits (in the wide sense) which include all the legality, regularity and performance audits. The final 10% of the workload is taken up in assistance work for the Swiss Parliament. According to the new Article 170 of the federal constitution, it is required that the federal programmes also have to be audited with respect to performance. In application of a special law and decree, the Federal Council and the offices are held to examine the federal tasks in a periodic and systematic way on their necessity and their correspondence with the principles of administrative activities and leadership. The SFAO contributes to this requirement with its implementation of effectiveness and performance audits.

The SFAO shall monitor and conduct audits on how the cantons use the federal funding allotted to them (subsidies, loans, advances), provided such control is foreseen by a federal law or decree. In all other cases the SFAO may only examine the use of federal funds with the consent of the cantonal government concerned. As a rule of conduct the SFAO will work together with the cantonal auditing services to which it may delegate certain auditing assignments. The strategy of the SFAO also mentions leadership in auditing questions and permanent audit formation. The cantonal auditing services and the internal audit units can participate in the SFAO formations. Because of the independence of cantons, the federal government has no role in dictating processes and procedures. But the SFAO does initiate an annual meeting and different working groups and can make recommendations on practices.

4.3. Internal control

The internal audit units (inspectorates) of the federal administration, including those of the Federal Court and the enterprises and institutions of the government, shall be responsible for the control of the financial management in their domain. They shall be directly assigned to the managing director, although being autonomous and independent in the fulfilment of their control duties. The SFAO approves their rules and regulations, supervises the effectiveness of controls, and guarantees the co-ordination of the financial inspectorates. The SFAO is also responsible for the training and further education of the personnel of the financial inspectorates within the general federal administration. There are no general requirements for an internal audit; however larger programmes do run internal audits. Where they exist, these are most often set up at the request of the SFAO. A few departments, like defense, have inspectorates although they are not specifically for financial matters. For example, they make management and programme recommendations.

5. Financial relations between levels of government

The cantons and municipalities have their own tax and non-tax revenues, amounting to around CHF 105 billion (including shares in the federal taxes by virtue of the prevailing tax-sharing systems, mainly 30% of income tax revenue, 10% of the dividend and interest withholding tax and 12% of the tax on mineral oils). Cantons also receive a share in the profit of the Swiss Central Bank. In addition, they receive around CHF 10 billion in federal transfers.¹⁴ There are some 50 transfers of this kind. More than 30 of them have an equalisation aim as well as the financing aim. These subsidies are in principle composed of a base rate and a rate that aims to compensate for differences in financial capacity. The financial capacity is assessed by means of an indicator which is based on various factors, one of which is inversely related to the actual fiscal sacrifice per inhabitant, relative to the federal average (so that a canton that already has a relatively high level of taxation per inhabitant is supposed to have low fiscal capacity) and another of which is the share of arable area (low in mountainous cantons). The cantonal and municipal shares in the federal taxes are also equalised by the indicator of financial capacity. However, equalising formulas differ between the various subsidies and cantonal shares of federal revenues.

Since the present system is considered as non-transparent, ineffective and inefficient, an entirely new system of financing and equalisation has been developed over the past several years. This project requires the amendment of 27 constitutional provisions. The constitutional amendments were approved by Parliament in October 2003 and ratified by referendum on 28 November 2004. The required changes in dozens of transfer laws will be discussed in Parliament in 2005 and 2006. In 2007, the equalisation parameters of the new system will be determined. In each of these phases, optional referenda may be held. In 2008, the new system is expected to be launched.

The present system is considered as non-transparent because equalisation takes place in more than 30 transfer laws and because transfers sometimes come from different federal departments or offices. Furthermore, the existing transfer laws often stem from a diffuse division of tasks between the Federation and the cantons. The present system is considered as ineffective because the differences in financial capacity between the cantons are equalised to a lesser degree than desired by the government and Parliament. The present system is considered as inefficient because it contains incentives for the financially weaker cantons to increase taxation and to concentrate expenditures on tasks that are relatively more subsidised. The new system, called Reform of Financial Equalisation and Redistribution of Tasks between the Confederation and the Cantons, aims to solve or mitigate

these problems through two levers: a new division of tasks between federal and cantonal governments, and a new equalisation system.

The new division of tasks aims at three goals: disentanglement of tasks and financing arrangements; more effective co-operation when tasks have to be shared; and more effective horizontal co-operation between the cantons. For the first goal, seven tasks have been identified that will be concentrated at the federal level, and a large number of tasks have been identified in the areas of social services, education, traffic and environment that will be concentrated at the cantonal level. For the second goal, 17 tasks have been identified where exclusive attribution to a single level of government is not desirable and where co-operation between federal and cantonal government remains necessary. In these areas, subsidies will be based on normative costs or budgets (not on costs of separate means of production) and multi-annual programmes. These programmes will specify targets for service levels that will be checked by the federal government. For the third goal, federal legislation will encourage co-operation. Presently, cantonal co-operation is voluntary. In the future, cantons will have to pay for services delivered by neighbouring cantons in exchange for rights of participation. The specific arrangements have to be laid down in separate treaties between the cantons concerned or in a general inter-cantonal treaty. At the request of a qualified majority of cantons concerned, Parliament will be able to impose inter-cantonal treaties on all cantons and to oblige individual cantons to accede to inter-cantonal treaties adopted by other cantons.

The new equalisation system will be separated from the current transfer laws and be managed as an independent transfer system. It is based on two principles: equalisation of revenue capacity and equalisation of service costs.

The objective of the equalisation of tax capacity is that the cantons with the lowest tax capacity will receive additional means so that their tax capacity after equalisation will be at least 85% of the average tax capacity per canton. This aim will be attained by an equalisation transfer that will be composed of a horizontal and a vertical component. The constitution states that the horizontal component has to be determined in such a way that it amounts to at least two-thirds but at most four-fifths of the vertical component. It appeared from model calculations for 2001/02 that under these conditions a horizontal equalisation transfer of around CHF 1.1 billion from the cantons with high tax capacity accompanied by a vertical equalisation transfer from the Federation of around CHF 1.6 billion would be required. The actual amounts of the vertical and horizontal components will have to be determined every four years by the Swiss Parliament in compliance with the proportional 2/3 to 4/5 band. In the next three years, the horizontal transfers

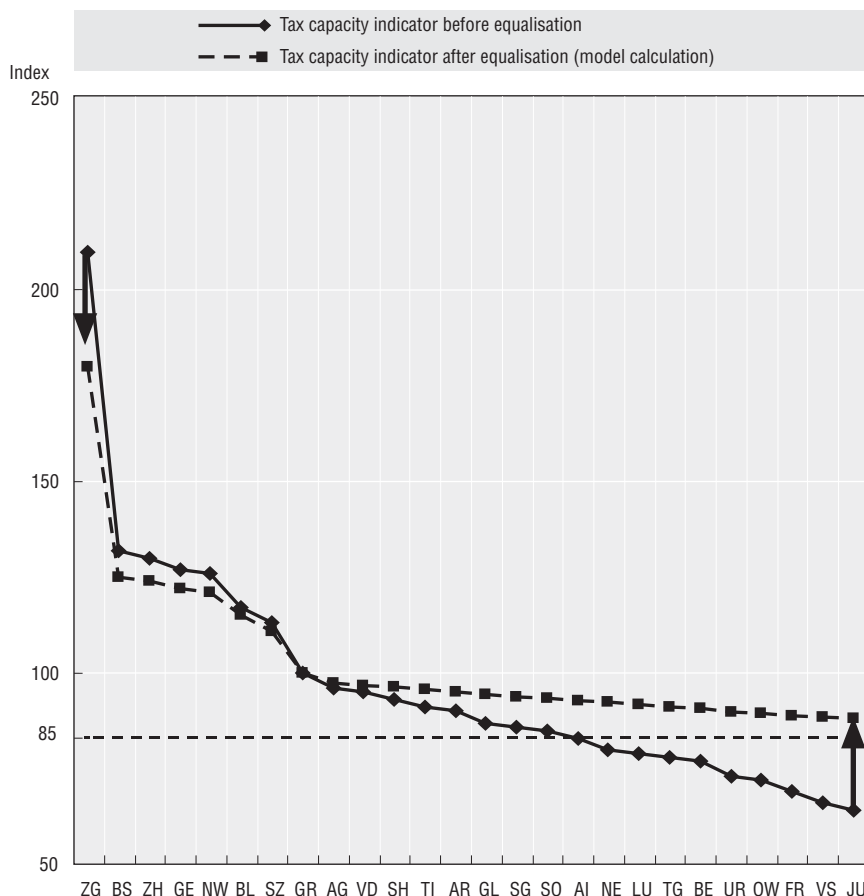
will be increased by the relative growth of the tax capacity of the transferring cantons and the vertical transfers will be increased by the growth of the tax capacity of all cantons.

The tax equalisation system is based on a tax capacity index. This index is based on the tax base of the cantons, not on actual tax revenue. The tax base is computed from the taxable incomes and wealth of family households and the taxable profits of firms in the canton. In order to arrive at an index that is comparable with actual tax revenue, it is necessary to define a measure of average depletion of the tax base, namely: the sum of the tax revenues of all cantons and municipalities divided by the sum of all tax bases of the cantons. This measure for 2002 is 31.5%. Tax capacity of an individual canton is subsequently defined as the average tax depletion rate times the tax base of the canton. This is the tax revenue the canton would receive if it would deplete its tax base at the average rate. This measure can be compared to actual tax revenue. It shows how much money the canton loses or wins by staying behind or exceeding the average depletion rate of its tax base. The index of tax capacity is the standardised tax capacity with an average of 100.

In order to arrive at the desired aim that the tax capacity of the canton with the lowest tax capacity after equalisation is above 85% of the average tax capacity, it became necessary to make the transfer to the receiving cantons slightly¹⁵ progressive in regard to the tax capacity index of these cantons (for instance, a canton with index 80 before equalisation getting more than twice what a canton with index 90 receives before equalisation). On the other hand, the transfers from the sending cantons are strictly proportional in regard to the tax capacity of these cantons (for instance, a canton with index 120 before equalisation paying exactly twice as much as a canton with index 110 before equalisation). Figure 7 shows the effects of the tax equalisation system on the tax capacity before and after equalisation for the year 2001/02.

The mountainous cantons and the cantons that comprise cities are confronted with relatively high service costs which they cannot avoid. In order to compensate for these costs, an equalisation mechanism for service capacity exists in addition to the one for tax capacity. The mechanism consists of two parts: a geographical-topographical and a socio-demographical equalisation mechanism. Geographical-topographical equalisation compensates for altitude (leading for instance to high costs for infrastructure), steepness (leading for instance to high costs for forest management) and low population density (leading for instance to high costs for infrastructure, education, and health services). Socio-demographical equalisation compensates for high costs caused by the population structure (social services related to poverty, old age and immigration) and for high costs caused by population and employment density (security services, traffic).

Figure 7. **The effects of the proposal for tax capacity equalisation**
(cantons on horizontal axis in order of tax capacity)



Source: Information brochure for referendum proposal of 28 November 2004, Federal Department of Finance.

Service capacity equalisation is independent from factual costs: it compensates for the costs of potential services, regardless of whether these services are actually provided. In this respect it is fully comparable to the equalisation of tax capacity. Service capacity equalisation compensates only for the additional costs of a basic package of cantonal and municipal services, not for those services that cantons and municipalities choose to offer in addition to the basic package (for instance swimming pools or cultural services). Spillovers between cantons (for instance in higher education, law enforcement, the prison system, cultural services) are in principle not compensated via the equalisation of service costs but via inter-cantonal co-operation (see above).

Service capacity equalisation proceeds by the calculation of three indicators, one for the geographical-topographical equalisation and two for the socio-demographical equalisation. The first indicator is composed of four partial indicators, one for steepness (median of the altitudes of arable surfaces), one for altitude (share of population living at a higher altitude than 880 meters) and two for population density (share of population living in settlements of less than 200 inhabitants, and number of inhabitants per hectare). The four partial indicators are standardised and integrated with weights 33.3%, 33.3%, 16.7% and 16.7% in the geographical-topographical indicator. On the basis of model calculations for 2001/02, this equalisation transfer will be received by 18 out of the 25 cantons.

The second indicator measures the high costs of social services. It is composed of three partial indicators, one for poverty (consisting itself of sub-indicators for long-term unemployment, drug dependence and single parents), one for the share of elderly population (>80) and one for the share of immigrants. The three partial indicators are again standardised and integrated with weights 40%, 23% and 36% respectively in the social services indicator. The transfer is received only by cantons with above-average costs. Since the costs of social services are concentrated in a few cantons, only seven cantons will receive this equalisation transfer.

The third indicator measures the high costs of police, law enforcement and traffic in cantons comprising large cities. It is composed of three partial indicators, one for the number of inhabitants, one for building density (number of inhabitants and jobs in relation to productive surface) and one for employment density (number of jobs in relation to population). Again the partial indicators are standardised and integrated with weights 25%, 37% and 28% respectively in the city indicator. This transfer too, is received only by cantons with above-average costs. Since the costs of large cities are even more concentrated than the costs of social services, only five cantons will receive this equalisation transfer.

In contrast to the tax capacity equalisation transfers, the service capacity equalisation transfers are financed exclusively by the Federation (there is no horizontal component). The size of the service capacity transfers is decided every four years by the Swiss Parliament. The size of each of the three transfers has to be decided separately. In the next three years, each of the three transfers is to be increased to compensate for inflation.

From model calculations for the year 2001/02, it appears that if the reforms had been introduced that year on the basis of budget neutrality (in comparison to the present system), the federal equalisation transfers would have consisted of 72.5% for the tax capacity transfer (the vertical component), 13.7% for the geographical-topographical service capacity transfer, 9.2% for

the social services component of the socio-demographical service capacity transfer, and 4.6% for the large city component of the socio-demographical service capacity transfer. The shares of the vertical and horizontal components in the tax capacity equalisation transfer would have been 59% (vertical) and 41% (horizontal). In order to achieve budget neutrality, the cantonal share of federal income taxes would have to have been reduced from 30% to 17%.

In order to avoid having certain cantons see their federal transfers diminish or grow less rapidly than intended as a consequence of the reforms, it will be necessary to introduce a temporary hardship transfer. The transfer is determined on the basis of an intended target of net benefits from the introduction of the reforms per canton. The intended target is dependent on the tax capacity index (a canton with a lower tax capacity before equalisation is supposed to benefit more). Cantons for which the target is not reached receive the hardship transfer. The transfer will be frozen for eight years and subsequently be reduced by 5% per year. Parliament can decide every four years to abolish the hardship transfer in the light of information about its effectiveness. The transfer will be paid from a cohesion fund which is financed two-thirds by the Federation and one-third by the cantons. For the federal part, the condition of budget neutrality does not apply (it will amount to a net cost of the introduction of the reforms). The distribution of the cantonal part will be based on population and thus be roughly equal per inhabitant (around 11 Swiss francs on the basis of 2001/02 data). On the basis of the 2001/02 data, the hardship transfer would apply to seven cantons and amount to around CHF 244 million. The total effects of the reforms for 2001/02 are shown in Table 3.

The reform of the transfer system is an impressive project. It is very large and complex and still seems to be well integrated and strongly co-ordinated by the responsible federal department. The design of the system is in accordance with modern principles of fiscal federalism. Equalisation, financing and compensation of spillovers are henceforth separated and independently manageable.

The equalisation system is based on tax capacity and service capacity and does not contain improper incentives to increase or decrease cantonal taxation or to increase or decrease cantonal service levels. The equalisation system fulfills a financing function as well as an equalisation function. Financing covers a basic package of cantonal services, often prescribed in federal legislation. Financing through special transfers will henceforth be limited to cases where collaboration of the Federation and the cantons is required. Compensation of spillovers will take place through inter-cantonal treaties and not involve federal budgetary means.

Table 3. **The new financial equalisation system: charges, payments and equalisation effects**

Charges (+) and payments (-) in thousands of Swiss francs

	Resource equalisation		Cost compensation			Resource indicator		Cohesion fund		
	Charges to cantons with above average potential of resources (horizontally)	Payments to cantons with below average potential of resources (horizontally and vertically)	Social services (poverty, highly aged population and immigrants)	Large city services (population, building density, employment density)	Geographic-topographic cost compensation	Total	Before resource equalisation	After resource equalisation	Charges of cantons	Payments to cantons
Zurich	578 211	–	–25 596	–50 537	–	502 078	132.7	125.2	13 551	–
Berne	–	–749 119	–	–1 879	–15 860	–766 858	78.7	91.0	10 641	–102 592
Lucerne	–	–225 482	–	–	–6 146	–231 628	81.3	91.5	3 845	–
Uri	–	–35 308	–	–	–9 666	–44 974	74.7	90.3	387	–
Schwyz	21 176	–	–	–	–3 626	17 550	111.8	109.1	1 419	–
Obwald	–	–33 696	–	–	–4 070	–37 766	73.6	90.2	358	–16 879
Nidwald	14 009	–	–	–	–855	13 153	126.4	120.4	409	–
Glaris	–	–13 007	–	–	–4 288	–17 294	88.6	93.8	429	–
Zoug	148 239	–	–	–	–75	148 164	207.2	182.7	1 087	–
Fibourg	–	–285 885	–	–	–12 506	–298 391	70.6	89.9	2 634	–
Soleure	–	–112 708	–	–	–	–112 708	85.2	92.5	2 708	–
Bâle-Ville	99 781	–	–25 094	–18 330	–	56 357	134.2	126.4	2 155	–
Bâle-Campagne	60 532	–	–	–	–	60 532	116.3	112.5	2 862	–
Schaffhouse	–	–11 593	–558	–	–	–12 151	93.2	95.6	819	–
Appenzell Rhodes-Extérieures	–	–11 743	–	–	–15 747	–27 490	91.4	94.8	598	–9 344
Appenzell Rhodes-Intérieures	–	–7 027	–	–	–6 468	–13 496	84.9	92.5	163	–
St-Gall	–	–187 892	–	–	–2 034	–189 926	86.3	92.9	4 994	–
Grisons	–	–6 793	–	–	–111 045	–117 838	97.8	98.3	2 101	–
Argovie	–	–30 817	–	–	–	–30 817	96.6	97.5	6 013	–24 347

Table 3. The new financial equalisation system: charges, payments and equalisation effects
Charges (+) and payments (-) in thousands of Swiss francs (Cont.)

	Resource equalisation		Cost compensation			Total	Resource indicator		Cohesion fund	
	Charges to cantons with above average potential of resources (horizontally)	Payments to cantons with below average potential of resources (horizontally and vertically)	Social services (poverty, highly aged population and immigrants)	Large city services (population, building density, employment density)	Geographic-topographic cost compensation		Before resource equalisation	After resource equalisation	Charges of cantons	Payments to cantons
Thurgovie	–	–162 293	–	–	–3 598	–165 892	80.0	91.2	2 539	–
Tessin	–	–66 202	–17 797	–	–11 455	–95 454	91.5	94.9	3 404	–2 206
Vaud	–	–91 311	–57 626	–3 521	–	–152 457	93.6	95.9	6 990	–
Valais	–	–402 282	–	–	–65 374	–467 656	66.6	89.7	3 041	–39 756
Neuchâtel	–	–102 243	–7 106	–	–19 179	–128 528	82.2	91.7	1 861	–45 752
Genève	167 785	–	–63 056	–24 149	–	80 580	128.6	122.1	4 527	–
Jura	–	–111 092	–	–	–3 253	–114 345	64.2	89.6	754	–
Total	1 089 732	–2 646 492	–196 832	–98 416	–295 248	–2 147 255	100.0	100.0	80 292	–240 875

Source: Swiss Federal Finance Administration.

