



OECD Journal on Budgeting

Special features

- Performance budgeting in Poland
- Value for money in public procurement
- Fiscal institutions in Central and Eastern Europe

OECD Journal

OECD Journal on Budgeting

Volume 2011/1

The OECD Journal collection comprises six periodicals: *OECD Journal: Economic Studies*, *OECD Journal: Financial Market Trends*, *OECD Journal: Competition Law and Policy*, *OECD Journal: General Papers*, *OECD Journal on Budgeting*, *OECD Journal: Journal of Business Cycle Measurement and Analysis*. Each periodical within OECD Journal retains its own ISSN, volume and issue numbering. The volume numbering of each journal corresponds to the calendar year, e.g. Volume 2011. Volume 2011 of *OECD Journal on Budgeting* contains three regular issues.



This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

Series: *OECD Journal on Budgeting*, Volume 2011 Issue 1
ISSN 1608-7143 (print)
ISSN 1681-2336 (online)
<http://dx.doi.org/10.1787/budget-v11-1-en>

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Corrigenda to OECD publications may be found on line at: www.oecd.org/publishing/corrigenda.

© OECD 2011

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.

Foreword

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

We are anxious to receive feedback from our readers. Your views on how to improve the Journal are welcome and can be sent to:

The Editors, The OECD Journal on Budgeting, OECD, 2, rue André-Pascal, F-75775 Paris Cedex 16, France. Fax: (33 1) 44 30 63 34; e-mail: sbo.news@oecd.org.

The Editors

Public Governance and Territorial Development Directorate, OECD

Rolf Alter

Director

Jón R. Blöndal

Head of Budgeting and Public Expenditures Division

Andrea Uhrhammer

Head of Communications

OECD Journal on Budgeting

Jón R. Blöndal

Editor-in-Chief

Board of Advisors

Gerhard Steger (Chair)

Director General, Budget Directorate, Federal Ministry of Finance, Austria

Barry Anderson

Former Deputy Director, Congressional Budget Office, United States

Richard Emery

Former Assistant Director for Budget, Office of Management and Budget, United States

Mike Joyce

Adjunct Professor, School of Policy Studies, Queens University, Canada

Joanne Kelly

*Associate Professor and Director, Graduate School of Government,
Australia and New Zealand School of Government*

Mogens Pedersen

Deputy Permanent Secretary, Ministry of Finance, Denmark

Table of contents

Performance Budgeting in Poland: An OECD Review by Ian Hawkesworth, Lisa von Trapp and David Fjord Nielsen.	7
Fiscal Transformation in Turkey over the Last Two Decades by Fatih Kaya and Selihan Yılar.	59
Reforming the Budgeting Process in China by Shulian Deng and Jun Peng.	75
How To Attain Value for Money: Comparing PPP and Traditional Infrastructure Public Procurement by Philippe Burger and Ian Hawkesworth	91
Fiscal and Monetary Institutions in Central, Eastern and South-Eastern European Countries by Zsolt Darvas and Valentina Kostyleva.	147

Performance Budgeting in Poland: An OECD Review

by

Ian Hawkesworth, Lisa von Trapp and David Fjord Nielsen *

Poland currently has a traditional budget system that is primarily based on organisational units and control of inputs. But Poland is in the process of introducing a new budget system, the performance-based budgeting system, in order to improve public finance management and strengthen allocative and operational efficiency, multi-year budgeting, and transparency and accountability. Poland faces hard choices on how to harness the advantages of performance management while minimising the costs in terms of organisational capacity and funding. This article assesses the reform process to date, examines cross-cutting institutional, technical, and strategic issues, and provides a series of recommendations for each stage of the budget process: budget preparation, approval and execution, and reporting, accounting and audit.

JEL classification: H500, H610, H830

Keywords: Poland, budget process, performance budgeting system, performance-based budget, PBB, public finance management, allocative efficiency, operational efficiency, multi-year budgeting, transparency, accountability

* Ian Hawkesworth (lead) is an administrator in the Budgeting and Public Expenditures Division of the Public Governance and Territorial Development Directorate, OECD. Lisa von Trapp is a policy analyst in the same division. David Fjord Nielsen is an independent consultant.

Preface

The Department for Public Finance Reform in the Ministry of Finance of Poland invited representatives of the OECD Budgeting and Public Expenditures Division of the Public Governance and Territorial Development Directorate to review Poland's evolving performance budgeting system. The OECD delegation comprised Ian Hawkesworth (lead) and Lisa von Trapp (both of the OECD Secretariat), and David Fjord Nielsen (consultant).¹

The delegation visited Warsaw from 13 to 17 September 2010 and held discussions with relevant departments in the Ministry of Finance and with representatives of the Chancellery of the Prime Minister, line ministries and agencies, parliamentary staff, and the Supreme Audit Office (NIK). The delegation also drew on responses to a questionnaire filled out by the Ministry of Finance. The OECD would like to thank the ministry staff for their assistance in arranging the mission and their gracious hospitality throughout.

In addition to a more general description of the Polish performance budgeting system, the review seeks to provide comparisons to other OECD countries and suggests areas for potential improvement. The review takes as its structure the stages of the overall budget process.

Executive summary

Poland currently has a traditional budget system that is primarily based on organisational units and control of inputs. In addition, Poland is in the process of introducing a new budget system: the performance-based budgeting system. This dual system will come into force in 2013. It is unclear whether the two budgets will remain in parallel or whether Poland will progressively abandon the traditional budget in favour of the performance-based budget (PBB). The purpose of introducing performance-based budgeting is to seek to improve public finance management and strengthen allocative and operational efficiency, multi-year budgeting, and transparency and accountability. This is in line with the vast majority of OECD countries where the use of performance information in public sector operations is now a uniform trend. The scope and ambition of Poland's reforms are striking, and great ingenuity and effort have gone into their design and implementation so far. With the 2009 Public Finance Act now in force, the scaffolding for the reforms is in place; however, many of the details have yet to become concrete. Poland faces hard choices on how to harness the advantages of performance management while minimising the costs in terms of organisational capacity and funding. A certain amount of flexibility and potential adjustments to areas of the reform in the coming years are to be expected. Keeping in mind the many challenges in store, this report nevertheless supports the efforts of the Polish government to use performance information and to move the reform process forward.

This report assesses the reform process to date, examines cross-cutting institutional, technical, and strategic issues, and provides a series of recommendations along the budget cycle.

Institutional issues

In order to ensure line ministry support, the Ministry of Finance set up two groups of senior line officials. Staff in the Chancellery of the Prime Minister have also played an active role. As with reforms in many countries, it has been a challenge to keep the political level focused on the reform's implementation. Strong support and political will on the part of the Chancellery of the Prime Minister, the Minister of Finance, and line ministers and their deputies are necessary for the reform to move forward.

The Department for Public Finance Reform and the State Budget Department (which prepares the traditional budget) are located under the same Deputy Minister. In order for the PBB to be fully accepted and integrated into the budget preparation and budget execution phases, a strong link must be established between the performance-based budget and the traditional budget work. This implies increased co-operation between the budget department and the PBB reform department.

Technical issues

The overall structure of the Polish performance system is well designed, but a number of technical issues remain unresolved. The most pressing technical issue concerns IT systems. There is no chart of accounts or accounting system that can provide financial information based on the PBB structure. Such information is necessary to enable the Ministry of Finance to monitor budget execution and the integrity of the accounts, particularly if the performance-based budget becomes the only budget in the future.

Strategic issues regarding implementation

The Polish performance budgeting system is designed to fully and equally cover all activities in the central government. The value of the PBB for the work of certain agencies has already been proven. However, the reform could be geared more towards the internal management of line ministries. The new initiative regarding contracts between the line ministers and the Prime Minister that will be agreed each year would seem to support such an approach.

Poland must decide whether to continue with a parallel system or switch to the PBB system only. For a switch to happen, unambiguous political support at the highest level is needed. It is likely that this will only be forthcoming if the PBB system quickly shows how and why it adds value.

Summary of conclusions and recommendations

Budget preparation

The PBB structure for the 22 state functions and the nine national development plans is helpful for the development of good performance objectives at lower levels of the state administration. The process of top-down imposed objectives combined with bottom-up input from budget holders provides a useful framework and supports subsequent refining of objectives and indicators. A number of initiatives would increase the value of the PBB system in the short to medium term:

- Consider selecting the areas most suited for performance budgeting and develop indicators and targets further in these areas, while at the same time relaxing requirements in other areas where the benefits are less apparent.
- Limit different organisations sharing the same programmes. In the longer term, align the new performance-based budget structure and the organisational structure of government.
- Focus on the operational efficiency of agencies. Support from the Ministry of Finance in terms of standards for preparation and reporting should continue, with the aim of ensuring that the PBB system adds concrete value to the work of budget holders at the implementation level.
- Work to increase the use of output and outcome indicators, rather than activity indicators. The type of indicators should be chosen according to the policy area and purpose of the performance information. It is noted that the use of activity indicators is planned to be gradually limited.
- Introduce multi-year agreements connected to the Multi-Year Financial Plan (MYFP) as a way to align budgeting and target setting while preventing overload in the annual budget process. In many areas, relevant outcome and output targets can only be reached within the medium term.
- Introduce spending reviews within specific expenditure areas to support the performance budgeting process. The reviews should be the basis for the multi-year agreements. Sufficient capacity in the Ministry of Finance must be made available, and the relevant regulation allowing reviews must be put in place. These actions are currently being discussed in the Ministry of Finance.
- Connect the new performance agreement system (“contracts” between the Chancellery of the Prime Minister and each spending ministry) to the MYFP, thus improving the conditions for formulating outcome targets and for linking agreements to budgets.

Budget approval

The Polish parliament’s role in the budget process is clear and well developed. According to outside observers, budget oversight by Poland’s parliament is generally strong. There is adequate time to examine the draft budget, in line with OECD best practices for budget transparency, and the parliament has a strong independent analytic capacity. The Supreme Audit Office (NIK) is also an important partner in terms of analysing and providing information on performance results. The performance-based budget adds new dimensions to the budget process and can be expected to increase the workload of parliament given that it is presented alongside the traditional budget. Recommendation:

- Enhance Ministry of Finance dialogue with parliament, particularly regarding how performance information is best presented to parliament, what types of performance information are most useful to parliament (e.g. which indicators are most relevant), and examples of good practice since the introduction of the PBB.

Budget execution

The current Polish system for reallocation seems to be sufficiently flexible and should be continued. The reserve system gives the government additional leeway during budget execution. Carry-over rules, on the other hand, are rather strict compared to most OECD

countries. The PBB introduces decentralised responsibility to budget holders for them to monitor agencies and units, which should improve both allocative and operational efficiency over time. In order to harness the potential of the performance-based budget in the budget execution phase, the Ministry of Finance should:

- Support budget holders in their tasks of monitoring and controlling performance by developing guidelines on appropriate controls that can be used by ministries and agencies.
- Consider relaxing the rules for carry-overs in order to support multi-year agreements or to act as an incentive for efficiency in agencies.
- For a certain period, collect and analyse data on in-year transfers in order to ensure that transfers are used appropriately in the new structure. (Poland should strive to keep the rules for in-year expenditure transfers as flexible as in the current system.)

Reporting, accounting and audit

Reporting and accounting remain some of the greatest challenges faced by the Ministry of Finance. The ministry has invested heavily in an assessment of the development of an IT system for reporting and accounting for the PBB system. The experience of many OECD countries has shown that reforming IT systems for reporting and accounting can be a very difficult and costly affair. Given the directions of Poland's reform and the continued existence of the traditional budget alongside the performance-based budget, the Ministry of Finance should continue developing an integrated IT system for reporting and accounting. Such a system should include automated bridges between the traditional budget and the performance-based budget.

The scope of internal evaluation of the performance-based budget (including its organisational, financial and methodological dimensions) still needs to be decided. A small Performance Audit Unit has been set up in the Ministry of Finance, but its mandate remains somewhat unclear. The new unit should be clearly tasked with developing guidelines for performance audits. Training may also be necessary to increase the capacity of the auditors to carry out performance audits.

The Supreme Audit Office (NIK) is supportive of efforts to introduce performance-based budgeting and is committed to its success. It will remain a key partner for the Ministry of Finance (and the parliament) in moving the reform forward and refining elements of the PBB system, particularly in terms of indicators, through its continued assessments and recommendations. The PBB initiative dovetails nicely with the direction the NIK is already taking in terms of increasing performance audits.

1. Special cross-cutting issues

Sections 2-5 below discuss the PBB system according to the phases of the budget process (preparation; approval; execution; and reporting, accounting and audit). However, there are a number of more cross-cutting issues that touch on all phases of the budget process; they are discussed in this first section.

1.1. Institutional issues

The introduction of performance-based budgeting in Poland is anchored within the Department for Public Finance Reform, which is part of the so-called budget area of the

Ministry of Finance led by a Deputy Minister.² The Deputy Minister is responsible for the co-ordination of the Department for Public Finance Reform and the rest of the budget area with regards to the reform. The department includes units working on the legal aspects of the reform, analytical aspects, IT support, international co-operation, and EU projects. Since 2008, it has been charged with introducing the performance-based budget throughout the central government in preparation for its implementation alongside the traditional budget in 2013. Located within the Department for Public Finance Reform is the National Co-ordinator for Performance Budget (NCPB), a deputy director appointment with certain duties regarding the performance budget reform. The NCPB is a statutory body created by Article 95 of the 2009 Public Finance Act.³

For performance-based budgeting to work, line ministry ownership is paramount. In order to ensure line ministry support and technical insight, the Department for Public Finance Reform has set up two groups which deal with performance implementation. One is the Strategic Group, which consists of a dozen managers representing budget holders (these are either secretaries/undersecretaries of state or director generals in the ministries). The second group comprises departmental (ministerial) co-ordinators (usually directors of budget departments in the ministries or heads of division responsible for implementation of the performance-based budget). The role of the Strategic Group is to ensure the support of top management for PBB implementation. The role of departmental co-ordinators is to co-ordinate PBB implementation in the ministries.