Economists have often emphasised that equalisation of tax capacity is largely a matter of allocative efficiency. Indeed, without such equalisation, the tax prices that households and firms pay for goods and services provided by sub-national governments would be dependent on the presence of other households and firms, particularly rich ones, in the area of the sub-national government. That would lead to price differences and spiraling effects of migration movements and additional price differences (Buchanan, 1950; Boadway and Flatters, 1982).¹⁶ This efficiency enhancing effect of tax capacity equalisation is stronger to the extent that the share of public goods in the budgets of sub-national government is larger (as opposed to private goods). This is the case because the tax price of private goods in more populous governments decreases only because of economies of scale, whereas the tax price of public goods in more populous governments also decreases because of the fact that costs do not increase but are shared by more taxpayers. In Switzerland, the share of public goods in cantonal budgets seems quite high (infrastructure, law enforcement, prison systems, public transport).

On the other hand, service capacity equalisation is a matter of solidarity between cantons. It also tends to harm allocative efficiency because it contains an incentive to steer productive activities towards regions where they cannot be carried out at minimal costs.

Although in the case of Switzerland it is entirely clear that the solidarity motive behind service capacity equalisation cannot be discarded and in a certain sense is a basic part of the constitutional set up of the Swiss Federation, it could nevertheless be sensible for the Swiss authorities to put more emphasis on the different allocative effects of the two types of equalisation while providing information to the public. This could in particular contribute to a relatively moderate development of the cost equalisation transfers in the future, or even a gradual reduction of these transfers.

5.1. Conclusion

Switzerland presently has a system of fiscal equalisation that is not transparent, not very effective and inefficient (wrong incentives). Therefore, it has undertaken an integral overhaul of the system. The introduction of the new system is an impressive project.

The design of the reforms is in accordance with modern principles of fiscal federalism. Equalisation, financing and compensation of spillovers are henceforth separated and independently manageable.

The equalisation system is based on tax capacity and service capacity and does not contain improper incentives to increase or decrease cantonal taxation or to increase or decrease cantonal service levels. Equalisation of tax capacity ensures that the tax capacity of each canton is at least 85% of the

average cantonal tax capacity, and equalisation of service capacity ensures that cantons with exceptional costs because of geographical-topographical or socio-demographical circumstances are compensated.

In public information about the reforms, the Swiss authorities could emphasise somewhat more the distinct effects on allocative efficiency of equalisation of tax capacity on the one hand and of equalisation of service capacity on the other hand.

Notes

1. Switzerland is not part of the euro area, nor a member of the EU, but in calculating its deficit it excludes exceptional factors in the same manner as required by the rules of the European System of Accounts (ESA 95; see Eurostat, 1996).
2. The highest in Europe apart from Norway that has substantial revenues from oil exploitation.
3. Each canton has one vote, except some small cantons which hold a half vote. In total there are 23 cantonal votes.
4. The value-added tax and the federal income tax are also limited in time. To keep these taxes in place they have to be approved periodically in referendums as well.
5. Presently the Federal Council consists of two Social Democrats, two Free Democrats, one Christian Democrat, and two Swiss People Party representatives. The Federal Council is elected every four years. The presidency of the Federal Council changes every year among its members.
6. However, since 2002 the federal loans to the unemployment insurance system are managed outside the federal budget so that the automatic stabilisation effect of the unemployment compensation system is not impeded.
7. Until the revision of the method for the budget year 2004, the trendline was constructed not only from past realisations but also from forecasts for the budget year and the three subsequent years.
8. The adjustments were proposed by the Group of Economic Advisers of the Federal Finance Administration and entailed among other things the removal of the GDP forecasts from the data from which the trendline is estimated and the adjustment of the Hodrick-Prescott filter to make it less sensitive to short-term fluctuations. The forecasts were introduced to begin with because the Hodrick-Prescott filter makes the trendline relatively sensitive to end-of-period estimates and thereby reduces the size of the cyclical factor. By using forecasts, the budget year would be further removed from the end-of-period estimate. However, this overlooked the fact that nominal forecasts are generally revised in tandem with revision of the realisation estimate (because the estimated growth percentage is not changed on the occasion of the revision), so that the problem is enlarged rather than reduced. Moreover the Group of Economic Advisers concluded that GDP forecasts are generally not very accurate (usually held at 2% in the last 20 years). The end-of-period problem was therefore mitigated by the adjustment of the filter itself (Bruchez, 2003a).
9. This fact is reflected by recent research to break down the deficit into three components: structural, cyclical and irregular non-cyclical (Bodmer and Geier, 2004). However, it is questionable whether policy reform on the basis of this

proposal could be made compatible with the constitutional formulation of the debt containment rule. Apart from that, it would complicate the rule and add to the subjective elements in its interpretation.

10. The main difference between the Dutch approach on the one hand and the British and Swedish approach on the other hand is that, in the Netherlands, the expenditure path is established at the beginning of a cabinet period and then remains fixed, whereas in the British and Swedish approach the expenditure ceilings are extended on a rolling basis (in the United Kingdom the planning cycle is biannual so that two new years are added at the end of the planning period every two years; in Sweden the planning cycle is annual so that one year is added at the end of the planning period every year).
11. However, in the United Kingdom the social security sector (the annually managed expenditures or AME) is exempted from the multi-annual expenditure ceiling and allowed to fluctuate. This strengthens the stabilisation effect and makes the fiscal rule anticyclical rather than acyclical. In Switzerland the unemployment insurance is exempted from the fiscal rule to the same effect.
12. One might pose the question of whether using trend GDP and structural revenue predictions instead of realisations is in accordance with the wording of the debt containment rule in the Swiss constitution. A relevant consideration in this respect may be that the budget by definition requires predictions or extrapolations because it is forward looking. The question thus hinges on how retrospectively observed deviations between predictions and realisations are taken into account. In the British, Dutch and Swedish approaches, such deviations have to lead to revisions of the GDP trend or structural revenues and adjustments of the expenditure path at the end of the planning period or in the next planning period, rather than in the next three years as required by the Swiss equalisation account mechanism.
13. Federal Council members are typically drawn from Parliament but they must resign their seat upon election to the Council. However, there is no requirement that Council members be parliamentarians.
14. In the Swiss budgetary terminology it is customary to make a distinction between subsidies that have the character of financial aid and those that have the character of indemnity. The first are given as an incitation for activities that cantons and municipalities have undertaken on their own initiative. The latter are given as a compensation for costs incurred by virtue of tasks prescribed by federal law.
15. The payment schedule cannot be made strongly progressive because that would violate the condition that the order of the cantonal tax capacities must not be changed before and after equalisation. If this condition is not imposed, cantons would no longer have an incentive to increase their tax base by attracting firms and family households.
16. There is a small difference between the equalisation of fiscal residuums as proposed by Buchanan and the equalisation of tax capacity as treated by Musgrave (1961) in that the former aims at equity at the individual level rather than at the sub-national level. In practice, both approaches are roughly identical.

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Market-type Mechanisms and the Provision of Public Services

by

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Market-type mechanisms are defined as “encompassing all arrangements where at least one significant characteristic of markets is present.” In the area of service provision, the prime instruments include outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. This article describes each instrument, surveys its use in OECD countries, analyses the key issues involved, and offers an overall assessment.

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1. Introduction

Market-type mechanisms are a broad concept. In the early 1990s, the OECD adopted the very comprehensive definition of “encompassing all arrangements where at least one significant characteristic of markets is present.” In the area of service provision, the prime instruments include outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. Other examples of market-type mechanisms include user charges and the use of transferable permits for allocating and managing limited-supply “public” goods (greenhouse gas emissions, for example).

The use of market-type mechanisms is increasing in OECD member countries, although there are marked country differences in this respect. The driving force behind this phenomenon is the need for governments to secure increased value for money in their operations. Some market-type mechanisms, most notably vouchers, move beyond this and have as their primary goal to increase the choices offered to the users of services.

The evidence that market-type mechanisms can secure such efficiency gains, either through lower costs or improved service levels, is substantial. However, the decision to use market-type mechanisms needs to be made on a case-by-case basis and the specific design of these instruments is critical to their successful application.

There are significant management challenges for governments in moving to a market-type mechanism model, especially in separating the roles of government as purchaser and provider of services. Traditionally, governments performed these roles concurrently. Governments will have to invest in capacity for specifying services and contract management skills that they have not typically possessed in the past. It concerns both new technical skills and an overall culture change in the public sector. By definition, it will not happen overnight.

Concerns have also been raised about the governance implications of the use of market-type mechanisms. At present, their use is secondary and operates at the margin of an overall dominant traditional role for government provision. The governance concerns will therefore likely increase as the use of market-type mechanisms expands. This is especially relevant for accountability, transparency, regularity, and the access to redress mechanisms for citizens.

This paper covers the main market-type mechanisms used for public service provision with a section each on outsourcing (contracting out), public-private partnerships (PPPs) and vouchers. Each section describes the instrument, surveys its use in OECD member countries, analyses the key issues involved – both in terms of design and governance factors – and offers an overall assessment. A box at the end of the paper highlights the other principal market-type instruments. The paper concludes by drawing together the main messages emerging from the discussion.

2. What are market-type mechanisms?

A broad definition of market-type mechanisms is that they encompass all arrangements where at least one significant characteristic of markets is present. Examples of specific kinds of market-type mechanisms are defined below.

Outsourcing is the practice whereby governments contract with private sector providers for the provision of services to government ministries and agencies, or directly to citizens on behalf of the government. Different terminology is used in different countries for outsourcing, including competitive tendering, contracting, and contracting out. The range of services outsourced in OECD member countries is very wide. They include blue collar support services (building cleaning, catering), professional services that are considered ancillary to the core mission of the ministry or agency (information technology), and core government functions (prisons).

Public-private partnerships (PPPs) refer to arrangements whereby the private sector finances, designs, builds, maintains, and operates infrastructure assets traditionally provided by the public sector. PPPs can also involve the private sector purchasing already existing infrastructure assets and redeveloping them. Public-private partnerships bring a single private sector entity to undertake to provide public infrastructure assets for their “whole of life”, generally 20-30 years. (The asset generally reverts to the government at the end of this period.) The private sector partner then charges an annual fee for the use of the infrastructure assets. This can either be paid by the government or through user charges, or a combination of the two. PPPs are also known as private finance initiatives (PFI), projects for public services, and private projects. PPPs have been most extensively used in the provision of transportation infrastructure, but other examples include schools, hospitals, office buildings, and water and sewage treatment facilities.

Vouchers separate the provision of public services from its financing. The funding remains with the government in the form of a voucher that is issued to individuals and which entitles them to exchange the vouchers for services at a range of suppliers. The individual voucher-holder chooses among the

different suppliers and pays with the voucher. Vouchers have been used for the provision of low-income (social) housing assistance, primary and secondary education, child care services, and care for the elderly.

Each of these mechanisms will be examined in turn.

3. Outsourcing

The primary objective of outsourcing is to increase efficiency by introducing a competitive environment for the provision of the services. The specific “business cases” for outsourcing generally cite one or more of the following points:

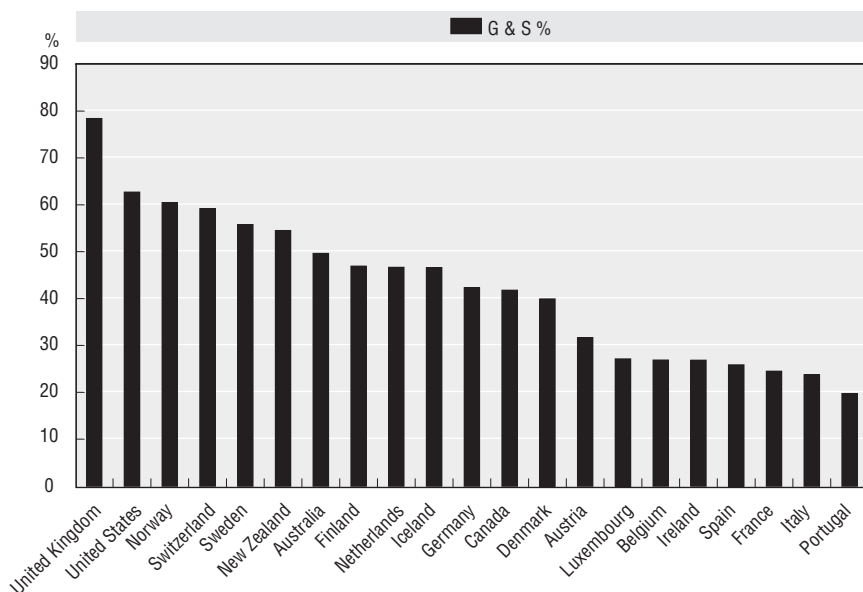
- to reduce costs;
- to access expertise not available in-house to meet one-off needs;
- to access expertise on a long-term basis in order to be able to vary its quantity and mix over time;
- to replace current government operations in extreme cases where their provision is unsatisfactory. This is rare and limited to cases where there is a long history of poor performance.

The use of outsourcing is clearly increasing in OECD countries although it is difficult to quantify precisely since governments do not maintain standardised or comparable data over time on their use. It should also be emphasised that outsourcing *per se* is not new in OECD countries. For example, the use of private contractors for the construction of various infrastructure projects has been the norm in most countries for an extended time. Conceptually, this was viewed as an acquisition (procurement) rather than as outsourcing.

Figure 1, using data from Government Finance Statistics (GFS; see International Monetary Fund, 2001) as a proxy, quantifies the use of outsourcing in selected OECD member countries. The figure looks at the share of government’s purchase of all goods and services from outside vendors as a proportion of total expenditures, excluding transfers and interest payments. As such, the figure includes purchases of items that would generally not be classified as outsourcing, and the aggregate numbers should be deflated appropriately – most likely equivalent to about 15-20 percentage points of reported total outsourcing. The figure also applies only to central (national/federal) governments. As a result, country differences may in some cases reflect the different assignment of functions among different levels of government. Nonetheless, the strong variations between individual countries are striking.

Based on these calculations, the United Kingdom has the highest level of outsourcing activity among the selected countries. Its level of outsourcing is nearly four times that of the country with the lowest calculated level of

Figure 1. **Outsourcing of government services**
(purchase of goods and services vs. in-house provision)



Source: OECD Secretariat calculations based on GFS data.

outsourcing. In general, outsourcing is applied to a greater extent in the English-speaking countries and the Nordic countries, and much less so in the continental European countries. Among the first group of countries, outsourcing has also been increasing significantly in recent years. For example, outsourcing is estimated to have increased by 33% over the past 10 years in the United States (Eggers and Goldsmith, 2003).

Aside from different views of the appropriate role of the State, the strong country differences in the use of outsourcing also reflect the nature of the public sector labour market in individual countries. Continental European countries tend to have a less flexible public service which can make it prohibitively expensive to retrench public servants and outsource their activities.

3.1. Outsourced activities

The range of services outsourced in OECD member countries is very wide. These can be divided into three distinct groups. The first consists of various blue collar support services. These are generally the first activities that

governments outsource and are common to all countries. In some, the outsourcing of such services is essentially complete, with the government having withdrawn completely as a direct service provider. The second group consists of various activities that are considered ancillary to the core mission of the ministry or agency. This moves beyond the blue collar support services to include various high-value professional services – often “back-office” activities. This is an area where the greatest growth has occurred in recent years but country variations are more pronounced. The third group includes the outsourcing of mainline functions previously conducted by the government. These are core activities that many would view as inherently governmental. This type of outsourcing is rare across OECD member countries but is prominent in certain sectors in individual countries. The three groups are also progressively more challenging in implementation, including the availability of competitive supplier markets.

The first group includes services such as the cleaning of buildings, facilities management, waste management, operations of food service outlets and the provision of guard services. The common thread is that these services are generally low-value, relatively labour-intensive and not considered critical to the mission of the agency. However, these can take place under extreme circumstances – catering for combat soldiers in hostile environments or the protection of high-risk facilities such as nuclear sites.

The leading example of the second group is the outsourcing of information technology functions. This has been a major trend over the past years with private providers taking on ever larger parts of the information technology infrastructure in government ministries and agencies. This often entails the outsourcing of related back-office operations. Other common examples include the outsourcing of legal, human resource management, banking and financial services. These are generally high-value services that are ancillary to the core mission of an agency but are nonetheless critical to its operations. Another characteristic of this group is that the functions outsourced are often complex in nature and involve rapid change in their operating environment.

The extreme example of outsourced services that many would view as inherently governmental is the outsourcing of prisons (Australia, Canada, United Kingdom, United States). Other core functions that have been outsourced include emergency rescue and fire services (Denmark), enforcement activities such as food inspection (Iceland), and the services of the audit office (New Zealand).

The use of outsourcing in health, education and welfare services has made important inroads in certain countries. This includes employment (job placement) services, diagnostic services, specialised hospital care, care

centres for children, education, child welfare services, and long-term care institutions for the elderly and for the handicapped. Outsourcing in this field has in some cases been motivated primarily by the poor performance of the previous government providers. In some cases, contracts are awarded based on a standard competitive tendering process. In other cases, contracts are made with a set of suppliers allowing users a choice of supplier as with a voucher scheme (see the section on vouchers below).

The outsourcing of research and development functions whereby private institutions compete for project-based funding has increased significantly and is an area where government withdrawal from a core area has been most pronounced across OECD member countries. Similarly common is the outsourcing of technical assistance in foreign aid programmes of OECD countries. The use of outsourcing for the operation of various infrastructure assets – transportation, water supply, sewerage – is also increasing in individual countries.

The evidence that outsourcing increases efficiency is substantial, with extensive studies having been conducted on the impact of outsourcing on service quality and costs. A survey of 66 large cities in the United States found that 82% of the cities reported they were satisfied or very satisfied with the resulting performance, and the remaining 18% were neutral. None were dissatisfied. The report found a 25% improvement in service on average. The shift to a competitive environment also resulted in savings of up to 60% (Dilger *et al.*, 1997). A study of over 2 000 outsourcing initiatives in the United States federal government found an average cost savings of 33% with same or higher levels of service (Clark *et al.*, 2001). In other countries, average cost savings have been estimated at 15-20% in Australia, 5-30% in Denmark, 20-25% in Iceland, and 20% in the United Kingdom.

3.2. Key issues

A number of governance-related issues arise from outsourcing, many of which are applicable to the use of market-type mechanisms more generally. There are strong obstacles to the introduction of outsourcing. This can be due to public concern about private sector involvement in traditional government activities. The variety of services outsourced in different countries shows that there are very few services that technically cannot be outsourced. Where outsourcing involves a direct challenge to existing government service provision there may be strong resistance from affected government employees, unions and their political allies.

Some OECD member countries have introduced mandatory policies to require market-testing (competitive sourcing) where existing employees compete with private providers for the provision of the services. This may be

appropriate in the introductory phases of a new outsourcing policy but it creates a very adversarial relationship. More sustainable is to mainstream outsourcing policy and for it to become an established feature of everyday management decisions. Tight budgetary restrictions are a key impetus for achieving this as they promote the use of best value-for-money solutions for the provision of government services. Such an approach also makes outsourcing a more dynamic opportunity for re-engineering government services rather than being a mechanistic consideration of outsourcing existing services.

Outsourcing can generate governance concerns in terms of the accountability for the services being provided by a private contractor. This is especially relevant when that service is being provided directly to citizens on behalf of the government.

In the traditional provision of public services, accountability was essentially an in-house affair based on hierarchical controls focusing on inputs and processes. Outsourcing introduces a separation between the purchaser and provider and requires the specification of the services to be delivered together with appropriate performance measures. This should serve to significantly enhance accountability. Performance is now monitored against explicit standards, and the potential conflict of interest of having the same organisation (or even the same official) responsible both for assessing performance and acting as the service provider is avoided.

Accountability can however become blurred in this environment simply because of the introduction of a new actor. In the traditional model, accountability was clear in the sense that it was one organisation responsible for the whole process. With outsourcing, the government entity is still accountable for the service provided, including actions carried out on its behalf by the contractor, but day-to-day responsibility for specific actions will lie either with the government entity or the contractor. It may be difficult for the users of services to determine who is responsible for the delivery of the service, especially if this division of responsibility is not clear as can be the case.

In this context, the inherent political nature of the public sector needs to be recognised as well, and the role it can play in superseding a purely commercial framework. The public and the media will always hold a minister accountable overall and responsible for the specific actions of contractors. Similarly, public and media pressures focused on specific outsourcing activities can serve to override specific commercial terms in a contract, generally resulting in a renegotiation of the contract at higher cost. Such risks need to be taken into account.

The capacity of governments to outsource effectively needs to be established and sustained over time. This involves both retaining the technical expertise of the function being outsourced and developing the

commercial skills for managing the outsourcing process. Based on countries' experiences, there is a risk that the technical capacity to assess future outsourcing options will be lost over time as the government is no longer directly providing the service. This may lead to a dependency on the incumbent contractor when the activity is re-tendered and/or may preclude the government from taking the activity back in-house. The commercial skills inherent with outsourcing are typically new to governments and need to be built up. It is important that these skills become an established and ongoing function rather than being seen as a one-off exercise each time. This has important implications for human resource management and internal structures of organisations.

The implications are well demonstrated in a report by a committee of the Australian Parliament reviewing the use of outsourcing for support services by the Australian Defence Forces (ADF):

Frequently, the successful tenderer for the support contract relies on recruiting the trained Defence personnel who have been made redundant in the ADF because of the function's transfer to the commercial sector. Through employing these already-trained personnel, the successful civilian tenderer is able to provide a commercially attractive initial price for a support capability because there is no need to factor in staff training costs in the contract. This process becomes disadvantageous to Defence where the successful tenderer becomes the monopoly supplier of the support service, and Defence must subsequently renegotiate that contract from a position of weakness, having eliminated its own in-house capability to perform the particular function.

(Joint Standing Committee on Foreign Affairs, Defence and Trade,
1998, p. 35)

Concerns have been raised about the nature of contract specificity in the public sector. Government contracts have a tendency to be prescriptive and process oriented, whereas private sector contracts tend to be more output (or outcome) oriented. There are several reasons for this. First, government agencies are rightly concerned with the accountability implications of outsourcing as noted above and are often more comfortable with these traditional means. Second, this may be a manifestation of resistance to outsourcing in agencies and designed to undermine its success. Third, it may be difficult to specify outputs (or outcomes) in concrete terms in some instances – in which case the decision to outsource in the first place should be questioned. The more prescriptive or input oriented the contract is, the more difficult it is for the contractors to be flexible and innovative in order to secure efficiency gains, which is the *raison d'être* for outsourcing.

The studies cited above on gains from outsourcing generally show the lower range of savings coming from input or process oriented contracts

whereas the higher range of savings come from output (or outcome) oriented contracts. An innovative solution is for governments to engage in a two-stage bidding process. First, the government formally issues a tender offer but specifies its needs only in general terms. Contractors are invited to be creative in responding to those needs. Based on the information gathered in this first round, the government puts out a more detailed tender offer in the second phase (Healy and Linder, 2003). This strives to achieve a balance between efficiency (flexibility) and specificity.

In general, the flexibility (discretion) of a contractor needs to be weighed against the notion of regularity (equal treatment) which is a hallmark of the public sector. Contractors' discretion can become an issue when a service provider is accorded "the power of the State" in determining eligibility or levels of eligibility for certain services (for example, case management in social services). Similarly, contractors could offer services to different client groups in different manners. For example, an outsourced job placement provider may decide to provide an individual client with a bicycle in order to commute to a new job. As a result, the service provider secures a payment from the government for having successfully placed the individual in a job. However, there may have been another individual in a largely similar situation who was not provided with a bicycle. *Prima facie* this could be interpreted as violating the regularity principle of the public sector. As part of their contracting functions, governments will need to be clear in establishing the boundaries for appropriate flexibility (discretion) in such cases.

Competitive supplier markets are a prerequisite for successful outsourcing. The government has a clear role to play in developing and sustaining such markets. Depending on the service that the government is outsourcing – commodity-like services vs. highly specialised services – such markets may not be in place when the government embarks on outsourcing. The government may in effect have to create such markets through its volume buying. As a result, the full efficiency gains achieved by outsourcing may materialise over time. The government also needs to ensure that its outsourcing policies promote sustainable competitive markets by avoiding over-reliance on a single supplier. Similarly, the length and size of individual contracts can impact the number of potential suppliers. In short, the government needs to focus on the impact on the supplier market-place of individual outsourcing decisions (United Kingdom Office of Government Commerce, 2003).

Lowest cost is traditionally the main criterion that determines a winning bid. There are examples of suppliers submitting unrealistically low bids ("low-balling") and then engaging in post-contract negotiations over the lifetime of the contract to increase the price. Such practices undermine individual

outsourcing projects and may lead to reliable suppliers withdrawing from the government market-place in general.

As discussed above, transparency is clearly enhanced with the specification of services to be delivered together with appropriate performance measures. However, there are some aspects inherent with market-type mechanisms that can reduce transparency. This is due to the fact that information which was previously in the public domain is now in the hands of private contractors; the public's right to access that information may be impaired. The general tendency in the private sector is for contents of contracts not to be made publicly available. They are considered commercially sensitive. This may justifiably apply in some cases (for example, protection of intellectual property) but is otherwise inappropriate in the public sector context. Appropriate information needs to be publicly available in order for outsiders to be in a position to make an informed judgement about the contracting decision. More generally, contract provisions need to ensure that sufficient information is turned over from the private provider to the purchaser organisation in order for the latter to maintain up-to-date knowledge of the activity for future tendering, i.e. maintaining capacity to avoid capture by the private provider.

Finally, the public sector has over time developed elaborate redress instruments for citizens. These include laws on administrative procedure, Ombudsmen, freedom of information, whistleblower protection and the like. In general, the jurisdiction of such instruments does not extend to private sector providers. It is therefore important for contracts to incorporate appropriate redress mechanisms. These will of course vary on a case-by-case basis but are most applicable to where the contractor is exercising a degree of flexibility (discretion) as noted previously. Governments will also need to ensure that contractors employ appropriate mechanisms to protect the privacy of confidential information they acquire on individual citizens.

3.3. Conclusion

Outsourcing has grown significantly over the past 15 years. It has been shown to be applicable to a wide range of government services. Apart from transitional concerns relating to the disturbance of vested interests, or change in the familiar profile of government, the constraints relate to the degree to which the delivery of the service can be monitored at arm's length, the need to maintain government's core capacity now and for the future, and the protection of other core governance principles. The benefits of outsourcing in terms of increased efficiency can be significant and the services that have been outsourced rarely revert back to government provision. Outsourcing can be expected to increase substantially in the coming years.

Box 1. Staff issues associated with outsourcing

The manner of moving to outsourcing is important. Staff will generally resist outsourcing initiatives, and morale among staff can decline during the process. The outsourcing process can take an extended period of time with anxiety building up during this period especially if communications with employees are poor. This insecurity caused by not being kept informed has been cited by some as the main staff concern in outsourcing.

Employees are often transferred to the private provider with their working conditions guaranteed, at least for a certain time period. It is by no means a given that working conditions will deteriorate with outsourcing. For example, a staff member whose function is ancillary to the core work of an agency will likely have an improved career track in a firm that specialises in that “ancillary” function.

There is specific legislation in place for the transfer of employee rights with outsourcing in the European Union. In the United States, federal legislation is in place that stipulates that certain benefits (for example, health care) offered by private providers have to be comparable to those for government employees. In some countries, a “clean break” approach is preferred whereby the government settles any redundancy payments and there are no transfers of rights. Governments may also have policies in place whereby preference is given to staff affected by outsourcing for other positions if they do not want to leave government employment.

4. Public-private partnerships

Public-private partnerships (PPPs) refer to arrangements whereby the private sector finances, designs, builds, maintains, and operates (DBFMO) infrastructure assets traditionally provided by the public sector.¹ Private sector involvement in individual aspects of DBFMO has been the norm in most OECD member countries for an extended time. Governments contract with private sector architects for the design of assets, with private sector contractors for the construction of assets, with various private sector entities for the maintenance and operation of assets. These have, however, been discrete activities with different private sector contractors performing each different aspect. With PPPs, a single entity is responsible for the infrastructure’s “whole of life”. As such they can be viewed as a specialised form of outsourcing, with the very notable difference that the private partner is responsible for providing the financing for the project.

Public-private partnerships – as a distinct concept – originated in the United Kingdom in 1992. The United Kingdom is today by far the largest user of PPPs among OECD member countries. Their use has, however, expanded to virtually all other OECD countries. Table 1 provides an overview of PPP activity in selected countries.

PPPs have most commonly been applied for the provision of highway infrastructure. For example, Portugal's ambitious EUR 5 billion National Road Programme employs PPPs. They are also used for other transportation infrastructure, such as airports and railways. The Netherlands is using a PPP programme to introduce high-speed rail links for the Thalys trains in the Netherlands. The new Athens airport was built on a PPP basis. The light rail linking Stockholm with Arlanda Airport employed the PPP model. PPPs are increasingly being used for environmental infrastructure projects such as water systems and solid waste facilities. In terms of number of projects, the greatest use has been for the provision of buildings – including schools, hospitals, nursing homes, prisons, embassies and general office buildings. In these cases, PPPs generally cover the building only and not the specialised services operated in the respective building. For example, the clinical services of a PPP-procured hospital would not be the responsibility of the private partner.

The extent of use of PPPs should, however, not be exaggerated. In the United Kingdom, only about one-tenth of its total capital investments in public services in 2003-04 were through PPPs and this has been relatively consistent over time. In other words, about nine-tenths of investments are conducted through traditional procurement practices.

Appropriately structured PPPs have the potential to improve the efficiency of the design-build-maintain-operate phases. The largest analysis of a PPP programme was undertaken in the United Kingdom in 2003 (H.M. Treasury, 2003). Nearly 90% of all PPP projects were delivered on time by the private partner whereas only approximately 30% of non-PPP projects were delivered on time. Four-fifths of all PPP projects were delivered on budget whereas only one-fourth of non-PPP projects were delivered on budget. All PPP projects that experienced budget overruns were due to changes in requirements by the government. In terms of operational performance, 35% of projects were assessed as “expected”, 16% as “surpassing”, 25% as “far surpassing” expectations. One-quarter of projects, however, did not meet expectations. (This analysis can also be seen as an indictment of the traditional procurement process for such projects in the United Kingdom.)

Analysis of other national PPP programmes have not been undertaken in such a comprehensive manner but the general assessment is similarly positive with the design-build-maintain-operate phases.

Table 1. **Summary of PPPs by country and sector**

	Roads and bridges	Light railway	Heavy railway	Schools	Health and hospitals	Central accommodation	Airports	Housing	Ports	Prisons	Water and wastewater (including solid waste)
	Principal sectors of PPP activity					Subsidiary sectors of PPP activity					
EU Member States											
Austria	▲		▲	●	▲	●	●			●	●
Belgium	▲	●	●	●			▲	▲			▲
Cyprus	▲						◆		▲		▲
Czech Republic	▲	●	●	●	●		●	●			◆
Denmark	▲		▲	▲		●			▲	●	
Estonia	●			●	●						
Finland	▲	●	●	▲	●	●					●
France	★	★	▲	●	▲	▲	▲		▲	▲	★
Germany	◆	◆	◆	◆	●	▲	●			▲	■
Greece	◆					●	★				
Hungary	◆	●		◆	▲			●		▲	◆
Ireland	■	▲		◆	▲	●		▲			■
Italy	■	◆			◆	●	▲	●	▲	●	▲
Latvia	●							●			
Lithuania		●									
Luxembourg							●				
Malta					▲			●			
Netherlands	◆		◆	▲	●	●		●	●	●	◆
Poland	▲	●	●			●	●	●	▲		▲
Portugal	★	◆	●	●	▲		●	●	●	●	◆
Slovakia	●						●				●
Slovenia											◆
Spain	★	◆	●	●	▲	●	●		★		◆
Sweden	●	●	●		●						
United Kingdom	★	★		★	★	★	★	★		★	★
Others											
Bulgaria	●						●				◆
Norway	◆		●	▲	▲	●				●	
Romania	◆				▲			●			◆
Turkey	●	●	●				◆				◆

Legend

● Discussions ongoing

▲ Projects in procurement

◆ Many procured projects, some projects closed

■ Substantial number of closed projects

★ Substantial number of closed projects, majority of them in operation

Source: European Investment Bank (2004), *The EIB's role in public-private partnerships*.

4.1. The transfer of risk

The objective of PPPs is to achieve efficiency gains through competition by private sector providers, transferring risks from the government, and taking advantage of private sector expertise. The effective transfer of risk is paramount to the success of PPPs and a key distinguishing factor of the PPP concept. There are a great number of specific risks but they can usefully be divided into three broad categories: construction risk, availability risk and demand risk.²

Construction risk covers events such as late delivery, additional costs, and technical deficiency. If the government is obliged to start making regular payments to a partner without taking into account the effective state of the asset, this would be considered evidence that the government bears the majority of the construction risk.

Availability risk is when the partner does not deliver the volume that was contractually agreed or fails to meet specified safety or public certification standards relating to the provision of services to final users. It also applies where the partner does not meet the specified quality standards relating to the delivery of the services. If the government is obliged to continue making regular payments regardless of the lack of availability of the asset, it is deemed that the government bears the majority of the availability risk.

Demand risk covers the variability in demand (higher or lower than expected when the contract was signed) irrespective of the behaviour of the private partner. This risk should only cover a shift in demand not resulting from inadequate or low quality of the service provided by the partner or any action that changes the quantity/quality of services provided. Instead, it should result from other factors, such as the business cycle, new market trends, direct competition or technological obsolescence. If the government is obliged to ensure a given level of payment to the private partner independently of the effective levels of demand expressed by the final user, rendering irrelevant the fluctuations in level of demand on the private partner's profitability, the government is deemed to bear the majority of the demand risk.

The efficiency gains with PPPs derive from these transfers of risks and the whole-of-life perspective. For example, the quality of the design and build phases will have a significant impact on their subsequent maintenance and operation. The private partner has a direct financial interest in ensuring the long-term success of the project.

The objective, however, is not simply to transfer as much risk as possible to the private partner, but to assign risks to the party that is best able to manage them, whether they remain with the government or go to the private partner. In short, the entity that is best able to mitigate each risk should be responsible for it. Transferring too little risk and transferring too much risk are

both equally undesirable. The government will expose itself to excessive contingent liabilities if it transfers too little risk whereas transferring too much risk can result in the private partner demanding an excessive fee for taking on the risk. There are no comprehensive rules as to what is the appropriate distribution of risk since all projects are different.

4.2. Financing

It is crucial that the private partner provide the project financing in order to have the proper incentives and assume the appropriate risks. If non-performance occurs, not only will the private partner be deprived of the annual fee paid by the government, but it will continue to be responsible for servicing the debt associated with the project. This is a powerful financial incentive for performance.

The major debate with PPPs, however, concerns the financing phase – notably how PPP financing relates to the traditional budget system and the cost of capital for the private partner.

The use of PPPs may offer governments – specific ministries – the possibility to bypass the established processes for ensuring budgetary discipline and constraining expenditure. Traditional procurements would record the investments as a “lump sum” up front and would form part of the government’s bottom-line surplus or deficit in that year. It would be subject to the same scrutiny as other expenditures. In a PPP environment, the investment may not be recorded up front, with only the annual fee paid to the private partner being recorded in each year’s budget for the infrastructure’s “whole of life”. The original investment could escape the scrutiny of the budget process, and future flexibility could be limited by the annual fees required to be paid to the private partner.

If a PPP is structured in such a way as to move the majority of the risk to the private partner, it may be appropriate to record investment and associated debt off budget. For example, the fiscal criteria for the European single currency allow governments to record transactions this way if the construction risk and either the availability risk or demand risk are transferred to the private partner. These are however very liberal criteria. Outside the EU, not even such criteria apply. No international public sector accounting standards (IPSAS) have been developed. In fact, governments could retain all the risk and use the PPP device solely for the purpose of not recording the transaction on budget.

The private partner’s cost of capital will always be higher than the government’s “risk-free” cost of capital. This is regardless of whether the payments by the government for the project, as called for in the PPP contract, are used as collateral by the private partner for obtaining financing for the loan.

The government's power to tax reduces default risk *vis-à-vis* other borrowers such that the private sector is willing to lend money to governments at a risk-free rate regardless of the underlying risks associated with the projects that the government may use the money for.³

It is, however, important to note that PPPs involve a transfer of risk from the government to the private partner, thus relieving the government of such contingent liabilities. The government's risk-free cost of borrowing does not reflect such project risks as discussed above, whereas those risks are very real. The private partner's cost of borrowing will, however, incorporate the project risks. It is inherently difficult to isolate, analyse and quantify this risk premium. It is nonetheless a fact that a private partner will have a higher cost of capital than the government, and whether the transfer of risk from the government is commensurate with that is difficult to establish (International Monetary Fund, 2004). From a public finance point of view, a PPP can only be justified if the transfer of risks and the efficiency gains outweigh the higher cost of capital. It is therefore essential that the decision to use the PPP model as opposed to traditional procurement be based on a rigorous and dynamic comparison of the benefits and costs of each approach.

4.3. Conclusion

The use of PPPs stabilised at around one-tenth of total annual capital procurement in the one country where it has been most extensively used. PPPs appear to be most appealing for large-scale projects that involve extensive maintenance and operating requirements over the project's "whole of life". This explains why highways are such prominent examples of PPPs. The size of the projects is a prerequisite since the transaction costs involved in preparing the project for bid and negotiating the contracts are such that they can only be justified for large-scale projects. The bundling of projects or the use of standardised contracts may be possible for certain smaller projects. The unique efficiency gains associated with PPPs derive from the interaction of the design-build-maintain-operate phases. The greater the maintenance and operation components, the greater the potential for efficiency gains.

The appropriate allocation of risk between the government and the private partner is fundamental to the success of PPPs. Certain risks – such as changes in government regulatory or taxation policy – should not be transferred since they serve only to increase costs. A more common problem is the tendency for governments to retain the majority of the risks with PPPs. This undermines the PPP concept and may reveal that it is only being used as a vehicle to move the transaction off budget.

A comparison of the benefits and costs of PPPs versus traditional procurement needs to be rigorously and dynamically conducted, and PPPs

should be subjected to at least the same scrutiny as traditional expenditures in the budget process. In general, the governance issues identified for outsourcing apply equally to PPPs.

5. Vouchers

In a voucher environment, the provision of public services is separated from its financing. The funding remains with the government in the form of a voucher which is issued to individuals, entitling them to exchange the vouchers for services at a range of suppliers. The individual voucher-holder chooses among the different suppliers and pays with the voucher.

Four definitional issues are in order. First, the vouchers are for the use of specific services only; they are not in the form of cash. Second, the voucher can equal the total or part of the cost of the service. Third, the eligibility for the voucher may extend to the whole population or may be limited to certain groups or be means-tested. Fourth, the suppliers can be both government bodies and private bodies, or private bodies only. Regardless, the government monopoly on service provision is ended and consumers have the right to choose among suppliers. This should lead to greater efficiency, notably in terms of quality improvements.