As with all large reforms of the public sector, it is important to have sufficient political and bureaucratic support at the top level for a reform to move from theory to reality. While the enactment of the new 2009 Public Finance Act testifies to the existence of the political will to introduce this reform, it has proven difficult to keep the political level focused on the reform's implementation. A key challenge for the success of this reform will be to maintain the active support of the Minister of Finance and his deputy ministers, as well as their counterparts in the line ministries. It is encouraging to note that the PBB complements the new strategic national development plan anchored in the Chancellery of the Prime Minister which defines strategic priorities. Strong support from the Chancellery is necessary for the reform to move forward.

In order for the PBB to be fully accepted and integrated into the budget preparation and budget execution phases, a strong link must be established between the performance-based budget and the traditional budget work. While co-ordination is taking place today, more is needed. This implies increased co-operation between the budget department and the PBB reform department. One option might be to form a standing internal steering group led by the Deputy Minister to ensure regular co-operation. The budget department in the Ministry of Finance should become more active in design, promotion, and training efforts regarding the PBB. The use of spending reviews could be an important tool in proving the value of the performance-based budget to the broader work of the Ministry of Finance.

1.2. Technical issues

The overall structure of the Polish performance system is well designed, but a number of technical issues remain unresolved. These include, for example, the development of a new chart of accounts and a new IT system, and ongoing work to refine and improve indicators. Another issue to be addressed is the lack of clear “bridges” between the traditional budget and the PBB system. While these issues do require attention, they are to be expected in a reform process of this size, and the Ministry of Finance is clearly working to address them.

The most pressing technical issue concerns IT systems. First, there is no chart of accounts or accounting system that can provide financial information based on the PBB structure. Such information is necessary to enable the Ministry of Finance to monitor budget execution and the integrity of the accounts, particularly if the performance-based budget becomes the only budget in the future. Second, there is no central IT system that can generate non-financial performance information on a whole-of-government basis. The first issue is important, the second less so. There is every reason to expect that rectifying the first issue will require substantial resources and funding. The Ministry of Finance is aware of this problem and is actively working to solve it with funding from the European Union. Experience from other countries points to the dangers of moving to tailor-made IT systems for the entire central government. In many cases, it is preferable to use existing off-the-shelf solutions.

1.3. Strategic issues regarding implementation

The Polish performance budgeting system is designed to fully and equally cover all activities in the central government. While this is commendable, it is also a heavy task. There is no reason to move backwards: the value of the performance-based budget for the work of certain agencies has already been proven, and no doubt more public entities will find it useful over time. However, the reform could be geared more towards the internal management of line ministries, giving greater autonomy to the line ministers to set standards and negotiate targets and indicators with their agencies. Such an approach could be supported by the new initiative regarding contracts between the line ministers and the Prime Minister that will be agreed each year. Clearly it would be important that the new contract system builds on the work already done in the PBB system and does not invent a parallel structure. Ensuring such coherence will entail a continuous dialogue regarding the performance-based budget and the contract system which is only to be recommended. The role of the Ministry of Finance as standard setter would remain, but the focus could shift to defining particular areas where performance information more easily produces value for the top level of the government. Health and education might be two such areas, both of which already seem to be at the forefront of the Polish performance budgeting reform.

Finally, Poland must decide whether to continue with a parallel system or switch to the PBB system only, and within what time frame. Once technical issues are resolved and institutional support in the Ministry of Finance and line ministries is secured, the only other requirement is clear political support at the highest level. There is an evident danger that, if this support is not forthcoming, performance-based budgeting will wither away and become a paper exercise which will not add value to the Polish public sector. It is therefore paramount that the performance-based budget quickly shows how and why it adds value and deserves to be brought forward.

2. Budget preparation

This section describes the budget preparation process as of the fourth quarter of 2010. It describes both the traditional system of budget preparation and the operation of the new performance-based budgeting system that is still being developed. The section addresses current issues facing the reform work and gives examples of how other OECD countries have tried to tackle these issues.

It should be noted that the application of the PBB has been gradual. In 2007, the PBB pilot covered only two parts of the budget (namely 28-Science and 38-Higher education). In 2008, the PBB covered 44% of the state budget expenditures, and in 2009 it covered all expenditures incurred from the state budget. Following the adoption of the new Public Finance Act in 2009, the PBB in the 2010 draft budget covered all expenditures of the state budget as well as expenditures/costs of 14 entities of the public finance sector operating on an extrabudgetary basis. The presentation of the PBB in the *Justification to the Budget* for the 2011 draft budget comprised all entities of the public finance sector (excluding the territory self-government sector and the National Health Fund).

2.1. Phases of budget preparation

At present, the traditional budgeting process governs budget preparation. The performance-based budgeting reform has introduced a new structure and other elements that add transparency and introduce new dimensions to the budget process. The performance-based budget does not have a legally binding status at this point. The PBB system has introduced policy objectives and indicators and a Multi-Year Financial Plan (MYFP) which exists in parallel to the traditional budget structure. The MYFP does have a somewhat formal role, discussed below. The aim is for both the traditional and performance systems to have formal status as of 2013 with the intention of eventually only using the performance-based budget (Perczynski and Postula, 2010, p. 32). However, whether Poland can gain real benefits from these ambitious new systems and tools depends on their design, on political will, and on the administrative ability to implement and make them work in practice.

The preparation of the draft budget begins in January-February in the Ministry of Finance. The budget draft's parameters are based on the ministry's financial strategy, consisting of projections of aggregate revenue, expenditure and deficit. The finance minister submits the fiscal strategy and overall targets to the Council of Ministers which discusses and approves them. The Public Finance Act (Article 138, Section 1) states that the convergence programme⁴ as well as the newly imposed MYFP must be considered during the preparation process. In addition, Article 105, Section 1, of the Public Finance Act specifies that the MYFP shall constitute the basis for preparing the budget bill for the subsequent budget year. In principle, the level of deficit in the budget proposal should not exceed the deficit planned in the MYFP, though there can be "justified" exceptions. Finally, specific debt rules apply if public debt is above 50% of GDP, seeking to limit the government's possibilities for increasing debt through running deficits. If debt should surpass 55 or 60% of GDP, the government must submit (respectively) a corrective or recovery programme to parliament aimed at reducing this ratio. The Public Finance Act provides certain other measures restricting public spending.

Around April, a circular regarding ministries' budget submissions is sent to line ministries. The Council of Ministers discusses funding priorities based on the government's current goals and strategies. Individual discussions may take place between the Prime Minister and line ministers at about the same time, and top-down envelopes are set by the Council of Ministers on the basis of a suggestion by the Minister of Finance. Envelopes are set at the level of the 84 budget parts (the highest level in the current budget classification), not at ministry level. Cuts are decided before budget envelopes are sent to the budget holders.

After the ministries have received their envelopes, administrators of budget parts (ministry departments, agencies and other organisations) must prepare and submit draft financial plans to the Ministry of Finance within three weeks. Timelines and formats for the preparation of these plans are stated in a circular from the Ministry of Finance. The plans are the proposed detailed budgets which must stay within the aggregated ceiling established by the Council of Ministers.

Subsequently, the Ministry of Finance has both a technical and a traditional budget discipline role. The ministry checks that the ceilings have been respected and conducts a number of bilateral discussions regarding requests from line ministries for additional funding. Such requests are common and substantial. Finally, in September, the Council of Ministers finalises the draft budget bill and submits it to parliament.

In the Ministry of Finance, several departments are involved in the budget process, totalling over 300 staff. Depending on their scope of activity, they are organised in divisions mirroring the public sector (health, education, higher education and science, labour and social policy, foreign affairs, interior affairs, and defence) as well as in divisions working on macroeconomics, tax collection, budget formulation or budget execution issues, and performance budgeting.

Traditionally, performance information is not used in the budget decision-making process. During this introductory phase of the PBB, the use of performance information remains limited and is not a deciding factor in budget allocation decisions. In some areas, though (such as education), performance information already plays a role in the budgeting process. The performance-based budget classification structure is presented to parliament as part of the *Justification to the Budget*.

The process of budget preparation in Poland is similar to many other OECD countries. The Ministry of Finance holds a central co-ordination role, and performance information is only used in the process in special situations or in specific areas.

2.2. The budget structure

The new performance-based budget structure works in parallel to the traditional budget structure. The latter defines the legally binding main part of the budget act, while the former is part of the *Justification to the Budget* in a non-legally binding annex. It should be noted that multi-annual programmes are prepared in a performance-based format and are part of a legally binding annex to the budget act. In 2013, the two budget structures will be included in the budget act, and both will be legally binding as mentioned above. No decision has yet been made as to any changes after 2013.

The PBB structure is the basis for the development of performance information. The preparation of the annual budget in the performance-based budget structure takes place in parallel to the preparation of the traditional budget. The regulation for the draft financial plans has added an extra form for drawing up performance-based financial plans for the relevant budget year and the two subsequent years. In this form, budget holders translate their appropriations from the traditional budget into the expenditures that will be incurred in the PBB structure. The traditional budget structure is based on parts, sections, chapters and paragraphs (see Table 1).

As the top classification level, the parts specify mainly high-level organisational units – e.g. ministries and other bodies like chancelleries, commissions, inspections, or agencies.⁵ An administrator of a budget part is the official responsible for one or more parts. A budget

part cannot be shared by more than one administrator. Sections denote the type of activity and area such as industry, agriculture or transport; chapters denote sub-activities or areas; paragraphs are mainly an economic classification, specifying the type of revenue, income or expenditure. Envelopes settled in the budget preparation with the Ministry of Finance are fixed to parts and categories of expenditures in the paragraphs (wages, capital expenditure) while the budget holders themselves allocate to sections, chapters and paragraphs within the previously set limits on wages and investments.

Similarly, the PBB structure also presents four levels, but in a clear hierarchical structure. Twenty-two state functions have been defined as the main classification level, representing the main areas of state activities. Each function breaks down into a number of tasks, sub-tasks and actions.

Tasks are set to achieve broad policy objectives. An example is “Crime reduction and activities for the improvement of social feeling of safety” which covers all the actions used to achieve this objective. The tasks should fit the structure of the national development plan, but this principle has not yet been applied.

Table 1. Budget classification¹ in Poland, 2010

Traditional budget structure	Example	Performance-based budget structure	Example
Parts (84)	Ministries, institutions, EU funds, local government grants, debt servicing	Functions (22)	Main policy areas such as Function 3: Education, upbringing and care, or Function 6: State economic policy
Sections (33)	Activities/areas such as industry, agriculture or transport	Tasks (145)	Main programmes such as 4.4: Public debt management, or 6.1: Increase of competitiveness of the economy
Chapters (576)	Sub-areas regarding sections such as industry, agriculture or transport	Sub-tasks (698)	Sub-programmes such as 6.1.3: Creating conditions for increasing the innovativeness of enterprises
Paragraphs (229)	Economic classifications such as wages or investment	Actions (<4 000)	Sub-activities such as 6.1.3.1: Creating conditions for functioning of enterprises

1. The horizontal rows of the table should not be read as though the levels of the traditional budget structure and the performance-based budget structure correspond.

Since the introduction of the new classification, the Ministry of Finance has worked extensively on the development of clear and easily understandable labels for the functions and tasks. For example, Function 10 changed from “Science” to “Supporting the development of Polish science”, and the tasks have been regrouped and given new labels.

The framework for the new classification was outlined by the Ministry of Finance with input from budget holders, and the number and the division between tasks and sub-tasks have been adjusted several times. The catalogue of tasks developed for the budget year 2010 will now provide the basis for the PBB structure.

An example of how the PBB is used is found in the Agency for Reconstruction and Modernisation of Agriculture. It prepared its first PBB for the year 2010, and has prior experience with a performance management framework due to its administration of various EU funds (co-financing and farm subsidies, etc.). The entity’s tasks are executed under two functions: Function 21: Rural and fishery policy, and Function 22: Strategic planning and administrative activities.

Function 22 covers expenditures that cannot be directly related to the execution of specific tasks. In essence, Function 22 concerns administrative overhead such as wages

paid to employees involved in co-ordination of budget holders' activities, strategic planning, administrative activities (accounting units, HR units, etc.) and technical maintenance.⁶ No cost distribution of this overhead cost is in place at the moment. An argument for a cost distribution of the indirect administrative cost (overhead) is to have a full and accurate picture of all costs connected to a task. For very specific purposes, such as full cost recovery from users, this is important. However, for many other purposes, this is less vital. Good cost distribution depends on the accuracy of the cost allocation system, such as a good IT system to manage the allocations (based on distribution keys, information about the cost centres, etc.). Before such a system is in place, it would be in line with good financial management to make a rough assessment of how the costs should be distributed and who are the main users of the administrative services.

The selection and establishment of the relevant functions, tasks and sub-tasks was done in co-operation with the Ministry of Finance and was based on the traditional budget and organisational structure of the entity. The new budget was presented to the Minister of Agriculture and Rural Development for approval at task and sub-task level, as were the accompanying indicators (approximately 18 targets in all). An example of an indicator was "per cent absorption rate for EU development funds". The set-up and operation of the entity are aligned with most OECD country practice.

In the following sections, the two budget structures are evaluated according to their relevance to the existing organisational structure and usefulness for internal management, expenditure control and IT system support. A main issue is that there is no direct translation key (bridge) from the traditional structure to the new performance structure. The functions and tasks denoting the new expenditure areas cross-cut the old parts and sections. As regular accounts have not yet been established to cover the new structure, there are worries about the one-to-one translation between the old and new expenditures as well as about the correct allocation of funding and expenditure control in the new system.