Vouchers can take at least three main forms. An explicit voucher is a physical coupon or smart card as described above; the supplier of the services in turn exchanges this for cash from a government body. An implicit voucher takes the form of a qualifying recipient choosing from a number of designated suppliers and, upon registering with one of them, the government pays directly to that provider of the service. The third form is for the government to reimburse the user for expenditure on qualifying services from approved suppliers. This would most often be through the tax system, but can equally take place as a traditional government expenditure programme. From the point of view of the user, these three main forms offer a choice of suppliers with the government financing the service.

5.1. Use of vouchers

The extent of use of these three forms of vouchers is significant in some sectors in OECD member countries, with their use being mainly focused on housing, education (primary and secondary), child care (nursery education), and care for the elderly.

Housing assistance to low-income families is a particularly good example of vouchers. Instead of large housing estates that cluster low-income families together, vouchers in this field offer them the possibility to participate in the general housing market. These explicit vouchers are generally designed such that they provide for the difference between actual rent paid, up to a limit

based on family size and local housing market conditions, and a certain percentage of the recipient's salary. The amount of the housing voucher is then adjusted regularly based on housing market trends.

Examples include the "Section 8" vouchers in the United States (launched in the mid-1970s) which provide benefits to about 2 million low-income households and had a total cost of \$21.2 billion in 2003. A report by the independent congressionally-chartered Millennial Housing Commission strongly endorsed the voucher programme in its May 2002 report, describing the programme as "flexible, cost-effective, and successful in its mission."⁴ Another prominent example is the "accommodation supplement" in New Zealand (launched in 1993), which provides benefits to 250 000 people. The New Zealand voucher programme does not differentiate between rent or mortgage payments. Similarly, tax credits for the reimbursement of mortgage interest expense can be viewed as a type of "reimbursement" voucher as described above.

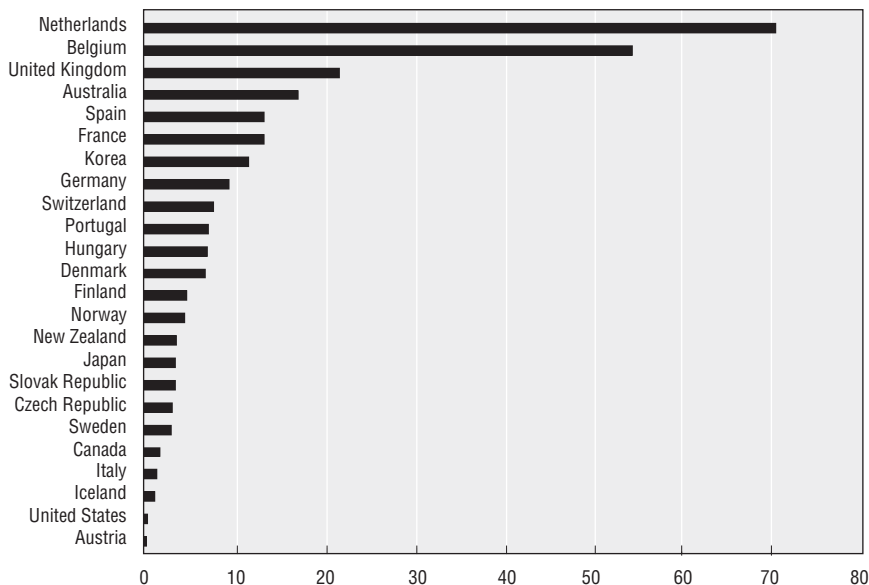
Box 2. United States food stamps programme

The United States food stamps programme is the largest and oldest explicit voucher programme in OECD member countries. Started in 1961, it provides 19.1 million low-income individuals with an electronic card they can use like cash at most grocery stores to ensure that they have access to a healthy diet. The programme cost \$23.9 billion in 2003. Interestingly, the programme is operated by the Department of Agriculture rather than a social services body.

Vouchers are most often discussed in terms of primary and secondary education. Figure 2 shows the percentage of total public expenditure for primary and secondary education that goes to private institutions in selected OECD member countries.

Most strikingly, over 70% of public funding for primary and secondary education in the Netherlands goes to private schools. There is a provision in the constitution (since 1917) which guarantees equal government funding for students in public schools and private schools. Most of the private schools have some linkages to churches. There is a standard minimum national curriculum which applies for both public and private schools. Public schools are not permitted to charge additional fees whereas private schools can. In practice, the private schools limit their charges to financing smaller class sizes and to the funding of "fringe" benefits such as excursions and sports facilities.

Figure 2. **Public expenditure on private institutions**
(percentage of total public expenditure on education)



Source: OECD Education Database.

The government funding is provided through an implicit voucher in that each school – whether public or private – receives an equal amount per student enrolled.

In 1992, Sweden embarked on a policy that also guarantees equal government funding to public and private schools. The share of students attending private schools has grown to 4%. Unlike the Netherlands, these schools are for the most part not affiliated with any religious group but rather differentiate themselves according to teaching methods or a focus on specialised subjects. Some schools use a foreign language as the main teaching language and/or cater to specific ethnic populations. The private schools are not allowed to charge tuition fees and must accept all pupils from their immediate geographic area. The government funding is also provided through an implicit voucher.

The use of explicit vouchers for primary and secondary education is most documented in the United States but its use is very limited. They have met strong resistance from public school teachers and their allies. Explicit vouchers are indeed used in some cities but they generally provide funding to relatively few students to opt out of the public school system and enrol in private schools. They cater mainly to students from disadvantaged

backgrounds. The programmes are so small in aggregate that their overall impact is minimal as can be seen from Figure 2.

A related development in the United States is the creation of charter schools which operate on an implicit voucher basis, i.e. the government provides funding for them in the same manner as public schools. In fact, most of the schools are part of the normal public school system but cater specifically to students from disadvantaged backgrounds. A few of these schools can however be viewed as private in nature.

Vouchers are also used for the provision of child care (nursing care) services.⁵ The most comprehensive of such reforms have been implemented in Australia. Those reforms aimed at equalising the level of public funding per child across public and private institutions by channelling all public funding through users, replacing the previous system based on grants to non-profit organisations and local governments. Now, public funding is distributed to families via the “child care benefit” earmarked for child care provided in government-approved services. As a result, the public subsidy is equal across different institutional settings, including for-profit and non-profit community-based day care centres and to some extent family-based day care. The Netherlands and Norway are currently considering similar comprehensive reforms. In the United States, child care vouchers have gained ground in federal family support programmes since the early 1990s. Whereas previously under this programme services were provided through direct funding to public institutions or through grants or contracts with selected private child care institutions, recipients are now entitled to a voucher or cash benefit giving access to a wider range of care facilities.

Tax credits and cash benefits conditioned on documented expenses for private child care, however, exist in many OECD countries. In some cases these subsidies and tax credits are targeted at low-income and working families to improve their work incentives. This is the case in Canada, Germany, the United Kingdom and the United States. Indirect public funding through tax credits and other support for employer contributions to child care expenses play a role in some countries including Belgium, Italy, the Netherlands and the United States.

Vouchers have also been used for the long-term care for the elderly where publicly funded provision is growing relatively rapidly in OECD countries. Care may take place in public and private residential institutions or at home, and there are often tax credits and income support for the (informal) employment of personal attendants acting as carers.

Providing publicly funded long-term care in private nursing homes and residential institutions typically takes the form of vouchers – either implicit vouchers paid directly to the institution based on the number of residents, or

reimbursing the fees paid by residents in part or in whole. Table 2 and Figure 3 show that publicly funded long-term care expenditure is significant in many countries. Furthermore, increasingly often, public finance goes to private providers. For example, over 80% of beds in institutions are private in Germany, the United Kingdom, and the United States, and around half of institutional beds in Canada, Ireland and the Netherlands are privately run. Exceptions are Finland, Norway and Sweden, with only 10-15% private residential institutions.

A growing range of programmes provides allowances for the families of the elderly and disabled to retain their role as caregivers, or for the elderly to employ personal attendants of their own choice. A key motive for their introduction in this sector is to promote home care, as this form of assistance is substantially less expensive than institutional care. This most often takes the form of an explicit voucher or the use of tax credits. The French scheme, introduced in 1997, allows the user to choose among different forms of care, including employing a personal attendant, with the restriction that family members can only be hired if currently unemployed. Likewise, the Finnish

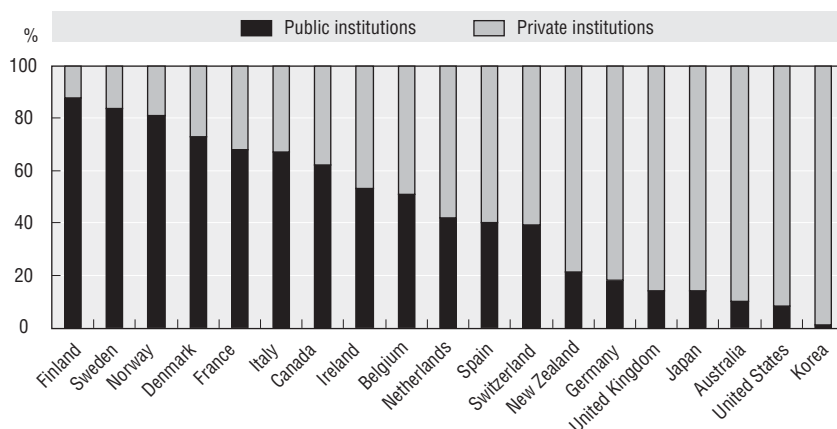
Table 2. Public and private expenditures on long-term care as a percentage of GDP

	Public expenditure			Private expenditure		
	Home care	Institutions	Total	Home care	Institutions	Total
Australia *	0.31	0.57	0.88	0.08	0.26	0.34
Austria	0.81	0.51	1.32	n.a.	n.a.	n.a.
Canada	0.25	0.83	1.08	0.00	0.17	0.17
Germany	0.42	0.50	0.93	0.05	0.17	0.22
Hungary	--	--	<0.20	--	--	<0.10
Ireland	0.19	0.33	0.52	0.00	0.10	0.10
Japan	0.25	0.51	0.75	n.a.	n.a.	n.a.
Korea	<0.10	<0.10	<0.20	n.a.	n.a.	n.a.
Luxembourg	0.15	0.37	0.52	n.a.	n.a.	n.a.
Mexico	--	--	<0.10	--	--	<0.10
Netherlands	0.56	0.78	1.34	0.05	0.02	0.07
New Zealand	0.11	0.39	0.50	0.00	0.27	0.27
Norway *	1.03	1.08	2.10	--	--	0.11
Spain *	0.05	0.11	0.17	0.18	0.26	0.44
Sweden *	0.82	2.06	2.89	--	--	0.14
Switzerland	0.17	0.53	0.70	0.04	0.85	0.89
United Kingdom	0.32	0.58	0.89	0.03	0.20	0.23
United States	0.25	0.50	0.74	0.13	0.38	0.52

* Data is for age group 65+.

Source: Pearson and Martin (2005, forthcoming).

Figure 3. **Public and private institutions in long-term care for the elderly, late 1990s**
(share of beds in nursing homes and residential care institutions)¹



1. This figure is based on collection of available national material where the exact definitions may vary. Generally only staffed homes providing nursing care and/or practical help with activities of daily living are included while long-stay hospital sections are not included.

Source: OECD based on national sources.

informal carer's allowance introduced in 1993 allows the user to employ a personal attendant, with the allowance being paid directly to that person. The German scheme introduced with the separate mandatory insurance for long-term care in 1995 allows users a choice from a menu of service provision and cash benefits.

This shows the wide range of sectors where vouchers can be utilised. Some of the areas are in their infancy or development phase, and the use of vouchers can be expected to increase in future years.

5.2. Key issues

An analysis of OECD member countries' experience with the use of vouchers shows that there are several critical design and contextual factors associated with the successful use of vouchers.

As with all market-type mechanisms, the need for competitive markets is paramount – the voucher-holders must be able to exercise a genuine choice of suppliers. Some of the areas where vouchers are most commonly used – primary and secondary schools being the outstanding example – tend to exhibit characteristics of local monopolies. Consumers place such a value on the proximity of the service that it outweighs the fact that more distant service

providers may offer a higher quality of service. As a result, the provider will not be under competitive pressure to improve performance.

For some types of vouchers, there is a tendency to establish rigidly defined service standards so that little or no product differentiation may be possible from suppliers. Again, this is especially the case in education. The benefit of multiple providers offering innovative services, perhaps serving niche markets, is therefore pre-empted. A preference for using “minimum” standards with room for substantial differentiation should be made.

A short-term shortage of attractive suppliers is not uncommon. Many services where vouchers are used require a heavy investment in order to expand the supply of services by individual providers. For housing vouchers, a tight housing market may also make their use difficult since the built-in adjustment mechanisms for market conditions tend to lag.

It may also be difficult for users of services to make informed judgments about individual service providers. This undermines the competition mechanism. Many public services are not “search goods”, with the characteristic that an individual can find out everything about the service before making a choice. Rather, they are “experience goods” where the consumer only finds out about the service in the course of using it. This problem is accentuated by the fact that many public services are not consumed repeatedly, or that it is costly to switch from one provider to another.⁶ League tables of performance of individual providers, such as test scores for schools or quality ratings by current and past users, can serve to alleviate this problem. Users, however, have much greater ownership of decisions they make themselves and this itself has a positive impact on their experience of the goods.

The capacity of individuals to assess the services offered by different providers may also be impaired in some instances, long-term care for the elderly being a prime example. This calls for a stronger role for the government in certifying suppliers and guiding the choice of users. Although it can mitigate the competition mechanism inherent with vouchers, the information provided by the government can lead to more informed (and more competitive) choices.

Voucher programmes often entail a prohibition of top-up payments whereby recipients can use their own resources to supplement the voucher. These are seen as unfair by some observers since they allow richer recipients to enjoy higher quality public services. On the other hand, such payments will facilitate a better match of the quality of services offered and the users’ capacity to pay and can lead to increased product differentiation which is a key benefit of the voucher concept. Such prohibitions therefore need to be reviewed carefully.

The payment structure of the voucher can have perverse incentives. If a voucher offers a uniform payment level irrespective of the costs associated

with servicing different categories of users – such as disabled children in child care, lower-score students in education or weaker persons in long-term care – this can accentuate cream-skimming behaviour from suppliers. In such conditions there is an incentive for private suppliers to screen voucher recipients for those who cost less than others and to exclude higher-cost recipients. A payment structure that recognises such differences is key to alleviating this potential problem.

The extent of voucher use in OECD member countries is significant. They are, however, subject to unique challenges in terms of design and contextual factors. An inappropriately designed voucher can simply accentuate pre-existing problems with the delivery of public services.

A major concern raised about vouchers is that they exert an upward pressure on public expenditure. Vouchers are generally available to all who meet a certain eligibility criteria. They are therefore demand-driven entitlement programmes. Previously, the expenditure associated with these programmes could generally be controlled by limiting supply. Similarly, vouchers that are based on formulas for the calculation of the benefit, for example rental assistance vouchers that are related to developments in wages and the cost of housing, can lead to significant and sudden expenditure increases. Both of these factors demonstrate the strength of vouchers from a consumer point of view, but they are sources for concern from a budgetary point of view. The rental vouchers in the United States are coming under strain for these reasons.

6. Findings and future challenges

There are several key messages emerging from this paper concerning the use of market-type mechanisms and their implications:

- The diversity of experiences among OECD member countries shows that market-type mechanisms can be applied to a very wide range of government functions.
- There are strong entry barriers to adopting market-type mechanisms. This is a function of the public's view of "the role of government" and also a function of the resistance by government staff affected by their introduction. This explains, for example, why the resistance is greatest to outsourcing and vouchers which directly challenge existing government service provision but less pronounced with other market-type mechanisms.
- The efficiency gains associated with market-type mechanisms can be substantial. These can be either in the form of decreased costs, improved service quality levels, or improved resource allocation economy-wide. The discussion showed, however, that care needs to be taken in their design to achieve these efficiency gains.

Box 3. Other market-type mechanisms

This paper has surveyed the experience in OECD member countries with outsourcing, public-private partnerships and vouchers. This box briefly highlights two other market-type mechanisms.

User charges assign to the specific consumers the full or partial cost of providing the respective services. User charges thereby create a direct link between the benefits and costs of consuming public services and thus aim at removing excess demand for previously “free” public services. Three types of user charges can be observed. The first concerns internal charges among government agencies. Previously, common service agencies may have received direct appropriations for services which they then supplied “free” to other agencies. With user charges, it is the agencies that consume the services that are given the budget. They now have an incentive to limit their use of common services – or seek them from alternative sources if permitted – since any savings accrue to them. The second form of user charges concerns services delivered to business and industry. These may include various regulatory services. Such charges are generally full cost recovery, and the primary motive is to relieve the general taxpayer of services benefiting specific users. The line between user charging and taxation is especially thin in this case. The third type is charges to individual citizens. These may include various education, health care and social services. These charges are usually partial, and the primary motive is to discipline user demand.

Transferable permits are mainly used for the allocation of scarce resources instead of regulatory measures such as comparative hearings (“beauty contests”) and lotteries. The government establishes a maximum amount of the resource that can be used, allocates it in the first instance by grandfathering current/past users or auctioning the permits to the highest bidder, and then allows a secondary market in the permits to operate whereby they can be sold to the highest bidder. This is the optimal economic allocation. This mechanism has been used for fisheries (where the allocation is the percentage of each year’s allowable catch), airport landing and take-off slots, and the radio spectrum (3G mobile phone licenses). It is much discussed for greenhouse gas emissions as well, since one ton of greenhouse gas emitted anywhere in the world has the same effect, and an international system of transferable permits would allow the reductions to take place at lowest cost.

- It is perhaps most surprising that market-type mechanisms are not more widely used in OECD member countries considering their potential for efficiency gains. Again, this highlights the strong entry barriers for their adoption.
- The ability to maintain key governance principles needs to be considered as an inherent part of the decision to adopt market-type mechanisms. These principles include accountability, regularity, transparency, and the availability of avenues for redress.
- Finally, there is always the risk that governments have the capacity to appropriately introduce market-type mechanisms only once in a sector, and then become beholden to that provider due to loss of capacity. Governments need to ensure that they continue to have the operational knowledge to make good policy and to choose – and alter – service delivery options in such a dispersed (or networked) environment and actively promote competitive supplier markets.

Notes

1. PPPs can also involve the private sector purchasing already existing infrastructure assets and redeveloping them.
2. This categorisation of risks and discussion draws on Eurostat's ruling on the treatment of PPPs in the context of deficits and debt (STAT/04/18, 11 February 2004). See European Union (2004) and <http://europa.eu.int/comm/eurostat>.
3. A private partner may enjoy lower borrowing costs than the government in certain non member countries, or than certain lower levels of government.
4. Report available at www.mhc.gov/MHCReport.pdf.
5. This discussion draws on Pearson and Martin (forthcoming, 2005).
6. This discussion draws on Cave (2001).

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Sustainable Budget Policy: Concepts and Approaches

by
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Concern about fiscal sustainability has been fueled by the projected ageing of populations in OECD countries and the likely surge in government spending on pensions and health care. For the most part, it has not been driven by worries about the current fiscal position of countries. Multiple dimensions of sustainability are discussed: solvency, growth, stability, fairness. Modes of sustainability analysis are related to existing budget practices, including baseline projections, balance sheet analysis, fiscal gap analysis, and generational accounting. The article concludes with a discussion of how to build sustainability analysis into the budget process and how to manage the sustainability process.

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It was not long ago that fiscal sustainability was an issue only for underdeveloped and emerging market economies that have fragile capital markets, rising debt and an expanding public sector, and are vulnerable to cyclical disturbances or financial contagion. Recently, however, concern about fiscal sustainability has spread to advanced countries, some of which have established ongoing processes for assessing their capacity to maintain their fiscal position for an extended period. Australia, New Zealand and the United Kingdom review fiscal sustainability as part of their new fiscal responsibility regimes introduced during the past decade. Member countries of the European Union comment on sustainability in their medium-term budget frameworks submitted to the European Commission (EC) pursuant to the Stability and Growth Pact, and the EC reviews the long-term outlook in its annual report on fiscal policy. The United States annually reviews the long-term sustainability of social security and Medicare, the two largest claimants on future budgets.

Concern about sustainability has been fueled by the projected ageing of populations in OECD countries and the likely surge in government spending on pensions and health care. For the most part, it has not been driven by worries about the current fiscal position of countries. In fact, countries with sound positions (such as Australia and New Zealand) have been in the forefront of this movement. Interest in sustainability has been stirred by innovations in accounting and economic analysis such as accrual accounting and budgeting, the application of present value analysis to government budgets, intergenerational accounting, and fiscal gap analysis. None of these is standard budget practice, but some are likely to be built into the routines of budgeting in the future. It is also likely that countries will experiment with different techniques and that some will build sustainability analysis into the annual budget process, while others will conduct such studies as a free-standing exercise.

In migrating from underdeveloped to highly developed countries, fiscal sustainability has shifted in focus from the near term to the distant future. In less developed countries, the immediate concern is whether the government will be able to service its debt if capital flees, the currency depreciates, and interest rates surge. This is the principal focus of sustainability work carried out by the International Monetary Fund. Its “assessments have two main dimensions: indicators of public debt and deficits, and medium-term fiscal

projections” (IMF, 2002, p. 12). In OECD countries, the focus is on the long term, typically 30-50 years ahead. Even countries that have had persistent budget deficits and elevated debt loads do not sense impending fiscal crisis; in fact, they have little difficulty financing current budget shortfalls. But many OECD countries are concerned that although their current fiscal posture is sound or manageable, it might not be a generation or two from now as future governments are encumbered with the costs of past policies and commitments. Inherently, fiscal sustainability in the OECD area has a long-term perspective that aims to prepare for the future by sensitising governments to the need for prudent action to sustain economic wellbeing for future generations.

Fiscal sustainability is more than projecting the future; it is about the urgency of policy changes as well as the need for new budget tools to assess governments’ fiscal position because conventional instruments are not up to the task. A medium-term expenditure framework (MTEF) and fiscal rules, two of the most prominent contemporary innovations, extend the timeframe of budgeting 3-5 years ahead, but they are not attuned to long-term issues. An MTEF does not look far enough ahead and, coupled with hard constraints, may spur some stressed governments to engage in budgetary legerdemain which improves the medium-term outlook at the expense of the country’s long-term fiscal health. This is not mere speculation, for a number of EU countries have used one-off savings to meet requirements of the Stability and Growth Pact (European Commission, 2004).

Although their time horizon is too short for sustainability work, MTEF and fiscal rules introduce techniques, such as baseline projections, which can be extended to analyse a country’s future fiscal position. Fiscal rules also have relevance because they sensitise governments to the downstream implications of budget policy. But the fact that governments and academics are working to devise new accounting and reporting tools to gauge sustainability indicates that existing techniques do not suffice.

This paper is based on the expectation that sustainability will be an essential element of future budget work. Section 1 makes the case that sustainability has multiple dimensions arising out of the diverse perspectives of those urging attention to the issue. Some of the main approaches to analysing sustainability are described in Section 2, which discusses their application to the budget process. The concluding section focuses on means of feeding sustainability results into the formulation of budget policy.

1. The multiple dimensions of sustainability

The shift to a long-term horizon has expanded the ways governments and international organisations think about sustainability. The term has

retained its original meaning as a measure of the solvency of government, but it has acquired several dimensions that pertain to governments that have no difficulty meeting current obligations. Contemporary sustainability analysis focuses on fiscal conditions that may retard economic growth, cause tax burdens to rise, or transfer significant costs to future taxpayers. The added dimensions reflect concern that governments have accumulated long-term liabilities that do not appear in current budgets or balance sheets but may disadvantage future generations when they come due. The expanded concept of sustainability is grounded on the norm that responsible governments should not do harm that will appear decades after the relevant policies were adopted.

Four dimensions of sustainability may be delineated. Although they are separated here for analysis, in practice they tend to appear in tandem:

- **Solvency** – the ability of government to pay its financial obligations.
- **Growth** – fiscal policy that sustains economic growth.
- **Stability** – the capacity of government to meet future obligations with existing tax burdens.
- **Fairness** – the capacity of government to pay current obligations without shifting the cost to future generations.

The four dimensions overlap, but it is useful to draw their implications by examining each separately.

1.1. Solvency

Solvency is usually thought to be a problem in some underdeveloped or emerging market countries, particularly those that have boosted public spending, taken on additional debt, and have an inadequate tax base. When misfortune arrives, often brought by a cyclical downturn or financial contagion, capital flees, currency plummets in value, and the government must rollover debt at very high interest rates while borrowing more to stay afloat. These are countries to which the IMF rushes with emergency assistance, in exchange for which it demands that they restore solvency by correcting unsustainable fiscal imbalances. A typical IMF demand is that the government run a primary surplus in order to finance its debt.

Solvency can be an issue in any country that takes on excessive debt. Although they may not face capital flight in the foreseeable future, affluent countries are sometimes tempted to debt finance current obligations, whether in response to political pressure or out of confidence that they can afford to do so. Some observers believe that this is the current fiscal predicament of the United States, and that its current course is unsustainable. In budget

projections that run out to 2050, the Congressional Budget Office concluded that under certain plausible budget scenarios:

...the growth of debt would accelerate as the government attempted to finance its interest payments by issuing more debt – leading to a vicious circle in which ever-larger amounts of debt were issued to pay ever-higher interest charges. Eventually, the costs of servicing the debt would outstrip the government's ability to pay for them, thus becoming unsustainable.

(CBO, 2003, p. 14)

The CBO warning relates to the long-term outlook. The 50 years covered by its projections are a long way off, but the CBO argues that it is appropriate to take action now to abate long-term imbalances. It provides specific examples of how timely action can avert projected insolvency.

Solvency is typically measured in business in reference to the firm's net worth. Applying this method to government is difficult because few have comprehensive balance sheets that cover all liabilities and assets. Moreover, net worth is a misleading measure in government because it does not include the power to generate additional revenue by raising taxes. Nor does it include the value of future pension liabilities. At best, the balance sheets now produced in national governments provide an incomplete but nevertheless useful statement of financial condition.

1.2. Growth

Sustained growth is one of the twin objectives of the European Union's Stability and Growth Pact (SGP) which commits euro zone countries to budget imbalances below 3% of GDP and gross debt below 60%. The case for these limits rests on the argument that growth will not be sustainable if deficits and debt breach these parameters. Thus, the broadened concept of fiscal sustainability encompasses the notion that governments should manage their finances prudently so as to assure future growth. In line with this reasoning, Britain's long-term fiscal objective is to ensure "that the public finances are sustainable, contributing to a stable environment that promotes economic growth" (H.M. Treasury, 2004, p. 4). In this light, fiscal policy is adjudged to be unsustainable if it would cause potential output to be lower at some future time than it would otherwise be. The logic of this argument runs as follows: the best way for government to meet future obligations, which certainly will be greater than today's, is by having a robust economy which supplies government additional revenue from the dividends of economic growth. If, however, fiscal imbalances diminish future growth, the dividends will be smaller or vanish altogether and government will be hard pressed to cover its obligations.

This reasoning led the European Commission in its 2004 review of public finance in EMU countries to argue that “the risk of unsustainable public finances increases considerably if the Member States do not achieve the SGP goal of budget position of ‘close to balance or in surplus’”. The report concluded that this position “is in the economic self-interest of Member States both individually and collectively ... it creates room for budgetary manoeuvre to either cut taxes or to increase growth-enhancing expenditures on items such as investment and R&D” (European Commission, 2004, p. 59).

Sustaining growth by running balanced budgets represents a sharp break with postwar economic doctrine which typically regarded deficits as appropriate in bad times and manageable in good times. This reversal in economic reasoning has been due to several transformations: from viewing the budget as an instrument of short-term cyclical adjustment to a means of undergirding structural soundness over an extended period; from looking at the budget as a policy statement for a year (or few years) immediately ahead to treating it as a strategic plan of future government financial capacity; and from formulating the budget as an instrument of government expansion to constraining it to be a stabiliser of government size. These shifts correspond to changes in contemporary political sentiment. Confidence in the capacity of government to sustain growth by taxing and spending more has waned. Moreover, recognition that the bulge in government spending will be in the form of transfer payments that subsidise consumption has weakened analytical support for the expansionary policies that once were popular.

1.3. Stability (stable taxes)

Maintaining the tax burden at or near current levels has become a dominant objective of fiscal policy in many OECD countries. This objective is highlighted in Australia’s *Intergenerational Report* which views “a balanced budget over the medium term, given a reasonable degree of stability in the overall tax burden” as “one of the key requirements for sustainable financial arrangements” (Commonwealth of Australia, 2002, p. 2). In running 40-year projections, the report assumes that Commonwealth revenues will remain a constant proportion of GDP. A key aim of the report is to assess the risk that tax burdens will rise in the future to accommodate spending pressures. It concludes that the Commonwealth’s fiscal position may be unsustainable because the projected trajectory of spending would compel higher taxes (or a larger debt) in the future.

The underlying premise of this sustainability argument is that tax burdens are already very high and that governments should adopt prudent fiscal positions that obviate pressure for future increases. In this version, the objective is to sustain tax burdens at their current level or lower. This dimension of sustainability is congruent with contemporary sentiment in

most OECD countries, and is reflected in the leveling off of tax burdens after decades of steep increases. Of course, sustainability recognises that taxes cannot be constrained if downstream spending demands are not. The notion that spending pressures must be abated to lower the probability of higher taxes in the future is as prevalent in countries with relatively low tax burdens as in high-tax countries. Even countries that have current budget deficits have joined the tax-cutting parade. At times, such behaviour would have been viewed as undermining sustainability; nowadays, it is often seen as diminishing the risk that taxes will be higher in the future.

During much of the 20th century, the tax burden and economic output expanded throughout the OECD area. In many (certainly not all) countries, it came to be accepted that by producing an educated workforce, efficient transport, income security, and other social goods, expansionary government establishes favourable conditions for economic growth. Taxes were the price paid by households and firms for purchasing government-supplied goods that elevated living standards. Governments (and most voters) were not troubled by the rise in taxes because disposable incomes were also rising and government was supplying more benefits. Sustainability strongly indicates that times have changed, partly because tax burdens are hovering around 50% in some countries, partly because of diminished trust and confidence in government performance. It matters little that popular images of government may be wrong; it does matter that voters look to government for lower taxes.

Here is where sustainability enters the picture, for spending trends embedded in government commitments and political expectations point to sizeable tax hikes in the future. Arguably, the surest way to maintain solvent government in the decades ahead is to generate sufficient additional tax revenue to cover the looming rise in public spending. The sustainability norm seeks to deter this option by defining tax stability as a core fiscal objective.

1.4. Fairness

The final version views fiscal policy as sustainable when tax burdens and expenditure benefits are equitable across generations. In this perspective, it is not fair to provide benefits to one age cohort that will have to be paid for by taxes levied on younger cohorts. This concept of sustainability is embedded in Australia's *Intergenerational Report* which asserts: "Fiscal sustainability ... ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation." Further, a sustainable fiscal stance "promotes fairness in distributing resources between generations of Australians" (Commonwealth of Australia, 2002, p. 2). Britain's *Long-Term Public Finance Report* declares a primary objective of fiscal policy to ensure "that spending and taxation impact fairly both within and between generations" (H.M. Treasury, 2004, p. 4).

Operationalising fairness may be more difficult than measuring budget balances, for as Peter Heller has observed, “there is no single definition or universally accepted measure of fairness ... Should future generations be expected to bear a higher tax burden than current generations would be willing to accept for themselves, because they will be richer? What obligations should future generations have toward current working generations?” (Heller, 2003, p. 130). Budget makers have enormous difficulty assessing fairness among current beneficiaries and taxpayers; it is even more difficult to reason through equity issues across generations, from those who are newly born to those who are nearing the end of long lives. Not only do layers of assumptions have to be made about distant tax burdens and expenditures, but normative questions demand attention. Would a fairness norm rule out any difference across generations or only those (in the words of Australia’s report) that are truly “unmanageable”? Perhaps it is the sharp divide across generations that gives rise to fairness concerns: today’s citizens are (by a wide margin) net gainers; tomorrow’s generations are projected (also by a wide margin) to be net losers. However, there is another way of defining this issue. Government policies that distribute costs and benefits may be regarded as a social contract across generations. In the same way that today’s citizens pay higher taxes and enjoy elevated material wellbeing compared to their forbears, future taxpayers should be expected to pay for and enjoy the greater affluence and enriched public services bequeathed to them. The counterargument is that the social contract has been broken by the prospective huge shift of costs and benefits across generations. Today’s older citizens have negative effective tax rates (taxes minus benefits) in excess of 25%; tomorrow’s will have effective positive net tax rates in excess of 50%. This breaches any social contract that may have been accepted in the past.

Here is where sustainability joins up with fairness. Grossly unfair distributions are not sustainable in either political or economic terms – politically, because future payers are likely to rebel against confiscatory tax rates; economically, because the wellbeing of the country will be retarded by the overriding need for tax rates that are strong disincentives for work, saving, and investment.

The four definitions of sustainability focus as much on the tax burden as on the public debt, though (of course) elevated debt can be expected to exert upward pressure on tax rates. In contrast to developing and emerging market countries where sustainability is a concern that arises out of inadequate tax mobilisation, in industrial countries the problem is that tax rates are already very high. But in all types of countries, sustainability analyses project that the ratio of tax revenue to GDP will have to rise to finance commitments that will come due in the future.

2. Modes of sustainability analysis

Because it is a new area of analysis and because making assumptions about the future can be done with a variety of techniques, there is no standard way of projecting taxes and burdens 30-50 years ahead. One approach is to examine the future from the vantage point of the country as a whole; another is to look at it from the position of an individual taxpayer who will receive a flow of costs and benefits from government; still another is to consider a similarly situated age cohort. Some techniques build on standard budget methods to project the future; others are grounded in accounting rules and analyse the future by means of a balance sheet. Some take a whole-of-government perspective; others focus on major programmes (such as social security) that have long-term implications. All require heroic assumptions about economic and social trends, such as rates of growth, price changes, and life expectancy. Rather than discuss methodological differences, this section relates various techniques to existing budget practices. If sustainability becomes an ongoing issue, it is highly likely that budget practices will evolve to incorporate an elongated timeframe into analyses of revenue and spending proposals.

2.1. Baseline projections

Governments that have moved to an MTEF (or have otherwise lengthened their time horizon) typically use baseline projections to connect current budget policy to medium-term fiscal outcomes. Sustainability analysis often uses similar techniques, but extends the timeframe 30 or more years ahead. Baseline projections begin with the government's current budget position (including policy changes that have already been approved but will not take effect until some future date). In constructing baseline projections, the overriding assumption is that existing revenue and spending will be continued as far ahead into the future as projections extend, without any substantive change. Of course, these projections are based on critical assumptions about GDP, wage and productivity trends, interest rates, and much more. In constructing a baseline, government has to reckon with revenue or spending provisions that are time-limited – that is, under current law, they will not remain in effect for the entire period covered by the baseline. In many such cases, there is strong probability that expiring provisions will be extended. Therefore, dropping time-limited items from the baseline may provide a misleading picture of future budget conditions. New Zealand's practice is to systematically report on such provisions, thereby allowing citizens and others to exercise judgment on whether it is realistic to assume that they will not be continued. This provides a fuller view of fiscal trends, but it is not the practice in other countries that rely on baselines.

Baseline projections are inherently unrealistic because it is highly unlikely that budget policy will be frozen as the number of pensioners receiving public money escalates. It is also unrealistic because (in most governments) the baseline projection does not assume significant changes in economic performance as a consequence of tax and spending policies.¹ Despite these limitations, baselines serve two valuable purposes in budgeting that can be applied to sustainability projections. First, they provide insights into future budget conditions if government stays on its fiscal course. This is especially useful in contemplating a distant future in which demographic and other conditions may be quite different from what they are today. Second, baselines provide a basis for estimating the impact of proposed or adopted policy changes on future budgets. In these projections, any variance between the baseline projection and revised estimates is defined as the future budget impact of policy change. In this way, baseline projections enable policy makers to assess the impact of changes in revenue or spending policies on the government's fiscal position.

Although baseline projections usually provide point estimates, in anticipating the future it would be preferable to present a range of plausible fiscal outcomes. Within the range, estimates would be differentiated by the assumptions on which they are grounded. It also would be feasible to base projections on alternative scenarios of key variables such as life expectancy, health costs, economic growth and interest rates. A surfeit of scenarios might drown the projections in confusion, but it would be sensible to construct 3-5 scenarios. Finally, it would be prudent to "stress test" long-term baseline projections to assess how they might be affected by significant changes in underlying assumptions.

In sum, while long-term forecasting is not yet common in budgeting, it almost certainly will become standard practice in many countries in the years ahead. Because baseline projections can be lengthened from the medium-term to the distant future, they are likely to become the most frequently applied technique of government in assessing long-term sustainability. However, budgets will automatically have as dominant a position in exploring sustainability as they have had in estimating annual or medium budget conditions. Economists and other policy analysts will vie to construct novel means of relating current budget postures to long-term sustainability.

2.2. Balance sheet analysis

During the past decade, some analysts have viewed the balance sheet as a fuller and more reliable statement of financial condition than the budget. In contrast to budgets which include only those flows that are within its ambit, the balance sheet includes all (explicit) assets and liabilities, regardless of their budget status. Moreover, it includes all liabilities, not only those that are

sovereign debt. The structure and content of the balance sheet are regulated by national or international accounting norms and are independently audited. Although national budgets usually are on a cash basis, the balance sheet accrues income and expense, thereby enabling government to recognise certain downstream liabilities long before they become due. Properly constructed, a balance sheet would provide a comprehensive account of the government's net worth and of future payments likely to arise out of existing liabilities. For these reasons, various scholars have urged that the government's fiscal position be assessed in reference to the balance sheet rather than the budget (Bléjer and Cheasty, 1991).

But the balance sheet has inherent limitations that greatly diminish its utility as a measure of long-term sustainability. One problem is that the balance sheet recognises only explicit liabilities, but many obligations of government are embedded in expectations about how it will behave in the future; another is that the balance sheet recognises liabilities arising out of past actions, not future obligations arising out of current policy. In assessing long-term sustainability, however, implicit commitments and future obligations weigh far more heavily than those that are explicit or have already been incurred. In fact, no government records future pension obligations on its balance sheet, though some append notes in which various matters that do not meet recognition standards are discussed. This is an area where accounting norms are likely to evolve in the future, but it would be imprudent for the balance sheet to show implicit liabilities or prospective payments for liabilities that have not yet been incurred. Doing so would make implicit obligations explicit, worsening the government's financial predicament and loading it with future payments that it might otherwise avoid.

The balance sheet is a snapshot of financial condition at a point in time; it is not a projection of what might occur in the future. It does not include revenue or obligations that have not yet accrued, nor does it differentiate between liabilities that may come due within the next year and those payable in the distant future. It does not assign a present value to the taxing capacity of government or to future revenue flows from the existing tax structure. In fact, pursuant to established accounting rules, the balance sheet completely ignores the capacity to generate revenue in the future. It does, however, account for certain unfunded liabilities, that is, for incurred liabilities that are not financed by accrued revenue. Some finance experts have argued that the balance sheet presents a misleading picture of future financial condition and that net worth is not a useful measure of a government's solvency; others have noted that the balance sheet applies identical recognition rules to liabilities and assets, that net worth is a relevant measure of government's capacity to finance incurred liabilities, and that the balance sheet is not designed to be a prognosis of future financial condition. What the balance sheet can do is to

provide a starting point (other than the baseline) for projecting future sustainability, but doing so requires consideration of matters that are not recorded on the balance sheet.