2.2.1. Issues regarding the budget and organisational structure

The traditional budget structure is based on organisational units, while the new PBB structure is based on functions (broad policy areas) and objectives. The assumption for the PBB is that both a function and a task can be executed by multiple budget holders (whereas in the traditional budget, parts could not be shared). One function (*e.g.* foreign policy) can have contributions from several budget holders under the jurisdiction of different ministers, as is the case for the Polish Agency for Enterprise Development. A minister can be responsible for the function, but must depend on other ministries to fulfil certain objectives. Similarly, multiple agencies can contribute via defined sub-tasks to one task, although this is uncommon.

On one hand, the organisational cross-cutting allows the budget to be presented according to a hierarchy of activities (*e.g.* sub-tasks or actions) with a cascading relationship to superior objectives (stated in functions or tasks) irrespective of organisational structure. This arrangement may support transparency, strategic planning and the planned systematic use of performance information in the budget process by presenting the different levels of tasks and their internal hierarchical relationship in a clear way.

On the other hand, a budget structure with cross-cutting organisational responsibility may cause unclear accountability between organisations and inflexibility within them. Shared resources and responsibility for tasks and functions could increase the risks

of organisational rivalry, strategic behaviour and suboptimal resource focus in both the budget preparation and budget execution stages. If a budget holder acting within a function wishes to reallocate funds, it may not be possible in some cases – probably limited – because reallocation would cross ministerial jurisdictions, thus requiring negotiations and high-level co-ordination. Likewise public finance sector entities which (via their tasks) contribute to different functions might have difficulty reallocating internally between different areas of the entity, because it would influence the objectives of another ministry. It is therefore advisable to keep the sharing as limited as possible or to make adjustments so that ministerial responsibility is closely aligned with the functions.

**Box 1. Contents of the Justification to the Budget for 2011
(in compliance with Article 142 of the 2009 Public Finance Act of Poland)**

Volume 1: Descriptive part

Chapter I – Evaluation of the macroeconomic situation of Poland and directions of fiscal policy

1. Evaluation of the macroeconomic situation of Poland
2. Directions of fiscal policy

Chapter II – The projected out-turn of the 2010 budget year

Chapter III – Basic data of the 2011 state budget

Chapter IV – Revenues of the state budget

1. Conditions of execution of revenues of the state budget in 2010
2. Revenues of the state budget in 2010
3. Tax and non-tax revenues
4. Tax revenues
5. Non-tax revenues
6. Non-reimbursable funds coming from the European Union and other foreign sources

Chapter V – Expenditures of the state budget

Chapter VI – Multi-annual programmes

Chapter VII – State special-purpose funds and executive agencies

1. State special-purpose funds
2. Executive agencies

Chapter VIII – Settlements with the European Union

Chapter IX – The European funds budget

1. Revenues of the European funds budget
2. Expenditures of the European funds budget

Chapter X – The financing of the state budget deficit

1. Domestic financing
2. Foreign financing

Chapter XI – Receivables of the State Treasury

Chapter XII – Public finance sector

1. Revenues, expenditures and balance of the public finance sector
2. Public debt

Chapter XIII – Directions of privatisation of the State Treasury assets

1. Legal basis
2. Considerations of privatisation processes
3. Planned privatisation activities
4. Expected incomes for 2011 from privatisation and revenues from dividends
5. The promotion of privatisation

Chapter XIV – Description of the articles of the 2011 budget act

Volume 2: Descriptive part – Expenditures of the state in performance-based form

Chapter I – Performance budget as an instrument of management of strategic spheres of state

Chapter II – 2011 state budget in performance-based form

Chapter III – 2011-13 financial plans of entities of the public finance sector in performance-based form

Chapter IV – The European funds budget

Summary

Volume 3: Tabular presentation – Expenditures of the state in performance-based form

Box 2. The Swedish experience with performance management

In Sweden, the government has worked with performance objectives since the 1980s. Reforms were enacted in 1997 and more reforms are currently under way. The Swedish performance system is based on 27 expenditure areas determined by the parliament. The expenditure areas are divided into 47 policy areas. Most of the policy areas are subdivided into activity areas. There are goals for the policy areas and activity areas which are formulated within the budget process. The purpose is to give a transparent picture of the objectives and the actual impact of the activities in the different policy areas.* The goals are proposed by the responsible minister and approved by parliament and have proved stable over time.

The Swedish appropriation system is based on rather small ministries and large, independent and powerful agencies. The main governing mechanism for the government is the annual "Letter of Instruction" based on the passed budget. In this letter, the responsible line minister specifies the objectives and the reporting requirements. The letter is drafted with input from the Ministry of Finance and on the basis of a preceding dialogue with the agency.

The performance information is normally not used as a basis for negotiations on future funding. This is true for both the relationship between the line ministries and the Ministry of Finance's budget department, and for the relationship between the line ministries and their subordinate agencies. The reasons are that the goals are diffuse and inexact, and that performance as reported by the agencies only reflects certain measurable dimensions of an agency's activities. Nor is it possible – or desirable – to base agency performance on data compiled by that agency.

Experience from Sweden points at the following:

- Performance targets, indicators and appropriations are directed at agencies, not programmes. The link between tasks and organisations is thus vital if performance information is to be used.
- It is advisable to keep the system of targets, objectives and evaluations as simple as possible. This limits the risk of information overload for the line ministry, the Ministry of Finance and parliament, and strengthens the focus on the value added of the performance information.
- A performance system needs continual pruning, as there are always arguments for making it more detailed, but too much detail will detract from its usefulness.
- It is difficult but important to keep the information relevant for the political level.
- While performance information should be used selectively in the budget process, government performance needs a multi-year perspective.

* Küchen, T. and P. Nordman (2008), "Performance Budgeting in Sweden", *OECD Journal on Budgeting*, 8(1):49-59.

In a number of ways and in overall approach, the Polish performance-based budget structure resembles the French system more than the Swedish, especially with regards to the overall notion of covering the entire central government equally. Basically, the Polish tasks are equivalent to the French missions. All country systems, however, seek to develop a transparent budget structure that shows what the government's main goals and targets are and help build an accountability framework. There are obviously substantial institutional differences between the three countries – e.g. the independence of the Swedish agencies

Box 3. France's experience with performance management (LOLF: Loi organique relative aux lois de finances)

In August 2001, the French parliament adopted France's new organic budget law introducing the performance-based budget. The reform was planned to be phased in over a number of years, and the 2006 budget was the first to be fully prepared, adopted and enforced under the new PBB framework. A testing phase occurred in 2005. The government prepared objectives and indicators which were reviewed by various institutions (parliament, Court of Audit, Inspectorate General) leading to some modifications in the programme organisation. The French PBB reforms sought to give greater budgetary authority to parliament, to modernise public financial management, and to increase transparency. Prior to the reform, parliament debated only those expenditures that had not appeared in the budget before (around 6%). Under the present PBB system, parliament debates the entire budget, votes to approve "missions", and may reallocate appropriations between programmes within a mission.

The French PBB structure is broken down into three classifications:

- Missions (currently 34): missions correspond to major government policies. A mission may fall under one or several ministries. This is similar to the current Polish structure.
- Programmes (currently 133): individual programmes fall under a single ministry. They are tied to strategic plans with explicit performance goals and indicators. On average, there are around five goals per programme and two indicators per goal, although there has been some adjustment downwards of goals and indicators over the years. There are three main types of indicators related to i) socio-economic effectiveness, ii) quality of services provided, and iii) management efficiency.
- Actions (currently 580): specify how funds are to be spent.

Each programme's strategy and objectives are defined by the relevant minister with the help of the programme manager. The strategy, indicators and objectives are presented to parliament in the annual performance plan appended to budget bills. The French parliament conducted an evaluation of the new performance management system in 2009.* Among the key findings and recommendations:

- Indicators need to be more reliable and result from better information systems, involving less manually collected data.
- Comparison between indicators should be enhanced through the development of more standardised indicators for comparable programmes.
- A better ownership of indicators and objectives should be sought.
- Often the performance-based approach is disconnected from operational management.
- There should be a stronger relationship between performance measurement and the budgetary process. The relationship should not be automatic, but performance should be part of the process.
- The involvement of parliament is necessary to maintain the momentum gained with performance-based budgeting.
- Managers have complained about complex procedures and burgeoning bureaucracy, in particular a significant lengthening of administrative channels and an increase in payment delays.

* National Assembly (2009), "Rapport d'information déposé en application de l'article 145 du Règlement par la Commission des Finances, de l'Économie générale et du Plan relatif à la performance dans le budget de l'État", Paris, www.assemblee-nationale.fr/13/rap-info/i1780.asp.

which is unique compared to most OECD countries. Sweden is also special as to the importance given to the Letter of Instruction from the government to the agency. The Swedish system is based on a continuous dialogue regarding goals and results, and the dialogue is both qualitative and quantitative in nature. Both the French and Swedish cases point to the fact that, while performance information is important for any government, the performance management system needs to be re-evaluated continuously to ensure that it continues to add value.

While the Polish system is not yet operational, it could perhaps be beneficial to look at ways of developing a dialogue process between the Prime Minister, the Minister of Finance, the line minister and his/her executive public finance sector entities as a supplement to the broad-based indicator system. Some elements are already visible in the newly proposed system where each minister picks certain key areas on which he/she wishes to focus in the coming year and then makes a report to the Prime Minister a year later. Obviously such key areas must fit with the national development plans, the medium-term strategy and the priorities of the Prime Minister and Council of Ministers. This procedure could provide the basis for setting up a dialogue between the Prime Minister/Minister of Finance on the one hand and the relevant line minister and his/her executive agencies on the other. The outcome of this dialogue would be a letter, or “contract”, where the coming year’s objectives are set.

2.3. Internal management

A key issue is for budget systems to support the efficiency and internal management of government organisations. Based on the experience of a number of different Polish pilot agencies and ministries, the evidence is mixed. In one public finance sector entity that was interviewed, the management had difficulties in seeing the connection between the new PBB structure and the entity’s internal organisation and activities. In addition, the PBB was very general and more unclear than the traditional budget. Preparation, reporting, and information handling using the PBB was perceived as an extra bureaucratic burden rather than a support for management. The entity emphasised that a choice of systems had to be made so that the double work of two budget systems could come to an end.

In other ministries and agencies, such as in the field of education and defence, the management saw a clear link between the performance-based budget structure and the actual tasks and operations inside their organisations. Hence the work with the new structure had brought gains in terms of improved understanding and presentation of the work performed by the organisations, compared to the traditional budget structure. The Ministry of Education highlighted that the PBB introduced new useful information as well as a new way of thinking with regard to policy preparation and execution on the part of the senior management in the ministry.

The budget department of the Ministry of Finance has indicated that the performance-based budget currently adds value to the budget process in the form of transparency about activities, targets and purposes of various agencies. The performance-based budget has helped the budget department conduct better examinations of public spending than before. In addition, it was also highlighted that the traditional system is currently particularly useful for maintaining budget discipline.

The expectation of reformers is that the Polish performance system will have to be in place for a number of years before it will provide meaningful information for the budget

process and before it can be used to improve allocative efficiency. This expectation is aligned with experiences from other countries which have encountered difficulties, even after years of work. In the meantime, the success of the Polish system will mainly rest on whether it will provide benefits to internal management. Agencies need to use the system and the indicators if they are to be worthwhile in the long term. In addition, indicators from other suppliers need to be used, such as those in statistical agencies and from research institutes, inspectorates and universities. The current methodological support provided by the Ministry of Finance to line ministries should be continued, as well as dialogue on how to calibrate the system so that budget holders have the best opportunities to harvest operational efficiency dividends.

2.4. Expenditure control and IT system support

The budget department is confident that it can maintain fairly strict discipline with the traditional structure. The department responsible for line ministries' spending is concerned that if the PBB were to become the only binding document, fiscal discipline and financial oversight would suffer. A concern with a transition to a new structure is that the Ministry of Finance will lose control and oversight in the process. The change from the traditional to the performance-based budget is perceived as radical in the sense that there is no direct link from the traditional appropriations of parts and sections to the new functions and tasks. The lack of a direct link is further complicated by the organisational cross-cuttings of the new system. There is a risk of double funding and lack of experience and clarity concerning new appropriations.

Apart from the vital problem of not having a clear one-to-one bridge from the traditional structure to the PBB structure, an element in understanding this scepticism is that the new performance-based budget structure does not include a level of economic classification – the paragraphs in the current traditional structure (see Table 1 above). The exclusion of this level reflects a trend in OECD countries where a number of countries have moved towards fewer input controls and more lump-sum budgeting under the heading “let managers manage”. There are certainly arguments for maintaining some input controls for selected items, but the argument is less strong for preserving other input specifications of the economic classification. It might be a good idea to introduce ministry-wide ring fencing of salaries, capital and transfers, so that no funds can be transferred between these categories. Salaries should be capped by the Ministry of Finance, in that there will be strong pressure to increase salaries in the public sector, but little countervailing market pressure. There are two main arguments for ring fencing capital expenditures: the technique is often used as a counter-cyclical tool, and thus needs to be visible; and there has been a tendency to under-invest in maintenance, because current expenditure is more pressing, leading to larger spending eventually. Transfers should be capped, in that the line ministry is in effect only a handler of payment where the expenditure level is exogenously given.