The balance sheet and related financial statements are likely to have greater prominence in assessing current and prospective fiscal conditions. One reason is the expansion of accounting and reporting standards to cover matters that were not previously recorded; another is the prospect of linking (or integrating) financial statements and the budget. At present, few national governments pay attention to the financial statements they are required to prepare; they see these statements as a technical chore that has little to do with the decisions they make or the financial issues they confront. This is likely to change as accounting standards are elaborated and monitored by national and international organisations. Recent developments in the United Kingdom may be a harbinger of a broader scope for these statements. The British government has announced that beginning with the 2006/07 financial year, it will publish whole-of-government accounts (covering national and local governments and public corporations) based on generally accepted accounting principles. In addition to accounting for incurred obligations, these new accounts will provision for certain future liabilities and will contain notes on contingent liabilities. This approach expands the balance sheet to include or provide information on various liabilities that have not yet accrued. Britain's approach is not likely to be an isolated move, for the International Public Sector Accounting Standards Board and other authorities are devising new rules that will expand the information that must be reported. As accounting practices are expanded, leading-edge governments will apply the same standards to budgets and will conform or reconcile them to financial statements. The integration of budgets and financial statements will unfold in stages, probably over an extended period, but it will provide a fuller basis for assessing fiscal sustainability.

2.3. Fiscal gap analysis

Fiscal sustainability is a problem when there is a gap between a targeted debt level and the debt that would ensue if tax and spending policies were continued without change. In measuring this gap, the government (or analysts) selects a target year as well as a target for the debt/GDP ratio. In other words, gap analysis focuses on a fixed point in time, not on a stream of years. This method enables government to calculate the primary balances it will have to run to assure that the projected deficit does not exceed the targeted level. A fiscal gap of zero would indicate that current fiscal policy is sustainable; that is, the debt target can be met without increasing the tax burden or cutting future expenditures. A fiscal gap above zero would indicate

that the projected debt exceeds the target and that the government will have to boost revenue or curtail spending to sustain its fiscal objective.

Fiscal gap measures can be developed for a number of target years (for example, 2030, 2040, and 2050) as well as for a range of debt burdens (40% of GDP, 50%, 60%). By adjusting the debt target and year, government can construct alternative scenarios and policy paths for the future. Thus, in contrast to baseline projections which often highlight the unsustainability of fiscal trends, gap analysis emphasises the policy response required to maintain (or restore) sustainability. Projections focus on the fiscal problems that lie ahead; fiscal gap studies indicate the scale of change in revenue and spending policy needed to stabilise public finance. Of course, gap analysis itself is grounded on long-term projections and is therefore sensitive to the timeframe and underlying assumptions.

One variant of fiscal gap analysis, generally referred to as the intertemporal budget constraint (IBC), calculates the primary balance (the surplus or deficit exclusive of interest payment) required to stabilise (eliminate, in some versions) the debt burden. This is done by discounting to present value all projected future revenue and spending flows plus the current debt burden. An intertemporal budget gap exists when the present discounted value of projected primary balances does not cover the current debt burden. This method extends gap analysis in several ways: it calculates the prospective gap for an indefinite period rather than for a target year; it recognises that the present value of fiscal gaps depends on the timing of future financial flows; and it establishes a fiscal constraint – the debt burden – to guide policy. But like all long-term projections, the IBC is sensitive to the starting year of the projection and the discount rate.

2.4. Generational accounting

The approaches discussed thus far define sustainability in terms of the aggregate fiscal position of government. They do not focus on the fairness of fiscal policy across generations, that is, on the benefits that each age cohort will receive (mostly in transfer payments) and the taxes it will pay. Age cohorts may be defined by year of birth or may be grouped into broader categories such as five-year intervals or decades. Net transfers (taxes paid minus transfers received) are calculated for each cohort. Generational balance (or fairness) exists when future generations have the same net transfers as current generations. Country studies typically show that while current generations have negative tax rates (they receive more from government than they pay) future generations face extremely high tax rates (in some cases, confiscatory).

Generational accounting is a controversial instrument (OECD, 1997). Its advocates propose to replace the traditional method of accounting for the

government's revenues and expenditures, and to thereby shift the accounting basis from the present stock of assets and liabilities to long-term flows to and from citizens. Generational accounting is a relatively new technique and is still undergoing development. Its key value may well lie in bringing together disparate information on the future implications of public finances in a single number that is comprehensible by the public at large. It can also be a useful tool in assessing changes in tax or expenditure policy which affect the distribution of costs and benefits across generations. But the apparent simplicity of generational accounts masks the many assumptions underlying it, including the assignment of revenues and expenditures to specific generations. It can be reasonably concluded that rather than replacing traditional measures of government revenues and expenditures, generational accounting will provide useful supplementary information along with a variety of other methods that shed light on long-term financial trends.

3. Budgeting for sustainable public finance

Fiscal sustainability is (or should be) a vital issue for all national governments in the OECD area because spending pressures will escalate as populations age and as prior commitments or expectations for income transfers and health services come due. In some OECD countries, demands on the budget will not peak for another 30-50 years; in others, they will mature much earlier. Almost all face a fiscal future in which a larger share of the budget is allocated to age-sensitive programmes. Many, possibly most, will trim commitments/expectations in order to avoid significantly higher debt or tax burdens. It may be politically expedient to defer action until problems are imminent, but it would not be fiscally prudent to do so.

Some countries (such as Australia, Sweden and the United Kingdom) have acted decisively to ameliorate future budget pressures by restructuring their pension systems or pre-funding future payments; most have made no adjustments or only marginal ones that will not significantly ease demands on future budgets. A few (such as New Zealand) have moved to accommodate future fiscal pressures by reducing the current debt burden. Norway has locked away much of the revenue from oil and gas exploration to assure that these monies are available to future generations. Setting up reserves is not a viable option, however, for countries struggling with current budget imbalances. Nor is it feasible for countries that have annual budgets or medium-term frameworks to extend the time boundaries of the budget process to the next 30-50 years. Many countries are still developing techniques to assess the impact of current revenue and spending decisions on the next 3-5 years; they do not yet have the capability to budget for a much longer horizon.

Yet the distant future cannot be ignored, for it will creep up on fiscally-stressed governments one year at a time. As far off as it may be, the future can be foreseen, not with perfect certainty but with a sense of the magnitude of the trends that await coming generations. By modelling future trends and calculating the present value of future revenue flows and spending demands, governments can sensitise themselves and voters to the fiscal path that lies ahead. Some may be spurred to revise tax or spending policies on the basis of the new information, while others may lack sufficient political strength or will to change course. All would have a fuller picture of how future fiscal prospects might be affected by current budget actions. Many will become more vigilant in considering options that would worsen future budget conditions.

Significantly, countries that have systematically examined the long-term fiscal outlook tend to be ones that have taken the strongest measures to assure sustainability by restructuring pension systems or setting aside funds for future needs. In fact, efforts to ease long-term budget pressures have preceded the publication of long-term sustainability reports. Perhaps governments that have already acted to reduce long-term fiscal pressures are more inclined to be transparent about their future so as to deflect political pressure to reverse their reforms. But all countries can benefit from boldly facing up to their future budget predicament.

3.1. Building sustainability analysis into the budget process

One option for facing the future would be to formally include long-term projections in the annual budget or medium-term framework. These projections would be updated each year the same way that medium-term estimates are rolled forward. The projections would be baselines; they would assume that current (or approved) revenue and spending policies will be continued and that no significant changes will be made. The budget would set out the key social and economic assumptions that underlie the long-term projections, including the estimated impact of fiscal trends on national output, prices, and interest rates.

Although it may be feasible to attach long-term baselines to the budget, it would not be prudent to do so. One should distinguish between a budget, which is inherently a plan for one or more financial years, and a projection, which is an assumption about how the future might unfold. The budget presents the government's revenue and spending proposals, including policy changes; baseline projections assume that existing policies will not be changed. The budget recommends a specific amount for each revenue or spending item voted by the legislature; the projections often provide a range of estimates or alternative scenarios. The projections will be revised frequently before the target year arrives as policies change, new methodologies are used and fresh information or insights impel changes in

basic assumptions. Some revisions will be exceedingly large, opening the projections to misinterpretation when the distant outlook improves or deteriorates. If sustainability projections were published in the core budget, they might be mistaken as government recommendations, rather than as forecasts.

Although these projections should not be integrated into the budget, neither should they be entirely separate from it. The risk that long-term projections will be ignored is no less a problem than the risk that they will be misused. The best course would be to report on the long-term prospect in a separate document, but to summarise key findings in a supporting schedule that is included in the budget. This is the tactic used by the United Kingdom. Australia publishes an intergenerational report every five years as one of a series of papers that accompanies the annual budget. No country has established a long-term budget framework comparable to the medium-term frameworks that are now in vogue. While a medium-term framework constrains the budget actions that government takes in the light of their impacts on review and spending levels for each of the next 3-5 years, the long-term projections have not yet been hardened into budget constraints.

It is highly probable that some governments will move to regulate the long-term budget impacts of current decisions. The budget resolution adopted by the United States Congress in 2005 contains a new provision (effective only in the Senate) that bars consideration of any measure that would cause mandatory spending to increase by more than \$5 billion in any of the four ten-year periods between 2016 and 2055. This provision may be waived by supermajority vote, and does not pertain to the House of Representatives. Nevertheless, it indicates the direction that budget rules might take as governments strive to constrain politicians from shifting costs to future generations.

Expansion of the time horizon will take different paths, but governments moving in this direction are likely to take (or consider) the following steps. First, they will develop baseline projections of future revenues and expenditures under current law. Without these baselines, it will be difficult to gauge the impact of current decisions on future budgets. Second, governments will develop capacities to estimate the changes that will occur in future revenues or spending as a consequence of policy change. These estimates will be made at the time the policy change is considered or adopted. They often will be wide of the mark, but they will sensitise governments to the reality that today's actions alter future budget conditions. Third, the methods for estimating these impacts will vary among governments. Some will estimate the present value of changes in future revenues or expenditures; others will estimate these impacts in current or constant amounts, and some will calculate the changes as a proportion of GDP. Fourth, some governments

will establish rules that restrict the government's authority to take actions that would increase future deficits (or debt) or reduce projected surpluses.

The procedures outlined here would regulate policy changes that affect future budgets. They are generally similar to those used by governments that have medium-term expenditure frameworks, but rather than working with a 3-5 year horizon, they have a 30-50 year perspective. There is no significant methodological difference between a medium-term framework and a distant one, but it must be recognised that the further ahead one looks into the future, the shakier the assumptions are. The problem is not only that long-term estimates are unreliable and will likely prove to be wrong; there is a risk that opportunistic politicians will manipulate the process in ways that would adversely affect future budget conditions. For example, suppose a government were to adopt a "deficit neutral" rule that bars any revenue or spending change that would increase future deficits. It would be possible for a government to "pay for" spending increases in one programme by proposing offsetting cuts in other programmes. The trade-off will not be an equal exchange, however, if the savings were canceled (or trimmed) before they took effect.

Regulating policy changes in reference to baseline projections would not deal with imbalances that are already embedded in the budget. This approach might deter governments from making matters worse; it will not, however, restore sustainability in countries where governments are on a fiscal course that would compel significant future increases in the tax or debt burden. It would be appropriate, therefore, for such governments to introduce policy changes that ease future budget pressures. It is not within the scope of this paper to recommend substantive changes in tax or spending policy, but a generalisation can be offered that pertains to a broad swath of national policy. During the past half century, national governments in industrial countries have become the holders of risk for society. They have taken on a broad array of direct and contingent liabilities that typically come due decades after critical policy decisions were made. Most of these pertain to income support in the form of pensions, health care, disability insurance, unemployment benefits, and other transfers. The countries which have a more favourable long-term outlook tend to be those that have shifted some of the risks back to households. Doing so is, of course, highly controversial and may have some adverse political or social side-effects. But no matter what means they employ to measure sustainability, governments will not be able to sustain their fiscal course if they continue to be the holders for all major financial risks in society.

It behooves national governments to take an inventory of the risks they are holding and to report on them in supplemental notes appended to annual financial statements. Some direct, certain liabilities should be recognised on the balance sheet, but those that are contingent, implicit, or remote should

not. Governments should also explore arrangements for contingent liabilities that reduce moral hazard and their exposure to future adverse events.

3.2. Managing the sustainability process

As envisioned in this paper, governments should consider four complementary approaches for bolstering sustainability. One would be to construct long-term fiscal scenarios using cutting-edge socio/econometric techniques such as generational accounting and present-value accounting. Second, governments should extend baseline projections beyond the medium term using methods that have been applied in medium-term frameworks. Third, governments should estimate the impact of current policy changes on the long-term fiscal outlook. Finally, governments should reconfigure fiscal risks, so that a greater portion is shared by households and current generations.

Some have suggested that sustainability work requires a greater degree of independence than conventional budget tasks and should therefore be conducted outside government. While government should not have an exclusive claim in assessing future fiscal conditions, it should have a prominent role. All four responsibilities outlined in the preceding paragraph should be assigned to government. In countries that assign the ministry of finance a broad swath of fiscal and economic responsibilities, it would be the appropriate institution to lead sustainability work. In those that have separate budget and economic management institutions, it would be appropriate for both to co-operate in carrying out these responsibilities. Because of the specialised skills and experience requisite for constructing baselines, it would be unwise to exclude the budget office from this work. When government reports on sustainability, its findings are likely to be regarded as more authoritative than those produced by outside analysts. The attention that sustainability reports have earned in Australia, New Zealand, the United Kingdom and a few other countries is a strong indicator of the advantage of conducting this work in-house. Moreover, when government takes responsibility for the findings, there is a greater probability that it will act to ameliorate downstream problems.

Although long-term sustainability does not normally vary significantly from one year to the next, there is considerable gain in routinising the process by reporting each year. The annuality of these reports fosters an expectation that government will take the problem seriously and that its findings will be fed into the budget and other decisions. The *OECD Best Practices for Budget Transparency* (OECD, 2002) call for a report assessing the long-term sustainability of current budget policies to be issued every five years, or when major changes are made in revenue or spending programmes. The OECD stresses that all key assumptions underlying the projections contained in the

report should be made explicit and a range of plausible scenarios presented. Reporting at five-year intervals would be a considerable gain for governments that do not presently produce any long-term forecast, but as sustainability becomes more embedded in budget work, best practice may be to shorten the interval and to report annually or every other year.

The manner in which key findings are presented will strongly influence the consideration they receive. Sustainability analysis is complex, open to a variety of methodological approaches, and often produces a range of estimates and an array of scenarios. For the results to filter to the media and the public, it is important that they be presented in ways that non experts can comprehend, even if doing so requires that some of the findings be simplified. One example of effective communication is the annual report of the trustees of the social security system in the United States. Each year the report captures front-page attention because it specifies the year in which the social security fund will be depleted if current policy continues without change. The trustees are appointed by the government but exercise independent judgment in their report which is regarded as an objective and authoritative forecast. The most recent report, issued in March 2005, projected that the main medical insurance fund will be exhausted in 2020 and that the social security fund will be exhausted in 2041. The report also contains 75-year actual forecasts that show social security expenditures rising from 4% to 6% of GDP and Medicare expenses soaring from 3% to almost 14%. Layers of assumptions undergird this single statistic, and these are appropriately discussed in the body of the report. It should be feasible to devise simple measures for the various types of sustainability analyses that national governments and outside experts have used to portray the fiscal future.

This paper began by noting that sustainability concerns have migrated from underdeveloped to developed countries and have shifted from medium- to long-term concerns. The long term may appear distant, but in re-engineering fiscal policy, it is already here. Most persons who will receive public pensions and health benefits 40 or 50 years from now are already in the country's workforce, contributing social insurance taxes and building expectations of what they will receive from government. Sooner or later all countries will have to confront the reality of expectations outracing means. Those that take on the task earlier will find it somewhat less onerous than those that tarry.

Notes

1. See Crippen (2003) for useful advice on dealing with the inherent uncertainty of long-term budget scenarios.

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Government Performance: Lessons and Challenges

by
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This article concentrates on attempts by OECD countries to introduce performance-based or results-based budgeting and management. The need to enhance public sector performance has become more urgent as governments face mounting demands on public expenditure, calls for higher quality services and, in some countries, a public increasingly unwilling to pay higher taxes. Performance budgeting and performance management seek to move the focus of budgeting, management and accountability away from inputs towards results, i.e. better value for money. Drawing on data from the OECD/World Bank Budget Practices and Procedures Database, the article explores the trends and country approaches (different phases, various objectives), discusses accountability to the public (including external performance auditing), and recognises the importance of context and a whole-of-government approach, in particular for changing the behaviour of key actors and motivating politicians to use performance information. The limitations and tensions of performance budgeting and performance management are also discussed, as well as problems of measurement and the efficient use of performance information.

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1. Introduction

Over the past two decades, enhancing public sector performance has taken on a new urgency in OECD member countries as governments face mounting demands on public expenditure, calls for higher quality services and, in some countries, a public increasingly unwilling to pay higher taxes.

To address these challenges, various OECD countries have sought to enhance their public sector performance by adopting a range of new levers and approaches to management, budgeting, personnel and institutional structures. Within government, these have included the introduction of performance measures into budgeting and management, the relaxation of input controls, the delegation of responsibility to line ministries/agencies, and changes in public employment typified by the adoption of contracts for public servants and the introduction of performance-related pay. Examples of institutional change include the creation of executive agencies and the privatisation or outsourcing of the provision of public services.

This paper concentrates on attempts by OECD countries to introduce performance or results-based budgeting and performance management. This lever of reform seeks to move the focus of budgeting, management and accountability away from inputs towards results. Managers and/or organisations are given flexibility in order to improve performance and are then held accountable for results measured in the form of outputs and outcomes. The provision of performance information is not an end in itself; rather, its overall objective is to support better decision making by politicians and public servants leading to improved performance and/or accountability, and ultimately, enhanced outcomes for society.

The quantity of performance information available to decision makers has substantially increased; however, countries continue to struggle with issues of quality and with ensuring that information is used in decision making. It takes time to develop performance measures and indicators, and even longer to change the behaviour of key actors in the system (politicians and bureaucrats) so that they use this information and develop a performance culture adapted to their particular country. The performance movement is here to stay. The benefits of being clearer inside and outside government about purposes and results are undeniable. But to gain these benefits governments need a long-term approach, realistic expectations, and persistence. This paper looks at the development of performance-based

budgeting, management and reporting in OECD countries and identifies the trends, the strengths and the limitations of current approaches and future challenges. First it discusses the wider perspective of government performance.

2. What does performance mean for government?

“Performance” is a term that encompasses many different concepts. Performance means the yield or results of activities carried out in relation to the purposes being pursued. Its objective is to strengthen the degree to which governments achieve their purposes.

The desire to improve government performance is not new. Governments have always wanted results from their spending and regulation. What is new is that, increasingly, governments are facing overall spending constraints. With no new money to spend, more attention must be given to achieving better results from existing funds. At the same time new ideas have emerged about how to re-organise and better motivate public servants to achieve results.