Directly linked to the question of budget discipline is the issue of IT system support. The lack of a functioning IT system in PBB format is a threat to spending control and budget discipline, as automated in-year spending information will not be available to finance and line ministries. The new performance-based budget structure is not underpinned by the current chart of accounts or the budget IT system, and the structure of a new chart of accounts and bookkeeping system has yet to be elaborated. This problem also impedes a clear transition from the old system to the new one. At present, budget holders have to develop their own solutions in order to translate the traditional budget structure into the performance-based

structure when preparing their financial plans and reports. The implication is that, in the preparation of the budget, numbers from the traditional budget structure need to be manually translated into the PBB structure through bridges and estimates developed by the individual budget holders. Some budget holders (e.g. the Ministry of National Education) have developed their own system enabling parallel bookkeeping, but these are exceptions. The accounting system is decentralised, and administrative units hold their own (different) accounting system software. Many of these systems cannot integrate a new chart of accounts or even adjust the current chart in a sufficient way. Clearly, without a reform of the accounting system, a transfer to the PBB is not possible. The issue of accounting system reform is thus a central concern.

In conclusion, the PBB structure classifies expenditures according to functions and tasks (programmes) in a hierarchical order. This new structure enables formulation of objectives and indicators which can be logically attached to each expenditure level. The purpose is to apply performance information to the budget process.

Since the PBB structure is classified according to functions and tasks, it cross-cuts the organisational structure which can cause co-ordination problems and suboptimal behaviour. Experience shows that the organisational units are still the basic hubs of funding, operation and accountability.

In time, performance-based budgeting should result in a marked improvement of internal management and increased efficiency and effectiveness. In the short term, however, the reform has caused extra burdens on ministries and agencies. It is important that the reform continues to focus on how the PBB can be of use to the management of agencies and line ministries to ensure their support and buy-in.

Finally, the PBB structure is not yet supported by a chart of accounts or an accounting system. This is a major challenge which should be solved if the new structure is to be used. Actual spending controls are not possible in the new system, so spending will have to rely on the traditional chart of accounts. In addition, there is no central budget structure “bridge” between the traditional budget and the PBB, so translations are performed manually by budget holders. This could cause concern about budget discipline.

2.5. The Multi-Year Financial Plan, spending reviews and performance information

The Multi-Year Financial Plan (MYFP) is a new concept in the Polish budget process that was adopted by the Council of Ministers in 2010 (for the period 2010-13). The plan has a rolling four-year horizon and covers general fiscal policy, economic projections, revenue and expenditure estimates, budget balance and debt. The plan is updated yearly in light of budget changes and is approved by the Council of Ministers. The plan does not set binding top-down expenditure limits, but the Public Finance Act states that the deficit targets of the plan should be respected except in “justified cases”, in which an explanation must be given to parliament detailing the reasons for the exception. The plan is to be the basis for the preparation of the budget and is meant to support the Polish Convergence Plan that aims at reducing the deficit to 3% of GDP by the end of 2012 with a view to euro adoption in 2014 or 2015. This target seems realistic given the strong economic performance Poland has exhibited after the global financial crisis and in contrast to many of its neighbours.

The MYFP is a central element in the development of the PBB reform in Poland. The plan is prepared according to the new PBB structure covering the functions of the state along with the PBB objectives and related measures. The plan provides an additional platform

for presenting and reporting on performance information. Ministers must annually submit information about the implementation of the MYFP to the finance minister, including information about the extent of achievement of their objectives. This information is then submitted to the Council of Ministers and published. A number of countries have introduced medium-term expenditure frameworks and performance budgeting as part of the same type of reform package – for example, Austria, France and Korea (OECD, 2008).

As the MYFP was only introduced in 2010, there is limited evidence as to how it will actually influence budgeting. For now, expectations in the line ministries seem to be that the allocation among functions in the MYFP will only be indicative. The Swedish experience shows the importance of institutionalising a medium-term expenditure framework so that all actors are aware that the government is committed to it (see Box 4).

Box 4. Medium-term expenditure framework and expenditure ceiling in Sweden

In Sweden, the parliament sets an expenditure ceiling for the next three years at the same time as it decides the limit for total central government expenditure for the coming budget year. The ceiling applies to all expenditure in the central government budget as well as the old-age pension system; only interest on national debt is excluded. Importantly, the ceiling includes transfers and other mandatory expenditures. The expenditure ceiling is given in nominal terms and works on a rolling basis as proposed by the government.

The total expenditure ceiling contains a “budgeting margin” for unforeseen expenditures, and parliament has full discretion to revise the ceiling. These are elements of flexibility, but also elements which can undermine the function of the medium-term expenditure framework. Thus, the ceiling not only builds on realistic and reliable projections but also on the fact that parliament and the government are interested in actually restricting their own discretion over the annual budget process according to medium-term fiscal targets. In other words, the government and parliament have to be committed to medium-term objectives, which has been the case in Sweden where the medium-term fiscal targets and the expenditure ceiling have become highly institutionalised.

Constructing the MYFP in the PBB structure with PBB objectives and indicators shows the intention of utilising performance information in multi-year budgeting. Poland has some experience in this regard through the co-financing programmes with the EU.

It takes time for policy to fundamentally have outcome effects – *e.g.* to reduce crime, improve the qualifications of students, reduce the number of road deaths, and increase the environmental health of lakes and rivers. A multi-year perspective is thus necessary, and may also be supported better by the MYFP than by attaching targets to the annual budget. A multi-year strategy for a particular area requires performance data as well as cost information and organisational data. It could therefore be helpful to introduce reviews of spending areas or programmes using performance information. These reviews could be used to settle multi-year envelopes with clear performance targets to be reported and re-evaluated in, say, four years along the lines of the Australian “strategic reviews” as discussed in Box 5.

However, the current regulation in Poland does not provide the Ministry of Finance with a mandate to engage in spending reviews. New initiatives and programmes are scrutinised,

but the Ministry of Finance does not perform spending reviews on existing programmes or sectors. This situation is quite unusual compared to most OECD countries. The introduction of a spending review system would require improved analytic capacity in the Ministry of Finance as well as adjustments to the Public Finance Act. Moreover, budget holders must accept and co-operate if spending reviews are to be successful. With this in mind, it is suggested to introduce a system of spending reviews on a very limited scale, where areas or programmes are strategically selected a few at a time. The reviews should support the use of performance information in multi-year budgeting.

Box 5. **Strategic reviews in Australia**

Australia has been grappling with the optimal manner in which to systematically review existing programmes. The most common method during the last decade was the use of so-called “lapsing reviews” whereby programmes would sunset if not renewed by a decision of the government. While this method ensured that a review was done, such reviews became a mechanical and ineffective exercise which rarely resulted in any significant changes to the programmes, despite an abundance of reviews – there were 149 lapsing reviews between the 2004/05 and 2006/07 budgets.

A new system of strategic reviews was launched in 2007 as the lapsing reviews were being abolished. The strategic reviews aim to take a holistic look at major clusters of programmes. The objectives are programme appropriateness, efficiency and effectiveness, and making sure that the programmes are aligned with government priorities. The focus is not to achieve savings. The reviews are commissioned by the Strategic Budget Committee and/or the Expenditure Review Committee (both Cabinet committees) based on recommendations of the three central agencies (the Department of Finance, the Department of the Treasury, and the Department of the Prime Minister and Cabinet). Areas to be reviewed are decided on the basis of criteria such as government priority, growth rate of the programmes, and the time elapsed since they were last reviewed. It is envisaged that up to seven large and seven smaller reviews take place each year. The reviews generally originate in January or February and take 3-6 months to complete – i.e. so that their results will be known prior to the following year’s budget formulation. The review teams are based in the Department of Finance, and the reviews are undertaken independently of the agencies responsible for the programmes; outside expertise is often used. The reviews can be led by academics, business leaders, former senior public servants, or current senior public servants seconded for the purpose. Agencies being reviewed and related bodies are encouraged to second staff to work on the reviews. A special unit in the Department of Finance has been set up to co-ordinate and contribute to the reviews. Importantly, the desk officers in the Department of Finance who handle daily contact with the agencies are not directly involved, reducing the likelihood that agencies perceive the reviews as savings exercises.

Source: Blöndal et al (2008), “Budgeting in Australia”, *OECD Journal on Budgeting*, 8(2):133-196.

Given that the spending reviews would entail the setting of performance targets for a sector for a certain period, the reviews could fit with the new initiative already planned which introduces ministerial targets that are to be reported to the Prime Minister yearly. These targets could be linked to the Multi-Year Financial Plan. A source of inspiration, albeit on another scale, could be the British public service agreements (PSAs) based on spending reviews and binding medium-term envelopes for line ministries (see Box 6).

The MYFP would benefit from being more closely tied to the annual budget process, especially if expenditure levels in the out-years for the functions are meant to be binding. At the same time, expenditure levels expressed in the MYFP should not turn into “floors” in the form of minimum envelope rights for spending ministries.

Utilisation of the MYFP – in terms of preparing performance information and executing spending reviews to establish multi-year envelopes and targets – will require investments in Ministry of Finance capacity, carrying out of spending reviews in co-operation with budget holders, and a process for negotiating and agreeing on multi-year envelopes. The Ministry of Finance should focus on targeted areas where in-depth analyses will result in savings and increased outcomes/results.

Box 6. Spending reviews and public service agreements in the United Kingdom

Starting in 1998 in the United Kingdom, the comprehensive spending reviews involved in-depth reviews of departmental aims, objectives and spending plans for each department for a three-year period. The comprehensive spending reviews of the first decade focused on combining multi-year spending plans with policy outcome targets for the period. This gave birth to public service agreements (PSAs) which set measurable targets for the government's objectives for public expenditure programmes. Each department had its own PSA (quasi-contract) negotiated with the Treasury to present the outcome delivered according to the funding level for a three-year period. Thus, the Treasury had a main role both in the development of the PSA performance framework and the departments' actual PSAs, and in the spending review process directed at each department.

The PSAs were introduced as *ex post* measurement of output/outcomes in relation to expenditures, but also as an *ex ante* tool to motivate departments to direct operations to deliver the right results. However, it was also recognised that the PSA performance measures and target setting could not be applied to all government expenditure.

Later comprehensive spending reviews took a deeper approach, turning from allocating incremental increases in expenditure to performing a set of zero-based reviews of involved departments' baseline expenditure. Departmental expenditures were analysed against the background of the government's long-term objectives in order to assess the departments' effectiveness in delivering and fitting expenditures to current priorities.

The 2010 spending review focused on establishing an encompassing framework for reducing the budget deficit involving budget reallocation, value for money and targeted savings. PSAs are also evolving from a top-down performance management system to “departmental business plans” which will provide information on performance and spending, including each department's:

- vision and priorities to 2014-15;
- structural reform plan, including actions and deadlines for implementing reforms over the next two years; and
- contribution to transparency, including the key indicators against which it will publish data to show the cost and impact of public services and departmental activities. This section will be published for consultation to ensure that the government agrees the most relevant and robust indicators in time for the beginning of the spending review period in April 2011.

2.6. Objectives, indicators and targets and their role in budget preparation

Along with the introduction of the PBB, the Department for Public Finance Reform of the Ministry of Finance has developed a framework for how budget holders should work with objectives and indicators. Starting with the 22 functions (the highest level in the PBB structure), the ministry has led the process of selecting and defining the functions and setting overarching strategic objectives.

In addition to the development of the 22 functions (involving the Ministry of Regional Development, the Ministry of Finance and the Chancellery of the Prime Minister), the Chancellery of the Prime Minister is leading a reform of strategic planning. The aim is to amalgamate the many existing governmental strategies developed by various institutions into nine strategies covering the public sector. It will be possible to translate the expenses incurred in the 22 functions into these nine strategies. The strategies cover: innovation and effectiveness of the economy; transportation; human capital; social capital; environment and energy; an efficient state; regional development; national security; and rural areas, fishery and agriculture. The MYFP has been prepared in compliance with these nine strategies just as each task in the performance-based budget structure has been matched with a strategic field. Essentially this is a controlled top-down process of setting the overall strategies and objectives of the state, which the lower level objectives should reflect.

The role of the Ministry of Finance in the formulation of objectives at the lower levels of the budget structure has been more limited. The ministry has not been involved in the content, but has described the methodological approach. The objectives have been defined as:

- Strategic: set at the highest level and constituting tasks for the highest level of organisational management;
- Tactical: set at a middle level and related to sub-tasks for managers of the middle organisational level;
- Operational: set at the lowest level and usually formulated at the level of actions for managers at the lowest organisational level.

Hence, the objectives as well as related indicators and targets are strictly ordered according to the new PBB structure. For each task, budget holders must choose one objective/indicator, and for each sub-task a maximum of two are allowed. The result might be more than 1 000 objectives, which is not uncommon (as seen in the targets in Table 2) but still on the high side. The Ministry of Finance envisages a gradual reduction of this number.

Table 2. **Number of performance targets in selected OECD countries**

Country	Number of targets
United States	3 700
Slovak Republic	1 641
Korea	1 033
France, Japan and New Zealand	500-600
Sweden	48

Source: OECD Budget Practices and Procedures Database, www.oecd.org/gov/budget/database.

2.6.1. Formulation of objectives, indicators and targets

The performance reform has introduced a substantial amount of performance information in the budget documents (the annual budget, the MYFP, and the reports on execution).

The Ministry of Finance collects performance plans covering the budget year and the two subsequent years from all budget holders (of budget parts). The information collected is presented in both the annual performance-based budget and in the MYFP. Performance information in the MYFP is only presented on the level of functions of the state (with targets and measures for each target), whereas the budget bill presents performance information for tasks and sub-tasks within the functions. The performance plans entail objectives, indicators and targets defined by the budget holders. Targets are annual: expected values (results) are stated for the coming budget year and two subsequent years. The Ministry of Finance has a co-ordinating and advisory role and does not impose the use of a certain indicator or target upon budget holders.

Instead, the ministry has established a database of indicators to support and increase the quality of indicator formulation. The indicators in the database were prepared for the Ministry of Finance by external experts in consultation with the budget holders. The use of the indicators in the database is not mandatory, although it would seem that many agencies do use them.