In the traditional public sector bureaucracy, performance was driven by ensuring compliance with set rules and regulations, controlling inputs, and adhering to the public sector ethos. This system generally worked well when governments had less complex and more standardised tasks to perform – and when complying with the rules was considered more important than efficiency or effectiveness. The system has been criticised, however, because employees tended to become more focused on process than on results, and there were weak incentives to use funds efficiently to achieve objectives. Modern public administrators not only have to serve collective interests of fairness and probity, but also have to meet individual needs and address complex social problems. Traditional public administrative systems were not designed to be flexible and adaptive in a modern society with customised services, the need for constant adaptation, pressure for efficiency, and the increased use of private agents. There is a call for sharper performance incentives than are provided by a traditional bureaucracy. Furthermore, governments have taken on more challenging and complex tasks, which do not lend themselves to the traditional approach.

Performance information is important for governments in assessing and improving policies:

- in managerial analysis, direction and control of public services;
- in budgetary analysis;
- in parliamentary oversight of the executive;
- for public accountability – the general duty on governments to disclose and take responsibility for their decisions.

Governments have adopted a number of different approaches to improving the efficiency and effectiveness of the public sector. These include: strategic management; business planning; performance budgeting and management; devolved and delegated decision making; structural change such as the creation of executive agencies; the use of contracts; and the introduction of competition and market-type mechanisms in service provision.

This variety of approaches towards improving public sector performance is rich but confusing. Each approach has different strengths and weaknesses and the best choice of approach depends on the purpose to be served. This paper explores the introduction of performance measures into budgeting and management and their use in decision making.

3. Performance budgeting and performance management

OECD countries use a variety of mechanisms to assess the efficiency and effectiveness of programmes and agencies. These include performance measures, benchmarking and evaluations. Evaluations can incorporate programme reviews, cost effectiveness evaluation, *ad hoc* sectoral reviews and spending review.

The term “performance information” includes both evaluations and performance measures. While this paper concentrates on examining the latter, it is important to acknowledge that evaluations have a valuable role to play in assessing the performance of programmes.¹

Currently, the strongest trend in performance across OECD member countries is the introduction of performance-oriented budgeting and performance management. Many governments have sought to adopt an approach to both management and budgeting which seeks to shift the emphasis of budgeting, management and accountability away from controlling inputs towards achieving results. In theory, input controls are relaxed and managers and/or organisations are given flexibility to improve performance. In return they are held accountable for results measured in the form of outputs and/or outcomes.

Moves to formalise targets and measurement in government management and budgeting systems have a long history. In fact, performance budgeting has existed in one form or other since the first Hoover Commission in the United States recommended it in 1949. Performance budgeting and performance management are used to describe a range of rather diverse of interpretations and approaches (see Box 1). For example, they can simply refer to the presentation of performance information as part of the budget documentation or to a budget classification in which appropriations are divided by groups of outputs or outcomes. A more narrow definition of performance budgeting is a form of budgeting that relates funds allocated to results measured in the form

Box 1. Performance management and performance budgeting

Broadly, performance management covers corporate management, performance information, evaluation, performance monitoring, assessment and performance reporting. In the context of the new performance trend, however, a stricter definition is a management cycle under which programme performance objectives and targets are determined, managers have flexibility to achieve them, actual performance is measured and reported, and this information feeds into decisions about programme funding, design, operations and rewards or penalties (OECD, 1995).

Results/performance-based budgeting too is subject to diverse interpretation. It can be broadly defined as any budget that presents information on what agencies have done or expect to do with the money provided (Schick, 2003). In this case it can simply refer to performance information presented as part of the budget documentation or to a budget classification in which appropriations are divided by groups of outputs or outcomes. A strict definition of performance-based budgeting, however, is a form of budgeting that relates funds allocated to measurable results. These results are measured in the form of outputs and/or outcomes. Resources can be related to results either in a direct or indirect manner.

Indirect linkage means targets being actively used to inform budget decisions, along with other information. Performance information is very important in the decision-making process but it does not necessarily determine the amount of resources allocated.

Direct linkage involves the allocation of resources directly and explicitly linked to units of performance. Appropriations can thus be based on a formula/contract with specific performance or activity indicators. This form of performance budgeting is used only rarely and in specific areas in OECD member countries.

of outputs and/or outcomes. Performance management also has diverse definitions: it can refer to corporate management or systems for evaluating and assessing individual or group performance. A more holistic definition, which is applied in this paper, is a management cycle under which programme performance objectives and targets are determined, managers have flexibility to achieve them, actual performance is measured and reported, and this information feeds into decisions about programme funding, design, operations and rewards or penalties.

Although various interpretations of performance budgeting and management exist, the common trend is that governments have sought to

adopt a results-based approach to both management and budgeting which shifts budgeting, management and accountability away from inputs towards a focus on measurable results.

4. Country approaches to implementing performance budgeting and performance management

Many OECD member countries have introduced performance measures into their management and budget systems. However, countries are at different phases of introduction and have varied objectives and approaches to implementing these reforms.

4.1. Different phases

New Zealand was among the first to begin the present round of performance management and/or budgeting in the late 1980s, followed in the early to mid-1990s by Canada, Denmark, Finland, the Netherlands, Sweden, the United Kingdom and the United States. A further phase began in the late 1990s to early 2000s (Austria, Germany and Switzerland). Turkey has recently begun a pilot phase of performance budgeting and management.

Country approaches to performance management are constantly evolving. For example, New Zealand began by concentrating on outputs and is now moving to an outcomes approach. Denmark is changing its accounting and budgeting systems to focus on outcomes. France recently passed a law which requires the production of outputs and outcomes in budget documentation for the majority of programmes.

4.2. Various objectives

It is possible to discern four broad objectives for which countries have adopted the formalisation of targets and measures in the government management process:

- Managing the efficiency and effectiveness of agencies and ministries and/or the internal control and accountability within individual ministries.
- Improving decision making in the budget process, and/or in the allocation of resources and accountability of ministries to the Ministry of Finance.
- Improving external transparency and accountability to parliament and the public and clarifying the roles and responsibilities of politicians and civil servants.
- Achieving savings.

Some countries have give attention to one or two of these objectives only. Other countries (Australia, Denmark, the Netherlands, New Zealand, the United Kingdom and the United States) have embraced all four objectives,

seeking to introduce performance-based management and budgeting across central government and to improve both performance and internal and external accountability to the legislature and the public.

4.3. Various approaches

In some countries (the United States is a good example) ministries have developed strategic and performance plans which include performance targets. Other countries have adopted performance agreements either between a minister/ministry and a subordinate agency, or between a minister and a department. Such agreements can also be between the Ministry of Finance and a ministry or agency.

In New Zealand there are purchase agreements between the minister and the relevant department which set out the agencies' agreed outputs. There are also formal performance agreements between ministers and chief executives of the departments. In the United Kingdom, ministries approve agencies' annual business plans, which establish performance goals and targets for the coming year. There are also performance agreements between departments and H.M. Treasury stating agreed objectives and targets. In Australia there are resource agreements between the Department of Finance and Administration and the relevant departments and agencies. In Denmark, there are performance contracts between ministries and agencies and between chief executives and ministries; these include links to performance-related pay.

4.4. Implementation

Some countries have adopted an incremental approach. For example, the United States had a four-year pilot phase before the government-wide implementation of the Government Performance and Results Act. Other countries have chosen an incremental approach which allows agencies to participate voluntarily in these reforms without moving towards total implementation across government. Germany and Ireland both use pilot schemes.

Australia, the Netherlands, New Zealand and the United Kingdom have taken a top-down and total system approach to implementation. Others (Finland in particular) have taken a more bottom-up and *ad hoc* approach where agencies have been given freedom to develop their own method with less enforcement from the top.

5. What is the current state of play?

Despite the differences in approach, a common trend in OECD member countries is to introduce a focus on measurable results in management and budget processes. This section examines the current trend in performance

management and budgeting in OECD member countries using data obtained from the OECD/World Bank Budget Practices and Procedures Database Survey.²

5.1. Performance information and targets in budget documentation and the budget process

Among OECD member countries there is a strong trend of routinely including non-financial performance information in budget documentation:

- 72% of countries include non-financial performance data in their budget documentation.
- In 44% of countries, these data are available for more than three-quarters of programmes.
- In 71% of countries, performance data include performance targets although there is a wide variation in terms of programme coverage.
- In 65% of countries, these results are included in the main budget documents and/or the annual financial documents.

While the introduction of performance information into budget documentation is becoming common, it has not been embraced by all OECD member countries. Over a quarter of countries that responded to the survey do not include any non-financial performance data in their budget documentation. Iceland includes performance data but not performance targets.

The most common way of including performance targets in the budget process is a combination of outputs and outcomes. Only 27% of countries include mostly outcomes and no country has mostly outputs. Countries appear to have recognised the difficulty in following an approach that concentrates solely on either outcomes or outputs. Only concentrating on outputs can give rise to goal displacement as agencies lose sight of the intended impact of their programmes on wider society and concentrate solely on quantifiable measures at the expense of activities that are less measurable. It can also result in less attention being paid to cross-cutting issues. While outcomes incorporate a wider focus on the impact of programmes on society and have greater appeal to politicians and the public, they are very difficult to measure. As will be discussed later in this paper, in many cases a mix of outputs, outcomes and inputs is desirable.

5.2. The current trends in performance budgeting

Some OECD countries have actively attempted to integrate performance targets into the overall budget process, but very few can be said to be carrying out “real” performance budgeting. This means including performance information in budget documentation and linking expenditure to outcome/

output targets, reporting performance against these targets and using the information to make decisions on future resource allocation. Using this strict definition, performance budgeting is very rare. The OECD surveyed the degree to which countries apply performance budgeting in this strict sense.

While 72% of OECD member countries routinely display targets in budget documentation given to the Ministry of Finance, the linking of expenditure to output and outcome targets is not common among OECD member countries:

- 46% of countries either do not link expenditure to targets or only do so for a few programmes.
- 35% of countries reported that they link expenditure to some targets.
- Only 18% of countries reported that they specifically link expenditure to all or most of their output or outcome targets.

A mixed picture emerges with regard to the use of performance results in determining budget allocations, with over 31% of countries stating that performance results are not used for this purpose. It is not common for politicians to use performance results in allocating resources between programmes or in any sort of decision making. Forty-one percent of OECD member countries reported that it was not common for politicians in the executive or the legislature to use performance measures in any decision making. This includes countries that have long experience of this area, such as the United States.

It is apparent that very few countries engage in any form of direct performance budgeting, since many countries do not even link expenditure to output and outcome targets, let alone make the appropriation of funds an explicit function of performance. This form of budgeting is only applied to a limited number of functional areas and only in a few countries. It is most commonly found in health and education, especially higher education. In Denmark, Finland, Norway and Sweden, for example, it is the main form of budgeting used to fund higher education.

As Figure 1 highlights, very few countries appear to have formal mechanisms in place that relate the success or failure in achieving a target to the reward or punishment of individuals or agencies:

- In 46% of OECD member countries, no rewards or sanctions are applied if a target is met or not met.
- In 20% of countries, rewards/sanctions are reflected in the size of the budget for the government organisation.
- In 16% of countries, pay is sometimes linked to performance. In all these cases performance is linked to the pay of a civil servant or a number of civil servants. For example, in the United Kingdom, performance against organisation targets is linked to the pay of the agency's chief executive.

Figure 1. **Are rewards and/or sanctions applied if performance targets are met or are not met?**



Source: OECD/World Bank Budget Practices and Procedures Database 2003.

5.3. Current trends in performance management

Greater progress has been made in implementing performance management reforms than performance budgeting. This section examines if OECD member countries have a system of performance management which incorporates the setting and reporting of targets and their subsequent use in the internal decision-making process of ministries and agencies:

- In 67% of countries, the relevant minister or the head of department is formally responsible for setting performance targets.
- In 56% of countries, performance against targets is continuously monitored internally in the relevant ministry.
- In 63% of countries, performance against targets is reported in a systematic annual report for some or most programmes.

Performance results that feed into decision-making processes appear in a number of countries. In nearly 50% of countries, performance results are used internally within agencies/ministries to set programme priorities, to allocate resources within programmes, and to change work processes. Performance results are used by the parent ministry in approximately half of countries to set programme priorities and in over a third in adopting new programme approaches. This information is used least in setting individual staff performance plans.

While this information is used in the decision-making process, it is not clear what other types of information are used (if any) and how much weight is given to performance results compared to these other types of information.

Approximately 50% of countries reported having a system of performance management. However, within a given country, there is variation in the

number of programmes and agencies to which performance management is applied. Australia, the Netherlands, New Zealand, Norway and the United States have taken a comprehensive approach and it is applied to nearly all ministries and agencies. In Belgium, Canada and Germany it is only applied in approximately a quarter of programmes.

The introduction of output and/or outcome targets as a system of management control requires relaxed input controls in order to give managers the freedom to use resources to achieve results and improve performance. To what extent has this trade-off between performance and controls been achieved in practice? In terms of the whole-of-government control processes, the information gathered from the OECD/World Bank Budget Practices and Procedures Database does not provide much evidence that this trade-off has occurred.

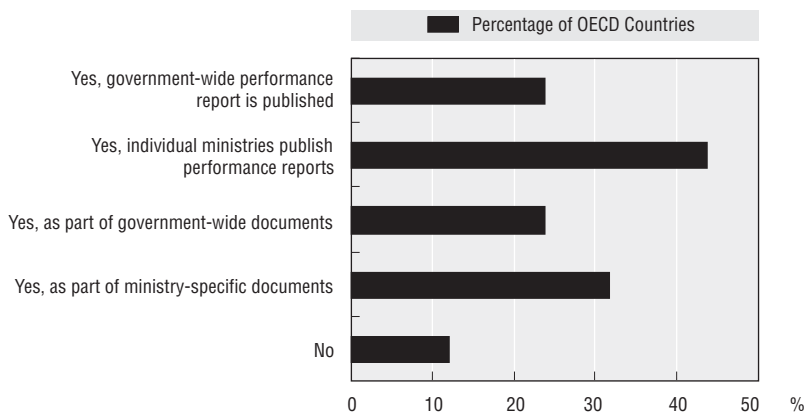
Among countries with a long experience of introducing performance indicators into budget and management systems, there is a large variation in terms of the degree of relaxation of input controls. Australia and the Netherlands appear to have extensively relaxed central controls. Others (such as Denmark, New Zealand and Norway) have also made substantial moves in that direction. However, in some countries (for example the United States), the introduction of performance indicators in management and budgeting does not appear to have been accompanied by a relaxation of central input controls.

Countries like Finland and Sweden register a high degree of management autonomy. This is to be expected given their long tradition of agencies. Equally, given that performance budgeting is a centrally driven device, they have only a moderate level of formalisation of performance indicators in their budget system. It is of interest that Australia, the country which shows the strongest trend of substituting input controls for performance controls, is, according to recent advice from the Department of Finance and Administration, finding the current reporting from departments insufficient for whole-of-government purposes.

6. Accountability to the public

As Figure 2 indicates, in OECD member countries the provision of information to the public on government performance is widespread.

In the survey, 24 OECD member countries claimed to report to the public on performance results. This is strong evidence that transparency has improved. In presenting this information to the public, the aim is to improve trust in government by showing what government does and most importantly how well it does it. As improving public sector performance becomes more important to citizens, in electoral terms it becomes increasingly necessary for governments to demonstrate that they are achieving these improvements.

Figure 2. **Are performance results made available to the public?**

Source: OECD/World Bank Budget Practices and Procedures Database 2003.

The problem for governments is that improvements in performance take time to achieve but the electoral pressures are such that they need to show improvements in the short term. Some governments believe that the public will be more convinced that services have improved by the presentation of numerical performance information. However, even with numerical information there are questions about quality and accuracy. While governments present performance results as objective evaluations, this information, depending on the nature of the political system, can become part of the political dogfight between the government and the opposition. This is more a problem in political contexts where the norm is adversarial rather than consensual politics. In this context, the opposition can use the very same results to discredit the government's performance and to raise questions about their objectivity. The media has also a large role to play: if the information is presented as pure party political propaganda and government spin, this could do more to increase public scepticism than to create trust.

A related issue is whether the public and interest groups are willing to accept the government's presentation of performance results. Performance results are generally aggregated outcomes for the whole country, a region or a single large institution. Even if accurate the general conclusion may be at odds with some individual experience. Thus it is almost inevitable that performance results will be challenged on the basis of that experience. The views of the public are more likely to reflect personal experiences or views presented in the media rather than the government's performance reporting.

6.1. External performance auditing

Having externally audited performance information would help to assure the public of the quality and accuracy of the information presented in government reports. One might have expected that, with the great increase in the number of countries with performance information in their formal reporting systems, there would be a commensurate rise in the routine auditing of performance reports by supreme audit institutions. There is indeed some trend in this direction, but it lags behind the introduction of performance reporting.

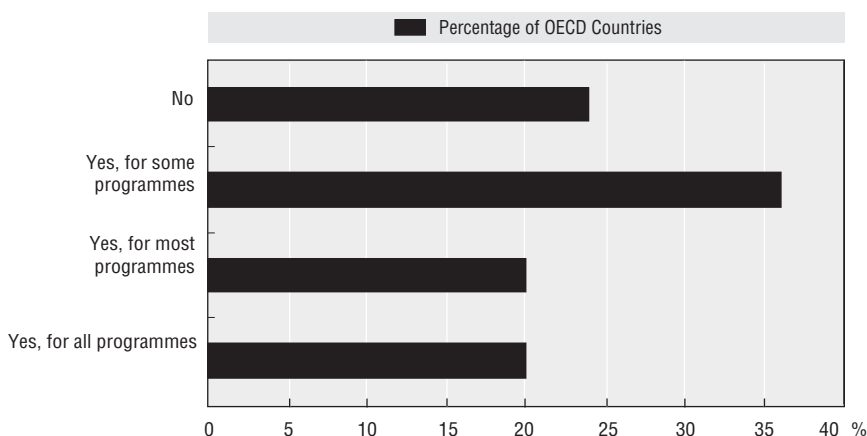
Assuring the credibility and quality of performance data is a key issue for OECD countries; taking performance information at face value can give a distorted picture. Threats to quality can come from poor practices in gathering and analysing data and from political pressure to look good (Schwartz and Mayne, 2005). The independent audit of performance data helps to reduce these problems.

Auditing performance information is costly and it is also different from auditing financial information. Therefore, auditors must have the necessary expertise and training to conduct these audits. In addition, there is a danger that performance becomes compliance – that is, too much emphasis on compliance with rules and regulations can reduce emphasis on flexibility and innovation needed to improve performance.

6.2. Summary of trends

Across OECD countries, there is a strong trend of introducing performance indicators into management and budgeting. There is also a strong common trend

Figure 3. **Is the performance data externally audited?**



Source: OECD/World Bank Budget Practices and Procedures Database 2003.

of introducing a systematic approach to performance management. While many countries have reached the stage of introducing performance targets into their budget documentation, fewer countries have integrated this information into their budgetary decision-making process and even less have used it in the allocation of resources. There is also a strong trend of reporting this information to the public and the legislature, although the tendency is for legislatures not to make much use of this information. In general, the performance budgeting movement seems at the moment to be stronger on process than on results.

7. Why context matters

The successful use of the formalisation of performance in the budgeting and management processes depends on other factors in the political and administrative environment of the country concerned. Reformers do not begin with a blank sheet; performance indicators and targets are introduced into existing and established systems of accountability and control, which have both informal and formal components.

Performance is only one dimension of accountability. Other aspects include assuring that correct administrative procedures have been followed and that funds have been spent as allocated. Traditional accountability mechanisms designed around input controls have not been extensively relaxed in some countries. Accountability for performance will co-exist alongside traditional mechanisms. The issue is not about completely replacing input controls with outputs/outcomes, it is more a question of how to find the desired mix of mechanisms within the system. Concentration on only one instrument of control can have distorting effects. For example, concentrating only on outputs can lead to goal displacement. Table 1 shows the different potential and limitations of control regimes for inputs, outputs, and outcomes.