The Ministry of Finance does not have a powerful role in setting targets, which is in line with practice in many OECD countries. Instead the focus is on letting the line ministries and agencies choose what they wish to be held accountable for. However, there is an issue regarding the capacity of line ministries and agencies for handling this task, and the evidence gathered suggests that this is still a concern.

2.6.2. Quality of objectives, indicators and targets

The indicators and targets currently in place vary considerably across areas. One example is the Polish Agency for Enterprise Development (PAED). The entity has tasks within four different functions; the related tasks, sub-tasks and actions, and their indicators and targets, are shown in Table 3. Most of the indicators measure activity (e.g. “number of implemented projects” or “number of promotional activities carried out”) but do not focus on the output, outcomes or quality of the activities. As the principals (e.g. the minister) are seldom interested in the specific internal activity of agencies, these types of indicators are not very useful, but should instead focus on outputs and later outcomes.

The Ministry of Interior and Administration is another example with both activity targets and outcome targets (e.g. “number of traffic accidents with fatal outcome” for the sub-task “Securing the operations of traffic service”; see Table 4). Here the indicator for “Securing the citizens’ safety” shows the possibilities for setting outcome targets (number of crimes registered) within areas where measurement is already more common. This is supplemented by an additional indicator measuring public perception of safety. In general, this type of information on the effects of the ministry’s operations is more relevant for decision makers whereas it may be less relevant for the budget process. Moreover, the outcome indicators are based on the assumption that there is a causal relationship between the entity’s activities and these outcomes, which may not always be the case. These issues are not solvable as such, and all countries need to negotiate them.

Outcome and output indicators are better suited than activity indicators to inform the budget. But for a purely mechanical relationship between results and funding in terms of, for example, “taximeter” budgeting (see the example from Denmark in section 2.6.3), the indicators will have to be developed.

The head of the PAED explained that finding and selecting relevant objectives and indicators had been a difficult task. “Due to the nature of activities carried out by the PAED, indicators relating to the whole PAED operational plan were assigned to individual tasks in the performance budget.” In other words, aggregate – but not necessarily relevant – indicators have been chosen in order to cover all parts of the entity’s operations and to translate the agency’s operational plan into the performance system.

In contrast, the Ministry of National Education perceived the process of developing indicators and targets as a contribution to internal management, giving clear targets to work towards as well as the possibility to present what the ministry intends to achieve for taxpayers’ money. Both the process and the results of working with performance information have varied across agencies.

Table 3. Examples of objectives, indicators and target values for the Polish Agency for Enterprise Development (PAED)

Tasks/sub-tasks	Objectives	Indicators	Base value	Value in 2011	Value in 2012	Value in 2013
6.1.2. Increase the competitiveness of the economy	Increasing the share of enterprises conducting innovative activity	Number of implemented projects supporting innovation	1 640	3 395	3 556	2 490
6.1.3. Create conditions for increasing the innovativeness of enterprises	Providing stable and development-friendly conditions for the functioning of enterprises	Number of enterprises, etc., which benefitted from advisory, training, information and financial services offered by business environment institutions supporting the development of entrepreneurship	247 680	229 449	253 857	246 917
6.1.3.1 Create conditions for the functioning of enterprises	Adjusting the structure of personnel to the needs of a modern economy	Number of persons who received training, a diploma, etc.	56 090	198 285	78 780	37 322
15.4. Support the adaptability of enterprises	International promotion of an appropriate image of the Republic of Poland	Number of implemented projects	474	1 467	1 911	1 509
15.4.1. Develop the international image of the Republic of Poland	Strengthening the positive image of Poland abroad	Number of promotional activities carried out	6	12	11	8
15.4.1.1. Promote the country	Creating favourable conditions for conducting business activity abroad by Polish traders	Number of assessed documents related to the development of economic policy	24	20	20	20
15.4.1.2 Co-develop economic policy and a common trade policy of the European Union which take account of Poland’s interests	Increasing the number of foreign co-operative links of Polish enterprises	Number of enterprises granted support	2 092	2 501	2 800	146
17.1. Intensify the exchange of products, services and capital	Improving the competitiveness of the regions, as well as the socio-economic and spatial cohesion	Number of implemented projects	69	122	88	151
17.1.3. Support regional development of the state	Speeding up the socio-economic development of eastern Poland’s voivodeships	Number of implemented (concluded) projects	1	36	27	30

Table 4. **Function 2–Internal security and public order**

Function	Responsible body	Part	Goal	Indicator			Predicted budget expenses in 2011 (PLN thousands)
				Name	Base value	Value in 2011	
2.1: Protection of citizens and maintaining of public order	Ministry of Interior and Administration	42	Securing citizens' safety	Indicator of the dynamics of the crimes in general terms (including the traffic regulation offences); as number of crimes registered in the current year to the number of crimes registered in 2008 x 100	100%	Dynamics < 100% in comparison to 2008	5 443 071
	Agency for Internal Security	57	Securing citizens' safety	Current monitoring: logical value YES/NO	YES	YES	491 916
	Voivodeship governors	85	Securing citizens' safety				12
2.1.1: Securing the state's internal security	Ministry of Interior and Administration	42	Improving internal security	Number of participants in basic training	8 702	5 000	31 975
	Agency for Internal Security	57	Improving internal security	Current monitoring: logical value YES/NO	YES	YES	491 916
	Voivodeship governors	85					12
2.1.2: Securing the safety of the most important persons, facilities and equipment in the country	Ministry of Interior and Administration	42	Improving safety connected with protection of persons and facilities vital for the country	Logical value YES/NO	YES	YES	177 468
2.1.3: Securing the operations of the prevention service	Ministry of Interior and Administration	42	Limiting the number of crimes	Indicator of the dynamics of the crimes especially in the categories of theft, theft with burglary, fights or physical assault; as number of crimes registered in the current year to the number of crimes registered in 2008	100%	Dynamics < 100% in comparison to 2008	4 502 957
2.1.4: Securing the operations of the traffic service	Ministry of Interior and Administration	42	Improving traffic safety	Number of traffic accidents with fatal outcome	4 862	Dynamics < 100% in comparison to 2008	675 620
2.1.5	...	...	...	...	...	...	...
...							
TOTAL							14 085 755

Source: Extract from the 2011 draft budget bill of Poland, performance-based budgeting framework.

Clearly, Poland is still in an early stage of using performance information. With time, budget holders will gain experience, targets will be formulated more precisely and better indicators will be developed. However, even if some improvements can be expected through the continuous effort of ministries and agencies, experience from other OECD countries that are further along demonstrates the difficulties in developing good targets and indicators. Moreover, some areas of the public sector do not lend themselves to this exercise.

2.6.3. Performance targets and use of performance information in Denmark

In Denmark, line ministries and agencies have worked with performance targets for two decades. The performance information system is designed as “contracts” between the core ministry and its underlying agencies. The performance contract management system in Denmark contains three core elements: setting targets, developing contracts, and annual reporting. Its implementation was intended to serve several functions. First, it was expected that an increased focus on outputs would make it easier for political decision makers to prioritise among competing government objectives. Second, focusing on outputs would improve the quality and efficiency of government services. Finally, this results-based management was expected to improve operational efficiency by reducing information imbalances between ministries and agencies.

The performance contract system is very rarely used for budgeting purposes, but is rather a tool to promote dialogue and control flows between the core ministries and their agencies.

The system was last reviewed in 2009/10 when the Ministry of Finance adjusted its guidelines for the performance management framework. The review showed that:

- Agencies in some areas have developed very good targets and indicators to measure and present their operations; however, in many policy areas, agencies were still struggling with the formulation of strategic, relevant targets and related indicators.
- In a few policy areas, quantitative targets and indicators have been assessed as useless for both management and control purposes and have been replaced or supplemented by a dialogue of qualitative objectives between the principal and the agency. The idea of “one size fits all” does not apply.
- Outcome targets and their measurement are particularly difficult to formulate, and agencies cannot always remain fully responsible for an outcome target due to multiple causal relationships. Central support is necessary and has been increased.
- In some cases, the requirement to have annual targets and annual evaluations following the budget year hampers the ability to formulate multi-year targets which would be more relevant and useful for steering and internal management.
- The performance management process is separated from the aggregate budget process, and performance information is seldom used internally in the line ministries for budgeting. However, targets in the performance contracts often reflect agreements made during the preparation of the budget.
- The vast majority of ministries and agencies benefit from the performance management system which has increased information for decision makers. The system has also served to promote dialogue and clarify agencies’ objectives in the planning process while providing benchmarks for evaluation. As such, there are only a few examples of agencies

where the performance process is merely a symbolic exercise isolated from real strategic, operational and budgetary planning.

Besides the contract-based performance management system, Denmark has a formula for performance budgeting (the “taximeter” model) in a number of policy sectors. These include the Ministry of Education (vocational schools, upper secondary education), the Ministry of Science, Technology and Innovation (universities), the Ministry of Interior and Health (hospitals) and the Ministry of Employment (the Public Pension Agency). There are different methods in each sector (*e.g.* average vs. marginal budgeting), but in all cases the funding is based on annual statements of activity levels (actual number of units performed) and previously agreed unit prices along with quality requirements.

One example is the appropriation model from the Ministry of Education. Within the taximeter system, grants to schools are linked with a school’s direct results, which are measured in terms of the annual number of full-time students or student full-time equivalents. The rate system that is applied at medium-level higher education institutions is structured around three basic rates: a teaching taximeter, a building and maintenance taximeter, and a collective expenses taximeter.

The majority of the educational programmes are distributed and placed in rate groups with common rates, which makes it possible to compare the different programmes’ financial situations. The placement in these groupings should be justified by actual differences in the demands placed on the programmes and in the teaching and organisational formats.

In light of the Danish case, the uniform structure of the Polish performance system could potentially be relaxed as the system matures. Some government areas are more suitable for performance budgeting than others, and a larger differentiation may be beneficial for the Polish system.

The main focus of the Polish reform – as it is stated by the Ministry of Finance – is directed at collecting and presenting aggregate indicators and targets to be available for future central budget decision making. However, the experience from Denmark points to increased operational efficiency in agencies as a possible benefit of performance management. Reformers in Poland – both at this stage where performance information is less integrated in the budget process, but also after 2013 – may wish to focus more attention on this area. Currently, budget holders must elaborate a plan to attain the performance targets. This exercise forces budget holders to integrate day-to-day operational management and planning with the performance system. One way to support the reform’s improvement of internal management in the agencies and other budget entities could be an increased focus on follow-up and evaluation. The reporting on performance results is currently a part of this follow-up, but there is not necessarily a counterpart (*e.g.* the line ministry, Chancellery of the Prime Minister, Ministry of Finance) giving feedback on the information reported. Introducing a systematic use of performance dialogues would add value to the system. This is discussed further in Section 4 on budget execution.

2.7. Conclusions regarding budget preparation

The PBB structure for the 22 state functions and the nine national development plans is helpful for the development of good performance objectives at lower levels of the state administration. The process of top-down imposed objectives combined with bottom-up input from budget holders provides a useful framework and supports subsequent refining of objectives and indicators. A number of initiatives would increase the value of the PBB in the short to medium term:

- Consider selecting the areas most suited for performance budgeting and develop indicators and targets further in these areas, while at the same time relaxing requirements in other areas where the benefits are less apparent.
- Limit different organisations sharing the same programmes. In the longer term, align the new performance-based budget structure and the organisational structure of government.
- Focus on the operational efficiency of agencies. Support from the Ministry of Finance in terms of standards for preparation and reporting should continue, with the aim of ensuring that the PBB adds concrete value to the work of budget holders at the implementation level.
- Increase the use of output and outcome indicators, rather than activity indicators. The type of indicators should be chosen according to the policy area and purpose of the performance information. It is noted that the use of activity indicators is planned to be gradually limited.
- Introduce multi-year agreements connected to the Multi-Year Financial Plan (MYFP) as a way to align budgeting and target setting while preventing overload in the annual budget process. In many areas, relevant outcome and output targets can only be reached within the medium term.
- Introduce spending reviews within specific expenditure areas to support the performance budgeting process. The reviews should be the basis for the multi-year agreements. Sufficient capacity in the Ministry of Finance must be made available, and the relevant regulation allowing reviews must be put in place. These actions are currently being discussed in the Ministry of Finance.
- Connect the new performance agreement system (between the Chancellery of the Prime Minister and each spending ministry) to the MYFP, thus improving conditions for formulating outcome targets and for linking agreements to budgets.

3. Budget approval

Box 7. The Polish parliament

The Polish parliament is bicameral. The Sejm (lower house) is composed of 460 deputies elected for a four-year term by proportional representation. There are thresholds for the allocation of parliamentary seats: 5% of the total votes cast for a party list and 8% for a coalition list, although national minorities' lists are exempt from the threshold requirements. Individual parties normally do not manage to gain power alone and therefore work with other parties to form coalition governments. With some exceptions, members of the government are typically chosen from a majority coalition in the lower house of parliament. The Senate (upper house) has 100 members who are directly elected, also for a four-year term. As Senate elections are not proportional, the party that receives the most votes is more likely to control a majority of seats. Both houses are involved in the budget process but the Sejm has primacy and can overrule the Senate.

Committees play a vital role in the activities of the parliament, particularly in regards to its oversight function. The composition of committees is determined by the Sejm and reflects the political composition of that house. The Standing Orders of the Sejm define committee activities and oblige all ministers and other state officials to supply information at the request of a committee presidium and to participate in committee meetings on matters falling within the scope of their activity. Committees may also invite outside experts to give evidence.

3.1. Parliament and the performance-based budget

Since 2008, the parliament has received a performance-based version of the budget as part of the justification to the traditional budget. As such, the PBB has been more of an informational or supporting document. This situation will change in 2013 when the PBB becomes a legally binding part of the budget law, but the overall parliamentary process for approving the budget will remain the same. Given that the traditional budget will remain in place (currently for an unspecified amount of time), it remains to be seen whether the new status of the PBB will lead to greater interest, debate and ownership by parliament. Despite intensive debate around the new Public Finance Act, parliamentarians generally have yet to take a strong interest in the PBB. Naturally, there has been more interest at the level of the Public Finances Committee and its subcommittees, including extensive discussions on the implementation of the PBB. This situation corroborates the opinions of the Ministry of Finance and the Supreme Audit Office (NIK) that, while the PBB so far has not been particularly popular within parliament, there is support for the idea of performance-based budgeting more generally. There may be several reasons. For example, MPs have a better understanding of the traditional budget structure (and input controls) and may lack the requisite knowledge and capacity to fully understand the PBB, particularly in terms of how to use the PBB process to obtain resources for their constituencies. Having to examine both the traditional and performance-based budgets also increases the already heavy workloads of MPs, and some may choose to only focus on the traditional budget to maximise their time.

Performance budgeting initiatives are often justified as improving accountability to the legislature and, as was the case in France, may even be instituted in response to legislative demands. In practice, however, many parliaments that have experience with performance-based budgeting have ignored, been reluctant to use, or had difficulties using performance information. In some cases, reforms have engendered a certain amount of resistance to the PBB within parliaments. This problem highlights the importance of engaging the legislature early in the process, and of thinking strategically about what information is most useful to the legislature in its budgetary deliberations and decisions. Legislators need an incentive to use performance information, and a large quantity of performance information may make it difficult for decision makers to quickly identify the most relevant information.

In the United Kingdom, parliament's experience with public service agreements (PSAs) sheds light on the potential difficulties of getting parliament to respond to high-level performance reporting. Previous governments committed to reporting performance information to parliament on a twice-yearly basis. As part of a modernisation process within the House of Commons, it was decided that departmental select committees should examine the departments' public service agreements, the associated targets and the statistical measures employed, and report if appropriate. Nevertheless, a study of parliamentary select committees concluded that "PSAs are not scrutinised broadly (only around one-fifth get any coverage) and of those that do get mentioned they are mostly tangential or a relatively small part of reports" (Johnson and Talbot, 2008, p. 123). Evidence from relevant cross-cutting select committees (the Public Accounts Committee, the Treasury Select Committee and the Public Administration Select Committee) was also mixed, although the latter two were more proactive in producing critical reports and recommendations (most of which were rejected by the government). The study went on to suggest that parliamentarians tended towards more traditional scrutiny approaches, and that "both formal and informal institutional restraints are very powerful breaks on change, although some incremental change does appear to be happening" (Johnson and Talbot, 2008, p. 128).

Sweden provides an interesting approach to improving the performance dialogue between the government and parliament. An informal working group of approximately ten civil servants from the Ministry of Finance and parliament's Committee on Finance was set up in 2000 and met over a period of several years. At times, when they were discussing specific budget areas relevant to them, representatives from various line ministries and parliamentary sectoral committees also participated in the group's discussions, thus ensuring that the group's advice and conclusions were available to a broader audience. The frequency of meetings throughout each year varied, with a greater number of meetings occurring after the formal decision on the budget was taken in parliament and before the preparatory work for the next budget bill started in the government. Members of the working group wrote memos and used existing examples of government performance information and committee responses as a basis for the group's discussions. While not binding, conclusions from these discussions were often included by the relevant ministries in subsequent budget bills as proposals or guidelines. The group served as a catalyst, spreading good ideas to governmental and parliamentary actors by identifying the types of performance information most useful to parliament in its deliberations on the budget, as well as how and when such information should be presented. In doing so, the group highlighted examples of best practice and brought them to the attention of the Ministry of Finance and line ministries where appropriate.

In Poland, the Department for Public Finance Reform in the Ministry of Finance is taking steps in the right direction. The department has increased outreach to MPs – for example, writing on performance budgeting in a special issue of the parliamentary newsletter which was distributed to all MPs in July 2010 – and is planning a training seminar.

Box 8. Parliament and the new Public Finance Act of Poland

The governmental proposal for the new Public Finance Act was presented in the Sejm in August 2008. The act was sent for more in-depth scrutiny to the Public Finances Committee which referred it to its Permanent Subcommittee for Budget Control. The subcommittee alone held 25 meetings on the new Public Finance Act between November 2008 and June 2009. On 23 June 2009, the subcommittee submitted a report on the Public Finance Act to the Public Finances Committee. Implementation of the PBB framework was not questioned in the report, indicating general acceptance of the reform. Moreover, two opinions prepared by the parliamentary Bureau of Research (BAS) supported the idea of the PBB in the act, stating that “it will not only increase the transparency of governmental activities (at national and local level) but it will also be an important evaluation tool, especially in multi-year programmes”. During the subsequent plenary debate on the Public Finance Act on 14 July 2009, MPs from all political parties outlined their viewpoints on the PBB. The chair of the Public Finances Committee spoke in favour of PBB, noting that it would allow Poland to use modern methods of public financial management as well as potentially making the budget bill clearer and more transparent. There was general support for the PBB, although several parliamentarians raised questions on the comprehensiveness of the PBB and the development of tasks and indicators. The act was adopted by the Sejm by 287 in favour, 33 against, and 114 abstaining on 27 August 2009 after the Senate submitted its amendments.

3.2. Legal framework

The Constitution of the Republic of Poland, the new 2009 Public Finance Act, and the Standing Orders of parliament regulate the fundamental aspects of the parliamentary budget process. Article 222 of the Constitution requires the Council of Ministers to submit to the Sejm a draft budget for the next year no later than three months before the commencement of the fiscal year. Typically the draft is submitted by 30 September, although in exceptional instances it may be submitted later.⁷ This timing is in accordance with OECD best practices for budget transparency.⁸ Currently the performance-based budget is submitted as part of the justification to the traditional budget, although this will change in 2013 when the PBB becomes legally binding.

Parliament is not consulted in the preparation of the national budget and does not hold a pre-budget debate.⁹ The government has the monopoly of legislative initiative with regard to the budget, public debt and state guarantee bills, but the legislature nonetheless plays a crucial role in scrutinising, amending (within deficit limits proposed by the Council of Ministers) and approving the budget, as well as overseeing its implementation. Outside of the main budget process, tax and spending legislation¹⁰ and private members’ bills with financial implications may be submitted by parliament and are not uncommon.¹¹

Box 9. Key oversight tools of the Polish parliament

- Hearing in plenary sitting
- Committee hearing
- Commission of inquiry
- Oral and written questions (oral questions are answered directly during the sitting and written questions must be answered within 21 days of receipt)
- Interpellations (answered within 21 days of receipt)
- Supreme Audit Office (appointed by the Sejm with the consent of the Senate, obliged to report to parliament)
- Ombudsman (appointed by the Sejm with the consent of the Senate, obliged to report to parliament)

3.3. Parliamentary approval process

Following the introduction of the executive's budget proposal, MPs are given roughly seven days to acquaint themselves with the budget (Rules of Procedure, Article 37, paragraph 4) followed by a one-day plenary debate on overall budget policy (or first reading). The draft budget is then referred to the committees. The main committee charged with budget scrutiny in the Sejm is the Public Finances Committee, typically chaired by a member of the ruling party for the duration of the term¹² with deputy chairs drawn from the largest political parties represented in the Sejm including those in the opposition. The Public Finances Committee has around 50 members and is supported by five staff. The corresponding committee in the Senate is the Budget and Public Finance Committee which is comprised of around eight members and supported by two staff.¹³

Table 5. Parliamentary budget approval timetable

End September	Presentation of the budget.
Early October	First reading and referral to the Public Finances Committee and other relevant standing committees.
End October	Standing committees send their opinions to the Public Finances Committee.
Mid November	The Public Finances Committee issues a first report; second reading.
Second half of December	Third reading and approval of the budget; budget sent to the Senate for review.
Third week of January	The Sejm reviews and accepts or rejects the Senate's amendments and sends the budget bill to the President.

The Public Finances Committee examines the bill and produces a first report, taking into account the views, proposals, and suggested amendments of the other standing committees. It is now common practice for ministries to send materials which contain performance elements to these standing committees. This step is followed by a second reading where MPs may propose amendments to the bill before again referring it to the Public Finances Committee which produces a second report.¹⁴ The third reading and approval of the whole budget bill typically take place in the third week of December.

After approving a bill in the third reading in the House, it is transferred to the Senate. The Senate cannot reject the budget approved by the Sejm (Article 233 of the Constitution), but it can adopt it as is or propose amendments. The Senate must state its position within 20 days following receipt of the budget. In a similar process to that of the Sejm, the Marshal

(Speaker) of the Senate refers the budget statute to the Senate standing committees. These committees, having considered the appropriate parts of the budget, transmit their opinions to the Budget and Public Finance Committee which prepares the draft for the Senate resolution. The Senate resolution is then sent back to the Sejm for consideration. The Sejm has prerogatives over the Senate and can choose to either overrule the Senate's proposed modifications (by an absolute majority vote) or include the Senate amendments in the budget. The Marshal (Speaker) of the Sejm then sends the bill to the President for signature.

Box 10. Biuro Analiz Sejmowych (BAS), the Bureau of Research in the Chancellery of the Sejm

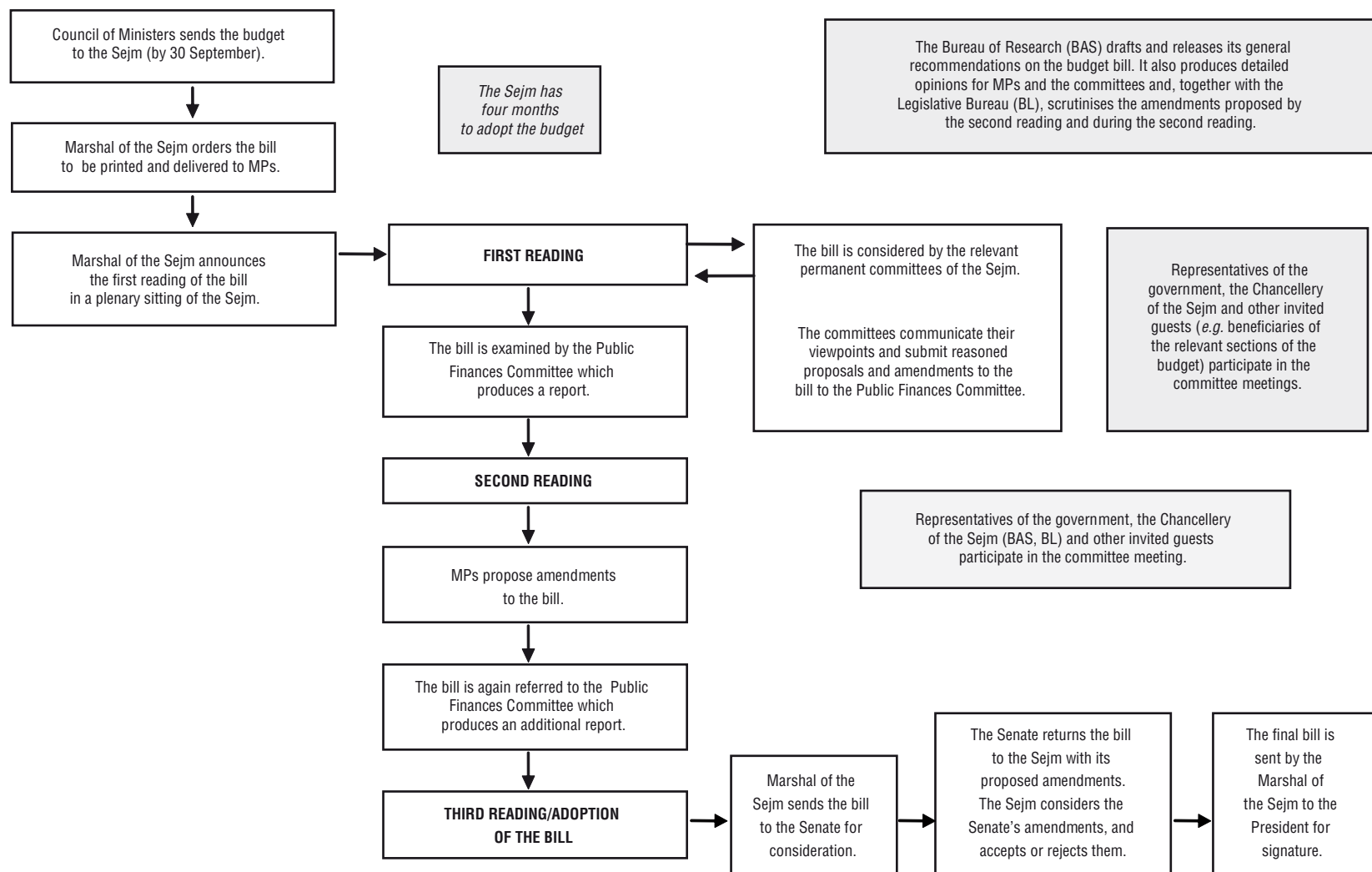
In order to effectively carry out their budgetary oversight role, parliamentarians everywhere require access to timely, up-to-date, accurate and well-researched information. This includes information from the government (which tends to have a much higher capacity than parliament in terms of both financial and human resources) as well as information from independent sources such as parliamentary budget offices. The Polish parliament has a well-developed research service including a special division for budgetary research established in 1991. Poland thus follows a growing trend within OECD countries: in less than a decade, the number of specialised budget research organisations serving legislatures has almost doubled.