Table 1. Potential and limitations of different management control regimes

	Potential	Limitations	Suitable contexts
Input	Easy and affordable; Strengthens compliance.	Does not support efficiency; Can be inflexible.	Low confidence and variable competence.
Output	Facilitates efficiency; Facilitates control of aggregate expenditure; Accountability for results.	Can distort focus; Measurement problems; Information overload.	Confidence, sound accounting and professionalism.
Outcome	Supports policy formulation and co-ordination; Long term.	Measurement problems; Accountability problems; Costs; Information overload.	The above plus dedicated politicians and the ability to set clear objectives.

The most appropriate balance of controls will depend on the country context and the problems these reforms are seeking to address. For example, if the problem is the susceptibility of a system or organisation to corruption, then placing the stress on input controls is a more suitable approach than stressing outcomes. For other systems and organisations where the problem is inflexibility and lack of adaptation, a combination of outputs and outcomes could be a more suitable approach. Within each system it is necessary to find the desired combination of controls between outputs and inputs. Furthermore, it can be desirable to have some flexibility to allow for a different mix of controls for different organisations.

7.1. Whole-of-government approach: changing the behaviour of key actors

Whatever the balance or mix of controls in a given country, when outputs and outcomes are introduced they have to be accommodated within the existing control system and this requires a realignment of relationships. In introducing these reforms it is important that governments take a whole-of-government approach – as the integration of performance measures into budgeting and management systems is not just about changing processes but is also about transforming the behaviour of both public servants and politicians throughout the political system. This is especially the case if governments have taken a comprehensive approach and seek to apply this reform across government to the majority of programmes. The key actors in this case can include public servants and managers in ministries/agencies and in the Ministry of Finance, and politicians in the legislature and the executive. The challenges in changing the behaviour of public servants in ministries/agencies and in the Ministry of Finance have been discussed elsewhere.³ This section will briefly examine the challenges in changing the behaviour of politicians.

Performance-oriented budgeting and management as a reform lever has wider governance implications: it has the capacity to help elected leaders to steer the public sector towards their policy objectives. It provides a mechanism for politicians to clearly articulate their goals and objectives for the government as a whole or for the relevant ministry and the means to monitor progress towards achieving these goals.

In theory, this model should help to clarify the respective roles and responsibilities of ministers and public servants. Politicians set the objectives; these cascade down to the relevant ministry and/or organisation and are translated into performance measures and/or targets. The results against these targets are used to hold agencies to account and to provide better information to be used in decision making on policy, budget and management

issues. For this model to succeed it is important that politicians use this information in decision making.

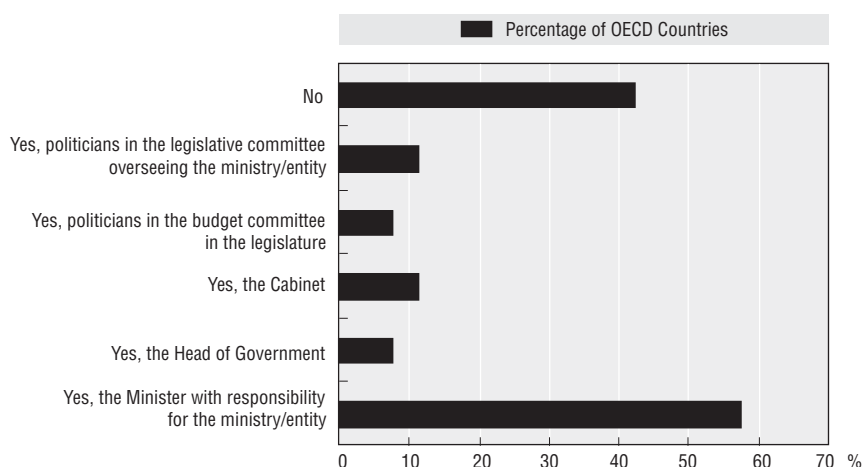
7.2. Motivating politicians to use performance information

Do politicians use performance information? The answer, it appears, according to Figure 4 is “not much”, with the exception of ministers responsible for the department delivering a target.

In 72% of OECD member countries, targets are routinely displayed in budget documentation presented to the legislature. However, in only 19% of countries do politicians in the legislature use performance measures in decision making. The percentage is even lower for politicians in the legislative budget committee, with only 8% using this information.

For countries that have introduced these reforms, clearly a major challenge is to change the behaviour of politicians and to create the right mix of incentives to motivate them to use this information. Table 2 summarises the necessary but not sufficient behavioural changes that are needed from politicians in the executive and legislature if these reforms are to achieve their aims. The table lists some of the possible incentives that could motivate these actors to change their behaviour and also the negative factors that discourage them from adopting this approach and using the performance information provided. This list of behavioural changes and incentives is not meant to be exhaustive.

Figure 4. **Is it common that politicians use performance measures in decision making?**



Source: OECD/World Bank Budget Practices and Procedures Database 2003.

Table 2. Incentives influencing whether politicians in the executive and the legislature change behaviour and use performance information in decision making

Key actors	Behavioural changes needed	Positive incentives and factors encouraging change	Negative incentives and factors discouraging change
Ministers and politicians in the executive	Provide leadership support for reforms.	Process to set objectives and monitor progress in achieving them.	Concerns about quality of information.
	Set clear objectives and targets.	Good quality information.	Information not relevant for real political issue and day-to-day concerns.
	Use performance results to hold agencies to account.	Information relevant to political needs.	Cost of being informed and monitoring.
	Use performance results in decision-making processes on policies/programmes or budgeting.	Provide information to voters on achievement of political goals.	Lack of time to use information.
Politicians in the legislature	Respect managerial freedom granted – by non interference in delegated areas.	Compatible with existing informal and formal mechanisms of oversight.	Little or no influence on career advancement.
	If applicable, set objectives.	Help to oversee government progress in achieving outcome goals.	Poor quality of information.
	Use performance results for oversight purposes.	Good quality information.	Information less relevant to political needs.
	Use information in decision making on programmes and/or policy and/or budgeting.	Relevant to political needs.	Cost of learning about new lever, continuing costs.
	Respect managerial freedom.	Presented in easy readable manner.	Lack of time to use this information in decision making.
		Compatible with existing informal and formal mechanisms of oversight.	Information presented in an unreadable manner.
		Provide benefits over and above traditional approach.	Receiving less detailed information.
			Concerns about having less control.

The impact of these incentives will vary with the political and institutional contexts and to some extent with the individual minister. In Westminster systems, accountability is focused on individual ministerial responsibility, and there can be a strong emphasis on faultfinding and blame. In these systems, there is a danger that despite the formal system of accountability, which concentrates on performance, politicians may be more concerned with avoiding errors and managing public perceptions and will use the various accountability mechanisms selectively to that end. Systems in which responsibility is more collective and the political system less adversarial may offer more room for the constructive use of performance information.

Despite these issues, according to the OECD survey, ministers with responsibility for a relevant ministry/entity have paid more attention to performance indicators than other politicians. There is a particular problem, however, with getting politicians in the legislature interested in using performance results. The factors which can discourage them are listed in Table 2. They include questions about quality, readability and relevance of information.

In a system of separation of power with a strong legislature that has a say over the setting of objectives like, for example, in the United States, there needs to be a high degree of institutional co-operation between the two branches of government. This need for strong co-operation is less of an issue in a country like the United Kingdom with a very powerful executive branch. Again, the behavioural changes required and the influence of incentives will vary to some extent with the political and institutional structures.

However, if performance management and budgeting is to have any impact in any political system it is important that the key actors in decision-making processes are provided with motivations and incentives to change. Without these provisions, performance information becomes a mere paper exercise. The combined experiences of OECD countries highlight the importance of taking a long-term approach. It takes time to change behaviour and to see the benefits of this approach emerge.

8. Limitations and tensions

This section considers some of the limitations and tensions which need to be considered when introducing performance budgeting and management.

8.1. Performance measures: only one source of information on performance

Performance indicators and targets provide a snapshot of performance in time. They do not provide a guide to future performance nor do they explain why a target has been achieved. Therefore, when making decisions about the performance of an agency or a programme, it is important to consider different types of performance information. To obtain an encompassing picture of organisational and programme performance, evaluations and performance indicators can be considered with other formal and informal sources of information and feedback. Unlike targets, evaluations can explain the results of a policy or programme and what changes will improve its performance.

8.2. Not everything can be measured

Unlike financial information, with performance information it is difficult to apply a “one size fits all” approach across government. Governments carry

out a large variety of diverse functions, from building roads to providing advice on foreign travel. The experience of OECD countries indicates that performance indicators and measures are more easily applied to certain types of functional and programme areas than others. Three types of programme can be distinguished: tangible and non-tangible individually tailored services, and non-tangible ideal services (OECD, 2001). Performance indicators are more easily applied in programmes which involve the delivery of a tangible good or service with observable outputs such as issuing passports or driving licenses or collecting taxes. It is easier to create reliable unit cost measures for this type of activity. It is possible, although more difficult, to design performance measures for complex services to individuals such as education and health care. Performance indicators are very difficult to apply to activities such as policy advice where the service is non-tangible and outcomes are not visible. In these areas where process is readily observable, a more obvious approach is to assess and control organisations on the basis of compliance with procedures.⁴ In some activities and organisations where neither outputs nor outcomes are observable, performance indicators are not a suitable option.

Given the different functions performed by government, consideration should be given to adopting an approach to performance management that is flexible enough to allow for the diversity of programmes and also for the fact that for certain functional areas other methods of assessing accountability and evaluating performance are potentially more effective.

8.3. Limitations of costs, capacity and time

Public sector performance information is, potentially, limitless, complex and expensive to collect. Any formal system of gathering such information must of necessity be highly selective. Complex areas of government are primarily managed in the context of a well-developed professional culture. Performance targets and information are of value only insofar as they strengthen the performance orientation of that culture. Good management seeks to maximise the internal motivation of staff and to minimise the need for formal management controls. These controls are expensive to operate, and at a certain point formal management systems reduce internal motivation.

There are limits to how much information decision makers can use; people have “bounded rationality” and so do organisations. Decisions are taken by busy, often distracted ministers and senior managers who operate under complex incentives. Providing them with more information does not necessarily help their decision making and may actively hinder it.

9. Future challenges

A great deal of rhetoric has surrounded the introduction of performance management and budgeting. Supporters claim that it has the capacity to transform governments. However, it is important that this reform should not be seen as a panacea and that governments have realistic expectations about what it can achieve and the time needed to reach these objectives.

9.1. Measurement

Even countries that have been using this approach for over 15 years continue to struggle with issues of measurement; this is especially the case for outcomes. A key challenge for all countries is obtaining good quality information which is valid, reliable, and timely. Numerous challenges can be encountered including setting clear objectives, finding accurate measures of performance and having good systems of data collection.

Setting objectives: For some agencies or programmes, even setting clear objectives can be a problem when there is no agreement on what the mission is, or there are diverse missions, overlapping and fragmented programmes, and stakeholders with different interests.

Finding accurate measures of performance: The design of measures is made difficult by finding measures for specific activities, and by relating what an agency or programme actually contributes towards achieving specific outcomes. Output and outcome measures each present a different set of challenges (OECD, 2002b). Outcomes are technically more difficult to measure; they are complex and involve the interaction of many factors, planned and unplanned. Also, there are problems with time lag issues and in some cases the results are not within the control of the government. Outcomes, however, have a strong appeal for the public and politicians. Most countries appear to have adopted a combination of outputs and outcomes.

Establishing and maintaining systems of data collection: To ensure quality there needs to be a process by which data collected are verified and validated. However, setting up and maintaining these systems can be both complex and costly. As discussed in Section 6, the auditing of performance information can help to improve standards and provide some legitimacy for the reported results. It is especially challenging to assure the quality of the data when agencies are dependent on third parties to provide the information. This is particularly a problem in federalist systems (Currstine, 2002).

9.2. Setting and using performance targets

Performance targets help to clarify performance expectations for an organisation for a given time period. Countries, however, continue to struggle with the issues of target level and numbers. There are problems with setting

targets too low and/or too high. Setting targets too low means that agencies are not challenged to improve performance. Setting them too high, while it can motivate organisations, also creates unrealistic expectations and situations in which agencies will fail (Perrin, 2002). It takes time to get the right level and to get the comparative data to realise that targets are set at too high or too low a level.

Too many targets: There is also an issue about how many targets to have. Too many targets create information overload and make it difficult to select priorities; too few targets create distortion effects. Again it takes time to get a realistic balance. Several countries have started out with a large number of targets and subsequently reduced them. For example, in the United Kingdom when performance agreements for departments were first introduced as part of the comprehensive spending review in 1998, there were in total 600 targets across government. By the time of the revised spending review in 2002, that number had been reduced to 130 targets (H.M. Treasury, 2004).

Avoiding distorting behaviour: This is a challenge for all governments. Possible perverse effects include goal distortion – that is, organisations and managers focusing on a few specific indicators and targets, usually the most achievable or “saleable”, at the expense of the overall objectives or programme. In extreme cases of goal distortion, agencies or staff, under pressure to meet targets, may deliberately present misleading information.

9.3. Challenges with using the budget process to improve performance

In many OECD countries, the objective of introducing performance into the budget process is to improve budgetary decision making and to act as an incentive for agencies to improve performance. Most countries, however, continue to struggle with this approach. As discussed above, one of the key issues is obtaining good quality and reliable performance data. Briefly, other challenges include establishing some link between financial information and performance information. This is particularly challenging for outcome measures. In many countries there are also problems with the structure of the budget and accounting issues. Budgets tend to be structured in accordance with institutional and functional boundaries and not according to results categories. Also if there is no system of cost recording, it is difficult to relate true costs to results.

Getting the right mix of incentives: This is particularly important when countries use performance information in resource allocation. A fundamental question is whether financial rewards should be given for good performance and bad performance should be punished and, if so, how. Punishing failure by removing resources creates a clear signal to other agencies that performance is considered important. However, it does not help address the underlying causes of poor performance. Indeed in some cases failure to meet targets can be the result of lack of funding or other resources. While rewarding good

performance is intuitively appealing, it does not take into account cost issues and government priorities. In a climate of budgetary saving, a question is whether to give additional funding to an agency, especially one that is not a government priority. In either case, there is always the danger that linking results to financial resources can create incentives to distort and cheat in presenting information.

9.4. Changing the behaviour and culture

One of the most difficult challenges is to create a results-based culture within organisations and throughout government. To achieve change in behaviour and culture across government requires a whole-of-government approach and the creation of the right mix of incentives that takes account of how the actions of key actors influence each other. Most countries continue to struggle with achieving change in the behaviour of public servants and politicians; this is a long-term process.

Obtaining and maintaining the support of managers and employees within government organisations is crucial. This reform has the potential to improve the focus on organisational goals, to provide managers with better information for decision making on programmes, budgets and policies, and to improve internal reporting and controls. Gaining these benefits is challenging because it requires technical as well as cultural change. In technical terms it can be difficult to measure what an agency does and to link organisational objectives to individual goals. It is important to obtain the buy-in of front line employees; this can be facilitated by the right mix of formal and informal incentives and controls. Obtaining the strong support of the organisational leadership and managers can be facilitated by giving them the necessary flexibility to achieve goals. Without this flexibility, managers will have the responsibility for achieving targets without the ability to deliver, and no one wants to be held accountable for targets that are not within his/her control.

Within the context of a government-wide approach, if and how the performance information is used by politicians and the Ministry of Finance can create incentives which impact on how managers behave. If performance information is required but not used by leaders or managers in decision making, there is a danger of it becoming a burden on organisations in terms of cost of information systems and staff time. The provision of this information, in addition to the requirements of the traditional control mechanisms, can interfere with getting the job done. If this happens, then performance management and budgeting can become a distraction, a distortion or an expensive paper exercise rather than a means to transform organisations and an essential part of good management.

Obtaining and maintaining the support of politicians: As discussed in Section 7, this is a key challenge facing reformers. The support of politicians in the legislature and the executive helps to reinforce the need for change and to push reform, although it is particularly difficult to obtain the support of politicians in the legislature.

Issues of horizontal and vertical co-ordination: Many goals and outcomes cut across government organisations and involve the work of many agencies. While some OECD countries have established cross-governmental horizontal goals and targets, it is proving difficult to achieve co-ordination across departments and to hold them accountable for results. At a vertical level there is an issue with different actors wanting the same information for diverse purposes; their informational needs are not the same.

Managing expectations: Realistic expectations are needed both about what can be achieved by this reform and how long it will take. A long-term approach and persistence are needed: it takes time to overcome the technical issues and to change the behaviour of public servants and politicians.

10. Findings and conclusion

The performance of government can be improved through a focus on results in policy advice, central and departmental management processes, and parliamentary and public accountability. It is important to first identify the relative priority of these areas in a particular country. What a government should do is different in each case.

The majority of OECD countries are implementing performance management and performance budgeting, although the extent and the approaches vary widely across countries. The introduction of performance management and budgeting appears to be an important and enduring innovation in public management. It is clearly a strong device for horizontal priority setting, policy alignment and cost analysis. These reforms have improved transparency through the provision of more information on government performance to the public. However, some initial hopes have been too ambitious.

Most countries continue to struggle with changing the behaviour of public servants and politicians. This is a long-term process. To achieve change in behaviour and culture across government requires a whole-of-government approach and the creation of the right mix of incentives and controls (formal and informal) and an understanding of the systems and how the actions of key actors influence each other.

There is no clear pattern of input controls being lightened as performance indicators are strengthened. This raises issues about balancing accountability and flexibility. Whatever the accountability systems in place, they need to be balanced against the freedom required by managers to do

their jobs. Critics of the traditional system of accountability argue that rules had become ends in themselves, that accountability stressed compliance, and that hierarchical structures hindered efficiency and performance. Thus, the critics emphasised the needs to relax input controls.

There are obvious dangers in relaxing input controls too soon after the introduction of output and outcome measures. However, there are also dangers in failing to relax these controls sufficiently, with the possible effect that output and outcome measures become an expensive paper exercise, with little impact on managers' ability to improve performance. If the system has too many restrictions and managers do not have enough freedom to improve performance, then failure to relax input controls can result in inefficiency.

The common assumption that the performance information that is useful for the executive would also serve the legislature remains unproven. With a few exceptions, performance reporting has been neither welcomed nor used by OECD member country legislatures in their oversight and decision making. Performance measures and targets are only one source of information about performance, and they are no substitute for the independent, in-depth qualitative examination of the impact of policies that evaluations can provide.

The combined experiences of OECD countries highlight the importance of taking a long-term approach and having realistic expectations about the capacity of performance management and budgeting to improve performance and accountability. A long-term approach and persistence are needed to achieve the necessary technical and behavioural changes that this lever requires.

Finally, from a wider perspective, the design of cross-government performance interventions needs careful analysis and consideration of options. Broadly, these interventions are: leadership; strategic planning; performance management; the inclusion of targets and measures in the formal budgeting, management and oversight processes; and policy evaluation. Each has different strengths and limitations. There is a danger of governments becoming fixated on a particular formal solution to the problem of improving performance.

The performance orientation of public management is here to stay. It is essential for successful government. Societies are now too complex to be managed only by rules for input and process and a public-spirited culture. The performance movement has increased formalised planning, reporting and control across many governments. This has improved the information available to managers and policy makers. But experience shows that this can risk leading to a new form of bureaucratic sclerosis. More attention needs to be given to keeping performance transaction costs in check, and to making optimal use of social and internalised motivators and controls.

Notes

1. See OECD (2005) for more details on evaluations in the budget process.
2. These data were originally collected in 2003. Out of the 30 OECD countries, 27 responded to this survey. All answers are self-reported.
3. See articles in OECD (2002a).
4. Although outputs can be observed in limited cases (see Wilson, 1989).

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