At present, the BAS is composed of 88 staff within 10 units, including the Department of Social and Economic Research (with around 20 staff in total) within which there is a Group for Financial and State Budget Research (with seven staff, two of whom are tax experts). This group deals with matters of public finance, among which: the state budget (including the PBB) and the budgetary law; taxes and the tax law; banking law; foreign exchange law; financial management of special-purpose funds; discipline of public finance; and administration of public finance.

The BAS and the group provide a broad range of services to the Sejm (committees, parliamentary club members, and individual MPs), such as:

- Analysing materials submitted by the government (the draft budget and report on the implementation of the budget), by the Supreme Audit Office, by the National Bank of Poland and by the Central Statistical Office.
- Preparing written opinions on the textual part of a budget bill, on individual parts of the budget, and on the macroeconomic and monetary policy targets.
- Participating in all sittings of the committees and subcommittees during the period of the adoption of the budget.
- Formulating deputies' proposals for amendments to the budget and analysing the financial consequences of the proposed amendments.
- Responding to other requests made by committees and deputies concerning the budget, finances, monetary policy, the taxation system and the banking system. It should be noted that the BAS completes more than 300 written requests in this area each year.
- Organising seminars on various issues in public finance.

If necessary, the BAS can commission outside experts. Experts may be called upon to: present written opinions on a number of subjects, prepare motions to be voted on during the committee and plenary sittings of the Sejm, and assist in the organisation of seminars on various issues in public finance, including – at the beginning of each term of the Sejm – special training for newly elected deputies on the budget and on the procedures for its adoption.

Figure 1. **Simplified budget adoption procedure in the Sejm**

The President signs the budget (or interim budget) submitted by the Marshal of the Sejm within seven days of receipt, and orders its promulgation in the *Journal of Laws*. While the President has the power to veto other legislation, he/she does not have the power to veto the budget. According to Article 219, paragraph 4 of the Constitution, if a state budget (or interim budget) has not come into force on the day of the start of the fiscal year, the Council of Ministers shall manage state finances pursuant to the draft budget. In addition, if after four months from the day of submission of a draft budget to the Sejm, it has not been adopted or presented to the President for signature, the President may, after 14 days, order the shortening of the parliament's term of office although he/she is not obliged to do so. However, timely approval is the norm.

3.4. The impact of parliament

The Polish parliament enjoys wide amendment powers which it uses in practice. Regarding the budget, the parliament can propose unlimited amendments provided it does not change the total deficit/surplus proposed by the executive (the number of amendments from year to year can vary widely, although it is typical to have several hundred amendments proposed during the parliamentary budget process). Unlike many Westminster system parliaments, amendments and the vote on the budget are not seen as a vote of confidence in the government. Table 6 shows the numbers of amendments proposed by both houses and finally adopted in 2008 (the 2009 budget bill) and 2009 (the 2010 budget bill); both bills included performance information in the *Justification to the Budget* documents.¹⁵ The data in Table 7 show that the effects of the amendments submitted and approved by the parliament on the overall budget revenues and spending are minimal. However, change to the various parts of the budget may be more substantial.¹⁶ It is unclear how the amendment procedure will work in the future when both the traditional budget and the performance-based budget are legally binding. However, as long as the traditional budget continues, it is likely that amendments to it will be translated to the PBB, again increasing the workload of parliament.

Table 6. **Parliamentary amendments to the budget bill in 2008 and 2009**

	2009 budget bill	2010 budget bill
Sejm (lower house)		
Amendments submitted	411	194
Amendments adopted	37	51
Senate (upper house)		
Amendments submitted	251	16
Amendments adopted by the Senate	27	16
Senate's amendments adopted by the Sejm	23	16
Total Sejm and Senate combined		
Amendments submitted	662	210
Amendments adopted	60	67

Sources: The Bureau of Research of the Sejm (BAS) and the Senate committees, Poland.

Table 7. **Impact of parliamentary amendments (PLN thousands)**

Specification	Draft of the budget bill for 2009	The budget bill for 2009 passed by the Sejm and published in the <i>Journal of Laws</i>	Per cent change	Draft of the budget bill for 2010	The budget bill for 2010 passed by the Sejm and published in the <i>Journal of Laws</i>	Per cent change
Revenue	303 544 670	303 034 805	0.2	248 983 601	249 006 601	0.0
Expenditure	321 744 670	321 221 112	0.2	301 197 817	301 220 817	0.0
Including <i>inter alia</i> :						
Part 01: Chancellery of the President	188 999	159 779	15.5	162 485	158 485	2.5
Part 02: Chancellery of the Sejm	420 085	382 762	8.9	404 960	395 323	2.4
Part 03: Chancellery of the Senate	162 481	154 915	4.7	163 088	161 970	0.7
Part 09: National Broadcasting Council	19 379	14 682	24.2	19 742	15 742	20.3
Part 33: Development of rural areas	10 116 810	10 316 810	2.0	4 628 065	4 479 065	3.2
Part 46: Health	4 694 696	4 694 696	0.0	3 452 421	3 482 702	0.9
Part 83: Special-purpose reserves	34 084 558	34 473 346	1.1	18 308 768	18 347 076	0.2

Source: The Bureau of Research of the Sejm (BAS), Poland.

3.5. Conclusions regarding budget approval

The Polish parliament's role in the budget process is clear and well developed. According to outside observers, budget oversight by Poland's legislature is generally strong. There is adequate time to examine the draft budget, in line with OECD best practices for budget transparency. The parliament has a strong independent analytic capacity in the BAS and its Group for Financial and State Budget Research more particularly. The Supreme Audit Office (NIK) is also an important partner in terms of analysing and providing information on performance results. The PBB adds new dimensions to the budget process and can be expected to increase the workload of parliament given that it is presented alongside the traditional budget.

As Poland makes the transition to a legally binding PBB, the Ministry of Finance should enhance its dialogue with parliament, particularly regarding how performance information is best presented to parliament, what types of performance information are most useful to parliament (*e.g.* which indicators are most relevant), and examples of good practice since the introduction of PBB in 2008. The ministry's Department for Public Finance Reform is taking steps in the right direction, with several recent initiatives to reach out to MPs, but the department should ensure that these efforts are more systematic and not merely *ad hoc*.

4. Budget execution

The ongoing reform process introducing performance budgeting elements in the Polish budget system has so far not influenced rules or practices in the execution of the annual budget apart from a few new elements being added to the in-year duties of the Ministry of Finance and budget holders. During the year, the finance minister exercises control over, among other things, "the effectiveness and efficiency of implementing the performance-based budget". The new performance-based budget is still not legally binding, but it is included in the *Justification to the Budget* and shows appropriations for tasks, objectives, indicators and targets that budget holders must take into account as part of budget execution. Until now, Ministry of Finance control of the implementation of the PBB referred to in the Public Finance Act is more related to a continuous dialogue about how to formulate the budget structure, objectives, and indicators than to systematic in-year monitoring of the content and results of these objectives, indicators, and targets.

For the traditional budget, execution reports are produced monthly, and the Ministry of Finance monitors the current accounts of large agencies.

A new element is that budget holders are obliged to “exercise surveillance and control over the effectiveness and efficiency of implementing performance-based plans on the basis of measures of execution of the objectives.” The intra-ministerial surveillance and control is still in an early phase. IT systems for systematic collection of indicator values, and clear process plans for how control should be exercised, are not yet in place. Nevertheless, the responsibility of budget holders to monitor and control their agents could become a central point in the future functioning of the performance-based budget system.

Systemising this element may establish a dialogue on objectives, operations and results. The dialogue can be useful for the units that execute the budget and plan operations (to achieve a clearer definition of expectations and goals for budget execution), as well as for budget holders (to achieve improved information and to be able to exercise not only financial but also performance control). As the monitoring, control and potential dialogue occur within a policy area, the professional and technical knowledge of that area is already in place, thus taking some of the pressure off of the Ministry of Finance as a controller.

From a budget allocation perspective, the decentralised monitoring and oversight may not necessarily improve general allocative efficiency among policy areas. However, as this section shows, budget holders of budget parts have relatively broad freedom to reallocate within budget parts. Thus, one way of utilising the performance information now being generated would be to enhance allocative efficiency within policy areas – in both the budget preparation phase and the execution phase. Under the precondition that the aggregate envelope will not be reduced by the Ministry of Finance (or the Council of Ministers), possibilities of internal reallocation within the envelope of a policy area could potentially lead to improvements in the reallocation from non-efficient to efficient programmes.

In addition to the new budget elements, some of the existing features in the budget execution phase are interesting and important for a well-functioning performance system. These features include the rules for the use of reserves, for internal transfers and for carry-overs.

4.1. Use of reserves

Poland’s annual budget contains a general reserve of a maximum of 0.2% of budget expenditures, as well as a number of special-purpose reserves. The special-purpose reserves can be used for various types of expenditures – for example, for expenditures not precisely divided into budget classifications during preparation of the budget bill.

Poland has four types of special-purpose reserves (two of which are not allowed to exceed 3% of budget expenditures). This leaves a considerable amount of specific budget allocation to the execution phase. The Minister of Finance allocates the special-purpose reserves in co-operation with other ministers, and the Council of Ministers also administers the general reserve.

While reserves are generally not conducive to maintaining budget discipline, they can be relevant in a performance context. From a performance budgeting perspective, reserves could cover not only new tasks as in the current system, but also changes in activities which need to be financially covered in an activity-based funding model. In suitable areas where the unit price of a product is calculable and variations in production are uncontrollable due to changes in demand, the use of reserves can be a way to fund activities within agencies.

In order to maintain budget discipline, an overall cap on activity-based budgeting funds should be maintained.

Box 11. Activity-based budgeting in Denmark

In Denmark, one example of how reserves can be used in a simple formula funding model is the processing of public pension applications from Danes living abroad. In addition to the basic appropriation in the budget act, the Agency for Pensions can draw on general reserves if the number of processed cases exceeds the fixed number covered by the basic appropriation. On the contrary, if the number of processed cases is below the number covered by the basic appropriation, the agency must return additional funding. The potential amount of extra funding is very limited in relation to the overall size of the reserve.

4.2. Internal transfers

Another flexible element in the Polish budget system is the rules for transfers during budget execution. Budget holders of budget parts are allowed to transfer expenditures between chapters and paragraphs within their relevant part and section of the state budget (Article 171 of the Public Finance Act). However, they cannot increase the expenditures planned for wages and for employees. Moreover, ministers administering several budget parts can transfer expenditures between these parts within one section and chapter of the state budget. To do this, they must notify the Council of Ministers which may overrule the ministers' decisions.

The finance minister must be notified of transfers concerning property expenditures and transfers concerning building investments which require his/her approval. Likewise, transfers involving a reduction or an increase of property expenditures by an amount in excess of PLN 100 000 (approximately EUR 25 000) on a one-off basis require the approval of the finance minister.

Generally, both line ministries and the Ministry of Finance expressed satisfaction with the current transfer rules as allowing flexibility and an appropriate level of control. Following the implementation of the performance budgeting reform, the rules for transfers have to be settled for the performance-based budget. The logic of the current system would suggest that budget holders of a budget function could be allowed to transfer between tasks, sub-tasks and actions within that function. Moreover, ministers or budget holders could be allowed to transfer between functions if they were responsible for more than one function. A typical example would be a public finance sector entity with tasks contributing to several functions. If the latter rule is not applied, it would be impossible for the management of an entity or the accountable minister to reallocate funds within the entity because different units of the entity analytically are related to different functions.

However, applying these two transfer rules to the new performance-based budget structure could entail challenges. The first problem is that reallocation within a function would not take place in an optimal way because different tasks, sub-tasks and actions belong to different line entities. Basic organisational theory would suggest that funds could not be transferred out of entities if no principal can decide on it. This problem is inherent

to the cross-cutting nature of the new performance-based budget structure, and transfer rules cannot change that.

The challenge related to the second rule (transferring between functions) is the risk that ministers or budget holders may reallocate too much. If more ministries and separated organisational units are contributing to the same functions or tasks, sub-optimising may happen as entities hope to rely on the effort and funding of other entities while transferring resources to tasks that are more important for themselves. This risk would be amplified if entities are held strictly accountable for certain objectives and targets.

Nevertheless, the way the Polish performance-based budget structure has been defined – with objectives, indicators and targets for each task, sub-task and action – minimises this risk. Every level is held accountable, and it would also appear in the reporting if extra resources had been transferred to an area. However, appropriate monitoring systems will have to be put in place.

The Ministry of Finance should keep the transfer rules flexible. To ensure that gaming is not taking place, the ministry could collect and analyse data on transfers for a specific period to monitor the development.

4.3. Carry-overs

A final flexibility issue is the possibility to carry forward unused funds at the end of year. The current regulations state that the “amounts of state budget expenditures which have not been utilised shall expire at the end of the budget year.” After obtaining an opinion from the Sejm Public Finances Committee, the Council of Ministers may define an explicit list and new financial plan for expenditures which will not expire at the end of the budget year. However, a detailed description of their use and a deadline for their implementation are necessary. Moreover, they must be utilised at the latest by 31 March following the relevant budget year. In practice, very few unused funds are carried forward, and the system is very strict.

If appropriations in 2013 become more closely linked to performance, the strict rules and practices for carry-overs may be relaxed, particularly in areas where certain results are agreed for a multi-year period. It should be noted, however, that the traditional budget should still be expected to be dominant after 2013. It should then be reasonable to look at the use of appropriations in relation to the results for the agreed period and not just the single budget year. Also, for areas where activity and performance can be measured accurately, the possibility for carry-overs could be used as an incentive to increase efficiency in entities. If the same activity (and quality) levels are reached with the use of less resources, agencies’ ability to prioritise unused funds within their own area could be part of a reward system. Such a relaxation of the carry-over rules should be administrated by the Ministry of Finance, which may have to submit decisions to a hearing in the Council of Ministers.

4.4. Conclusions regarding budget execution

The current Polish system for reallocation seems to be sufficiently flexible and should be continued. The reserve system gives the government additional leeway during budget execution. Carry-over rules, on the other hand, are rather strict compared to most OECD countries. The PBB system introduces decentralised responsibility to budget holders for them to monitor agencies and units, which should improve both allocative and operational

efficiency over time. In order to harness the potential of the PBB in the budget execution phase, the Ministry of Finance should:

- Support budget holders in their tasks of monitoring and controlling performance by developing guidelines on appropriate controls that can be used by ministries and agencies.
- Consider relaxing the rules for carry-overs in order to support multi-year agreements or to act as an incentive for efficiency in agencies.
- For a certain period, collect and analyse data on in-year transfers in order to ensure that transfers are used appropriately in the new structure. (Poland should strive to keep the rules for in-year expenditure transfers as flexible as in the current system.)

5. Reporting, accounting and audit

5.1. Reporting and accounting

According to Article 41[4] of the new Public Finance Act, “the finance minister shall define, by ordinance, the types, forms, deadlines and methods for preparing reports on the execution of performance-based financial plans by state budgetary units, administrators of state special-purpose funds, executive agencies, budget institutions and state legal persons.” The Ministry of Finance provides monthly reports (with roughly a two-week lag), as well as quarterly, mid-year and annual reports. Currently only the annual report contains performance information, although the ministry has indicated that some performance information will likely be added to the quarterly and mid-year reports in the future. Figures are reported at the central government level, ministry level and chapter level. During the year, parliament scrutinises these reports through the Public Finances Committee.

The annual report on the implementation of the budget and the condition of the state debt is submitted to the Sejm and the Supreme Audit Office (NIK) by 31 May of the subsequent year (or within five months of the end of the fiscal year). As noted above, the annual report includes information on the execution of performance-based expenditures which, according to the 2009 Public Finance Act, should contain:

- a review of the implementation of the performance-based plan of expenditures, including the implementation of objectives set;
- a statement of expenditures planned and incurred for the implementation of tasks;
- a statement of expenditures planned and incurred for the implementation of sub-tasks; and
- a statement of planned and achieved values of measures of implementation of objectives (Article 182[6]).

Annual information about the implementation of the state’s Multi-Year Financial Plan, and the extent of execution of objectives, is also published. The Sejm must examine the report and, taking into consideration the opinion of the NIK, decide whether to pass a resolution to grant or refuse approval of the government’s accounts within 90 days of receipt (Article 226 of the Constitution). Refusal to approve the government’s accounts may lead to a vote of no confidence against the Council of Ministers, although this is not automatic.

Box 12. **New management control and reporting in Poland**

Chapter 6 of the new Public Finance Act specifies management control and co-ordination of management control in public finance sector entities. Management control is defined as “a set of activities undertaken in order to ensure the implementation of objectives and tasks in an effective, economical, and timely manner compliant with the provisions of law”. Among other things, such control seeks to ensure the credibility of reports. The finance minister is required to publish a communication on management control standards for the public finance sector, compliant with international standards, in the Official Journal of the Finance Minister (Article 69[3]). The finance minister and the minister in charge of a department may also publish detailed guidelines on management control for the public finance sector and the department respectively. Each minister in charge of a department must draw up an action plan for the following year which includes “a specification of objectives within individual budget tasks” and “an indication of sub-tasks for achieving the objectives and measures specifying the extent of objective implementation and the planned values thereof”. Reports on the execution of these action plans must be submitted by the end of April along with a statement on the condition of management control for the preceding year (a specimen of which is defined by the finance minister by ordinance). The action plan, the report on the execution of the action plan and the statement on the condition of management control are all made publically available through the Public Information Bulletin. According to Article 71 of the Public Finance Act, the finance minister is responsible for co-ordinating management control in public sector finance entities through:

- propagating the standards referred to in Article 69[3];
- issuing guidelines;
- co-operating with domestic and foreign organisations; and
- co-operating with the auditing committees referred to in Article 288.

In principle, information is collected in good time so that it can be fed into the subsequent budget preparation process. However, as the performance indicators and targets have only been in place for a short time, their usefulness for decision making has been limited. The Ministry of Finance clearly intends to use the reporting on performance results to inform the budgetary decision-making process from 2013 onwards. Performance information should in time constitute an important factor on the basis of which allocative decisions can be taken.

The major challenge facing the Ministry of Finance and budget holders today is the need for a new chart of accounts for the PBB structure and an adequate IT infrastructure for PBB reporting and accounting. The current IT infrastructure does not support translation between reporting and accounting for the traditional budget and reporting and accounting for the PBB, and individual budget holders decide independently on how to keep records of performance-based expenditures. Several entities (for example, the Ministry of National Education) have developed their own system enabling parallel bookkeeping in which all accounting documents simultaneously describe both the traditional and the performance-based classifications. Other entities prepare their plans and reports on the basis of estimates. For many budget holders, this situation essentially means double reporting and an increased workload. Reporting and accounting are further complicated by the fact that, even for the traditional budget, there is no centralised accounting system. Budget

holders use a wide variety of systems, some of which have been tailor-made for them by small Polish firms. It is important to note that the Ministry of Finance reported significant improvement recently in the quality of data submitted for the purpose of preparing the annual report on the execution of performance-based expenditures, indicating that budget holders have improved their methods of collecting performance-based information.

The new Public Finance Act (Article 40[4.1]) obliges the Ministry of Finance to set the parameters for the new accounting system for the PBB. To address the issues raised above, the ministry hired outside experts to provide an in-depth analysis of the current situation, including a survey of budget holders in July 2010. The survey comprised 309 questions and had an 85% response rate (1 940 budget holders out of 2 283). The main findings and recommendations were presented to the Ministry of Finance in the form of a detailed report in September 2010.¹⁷ The report highlighted the diversity of suppliers of accounting systems (around 150) and of types and versions of accounting systems (over 150), as well as licensing issues. In addition, the size of the various systems (number of records, users, etc.) varies greatly from one budget holder to another. Only 190 respondents were able to estimate the costs of adjusting their systems to service expenditure in the PBB format, and only 40% believed that they have the skills necessary to account in the PBB format. IT solutions will have to take into consideration the fact that some units will resist or have difficulty integrating into a single accounting system. Any centralised system will have to be tailored for both very large and very small budget holders, and the latter may not have the capacity to service expenditures in a very complex system (again, for some their accounting system is very simple, often serviced “by hand”).¹⁸

Three major options exist: i) the development of a totally new system solely for the PBB; ii) adjusting the current Ministry of Finance system that applies to the traditional budget (TREZOR system); and iii) adjusting the various systems used by budget holders. No decisions have been taken yet as to the options presented. As demonstrated by the French experience, the development of a totally new system would likely prove to be a complex and expensive undertaking. Nevertheless, the results of the survey also support this approach and note that the most benefits will be visible at the start of the implementation process of the single accounting system and that the costs of subsequent adjustments will ultimately be lower for a single system. Moreover, the cost issue is mitigated, as the budget for implementation of a new system has already been secured from European Union funds.

Given the enormity of the task (from design, to training of users, to execution) and the potential drain on the capacity of the Ministry of Finance, the survey report recommended that the implementation process, as well as any supervisory activities, could be outsourced. To create a single, centralised accounting system, the survey report indicated that the ministry must address three issues:

- The system should be acceptable to all units.
- Special solutions should be found for very small budget holders, and an equitable system should be set up for sharing adjustment costs among the many budget holders.
- Universal rules (specification requirements) should be developed for large units which are solely responsible for building their own IT system, whether they choose solutions already available in the market or to develop new systems.

The Ministry of Finance plans to commission a feasibility study sometime in 2011 on the implementation issues regarding a new system. Based on the outcomes of this

forthcoming study, the decision will be taken as to what system will be introduced and when. Once a decision is reached, the tender procedure will commence.

5.2. Internal audit

According to the 2009 Public Finance Act, the finance minister defines by ordinance the detailed methods and modes of carrying out, and reporting on, the progress and results of the internal audit.¹⁹ In Poland, internal audit follows EU standards and is carried out on the basis of an annual internal audit plan prepared by the end of each year for the subsequent year, although additional internal audits may be done outside of the scope of the audit plan in justified cases. By the end of January each year, the internal audit team must also “prepare a statement on the execution of the audit plan for the previous year” (Article 283[5]). Both the plan and the statement on the execution are made public. The reports of the internal auditors are also available to the Supreme Audit Office (NIK).²⁰

Internal audit is considered autonomous and independent, reporting to the management of the budgetary organisation or the line minister. With some exceptions, there are typically 3-5 people responsible for internal audit in ministries and 1-2 people in agencies. To date, internal audit focuses on legality and regularity, and there has been only limited assessment of economy, efficiency and effectiveness (or performance). However, it should be noted that a certain amount of experience in performance auditing already exists within ministries and agencies dealing with EU funds. For example, evaluators have examined performance indicators in operational programmes under cohesion policy in certain ministries and agencies in several evaluations during the past six years.

In accordance with the Public Internal Financial Control (PIFC) framework being implemented by all new EU member states, the Ministry of Finance established a Public Finance Sector Audit Department which serves as a central harmonisation unit supporting managerial accountability (financial management and control) and functionally independent internal audit. In line with EU recommendations on good practice, the Public Finance Sector Audit Department of the ministry is separate from the internal audit unit.

In 2009, as part of the broader reforms, the Ministry of Finance established a new Performance Audit Unit within the Public Finance Sector Audit Department. Like the department does more broadly, this new unit will play a “soft co-ordination” role mainly through networking and providing methodological guidance and training for internal auditors with regard to performance auditing and related issues.

The new Performance Audit Unit faces several challenges. It is currently quite small, with only two staff members, although it does have the capacity to hire external experts and may receive funds from the EU co-financed project on performance budget. While the first internal evaluation of the performance budget is not scheduled until 2013, the Performance Audit Unit is preparing to provide advice (in co-operation with the Department for Public Finance Reform) on a methodological framework, including models of existing good practice they have identified (for example, the work of the Ministry of Regional Development’s National Evaluation Unit). The Performance Audit Unit would like to develop resources such as a website, and ensure that sufficient training opportunities are available in advance. Ideally, the unit would like to provide expertise on up to five budget parts for the internal performance audit, such as the Ministry of Health, the Ministry of Justice, and the Ministry of Finance itself.

At the moment, however, the unit's mandate is somewhat uncertain. There is no legal framework and no binding decision on the part of the Council of Ministers or Minister of Finance about the shape of, or even who is ultimately responsible for, internal evaluation of the performance budget. Questions remain regarding both expectations and quality assurance. It is unclear how existing internal auditors will both organise and carry out performance audits (although it is worth noting that the Ministry of Finance has provided training on performance budgeting which included 323 internal auditors and 180 heads of public finance sector entities). Moreover, concerns have been raised about the additional costs associated with this exercise, in terms of both financial and human resources, and how it will be financed, particularly when EU financing comes to an end.

Box 13. The EU and Public Internal Financial Control (PIFC)

The PIFC model of the European Union attempts to “assist national governments in re-engineering their internal control environment and in particular to upgrade their public sector control systems in line with international standards and EU best practice.” The main international standards underpinning the PIFC model are the INTOSAI “Guidelines for Internal Control Standards for the Public Sector” and the ECIIA “Position Paper on Internal Audit in Europe”, complemented by the INTOSAI “Lima Declaration of Guidelines on Auditing Precepts” of 1977 which are key international standards for public external audit.

An essential element of the PIFC model is a central harmonisation unit (CHU) that is “empowered to manage the development of PIFC.” According to the European Commission, a CHU is defined as “a policy unit attached and directly reporting to the Minister of Finance on the status of internal control in the entire public sector, responsible for redesigning, updating and maintaining the quality of the internal control systems, for harmonising and co-ordinating definitions, standards and methodologies, for networking between all actors (managers, financial officers, internal auditors), for the establishment and co-ordination of sustainable training facilities, including the setting of criteria for the certification of public internal auditors, and for all other actions to improve public internal control systems.”

Ideally the tasks of a CHU are facilitated by “close co-ordination and co-operation with the State Audit Office, professional private organisations (such as the local Institute of Internal Auditors) and academic circles”.

Source: European Commission (2006), “Welcome to the World of PIFC”, Directorate-General for Budget, European Commission, Brussels.

5.3. External audit

Poland has a rich historical tradition of state auditing, going back to the 16th century. The organisation and functioning of the Supreme Audit Office (NIK) are set out in the Constitution of the Republic of Poland and in the NIK Act of 23 December 1994. The NIK reports to the Sejm (Article 202 of the Constitution) and acts in accordance with the principle of collegiate responsibility. Several mechanisms are in place to guarantee its independence from the executive. First, according to Article 205 of the Constitution, the President of the NIK is appointed by the Sejm with the consent of the Senate for a six-year term (renewable for one additional term only) which does not overlap with the four-year term of the Sejm.²¹ Second, the NIK President is protected by immunity.²² Finally, the annual plan and budget of the NIK are established autonomously and can only be amended by parliament.

The College of the NIK is composed of the NIK President (chair of the College), Vice-Presidents, Director General and 14 other members (seven representatives of legal and economic sciences, and seven directors of the NIK organisational units or advisors to the NIK President). Members of the NIK College (apart from the President) are appointed by the Marshal of the Sejm for a three-year term of office upon the NIK President's request. The NIK College enjoys a wide mandate. It is involved in the process of approval and adoption of the key documents submitted to the Sejm each year, and approves the draft budget²³ of the NIK, the work plan and the report on NIK activity (also submitted to the Sejm). In addition, the College assesses audit programmes and gives its opinion (pronouncements) on the results of particularly important audits, and considers post-audit claims.

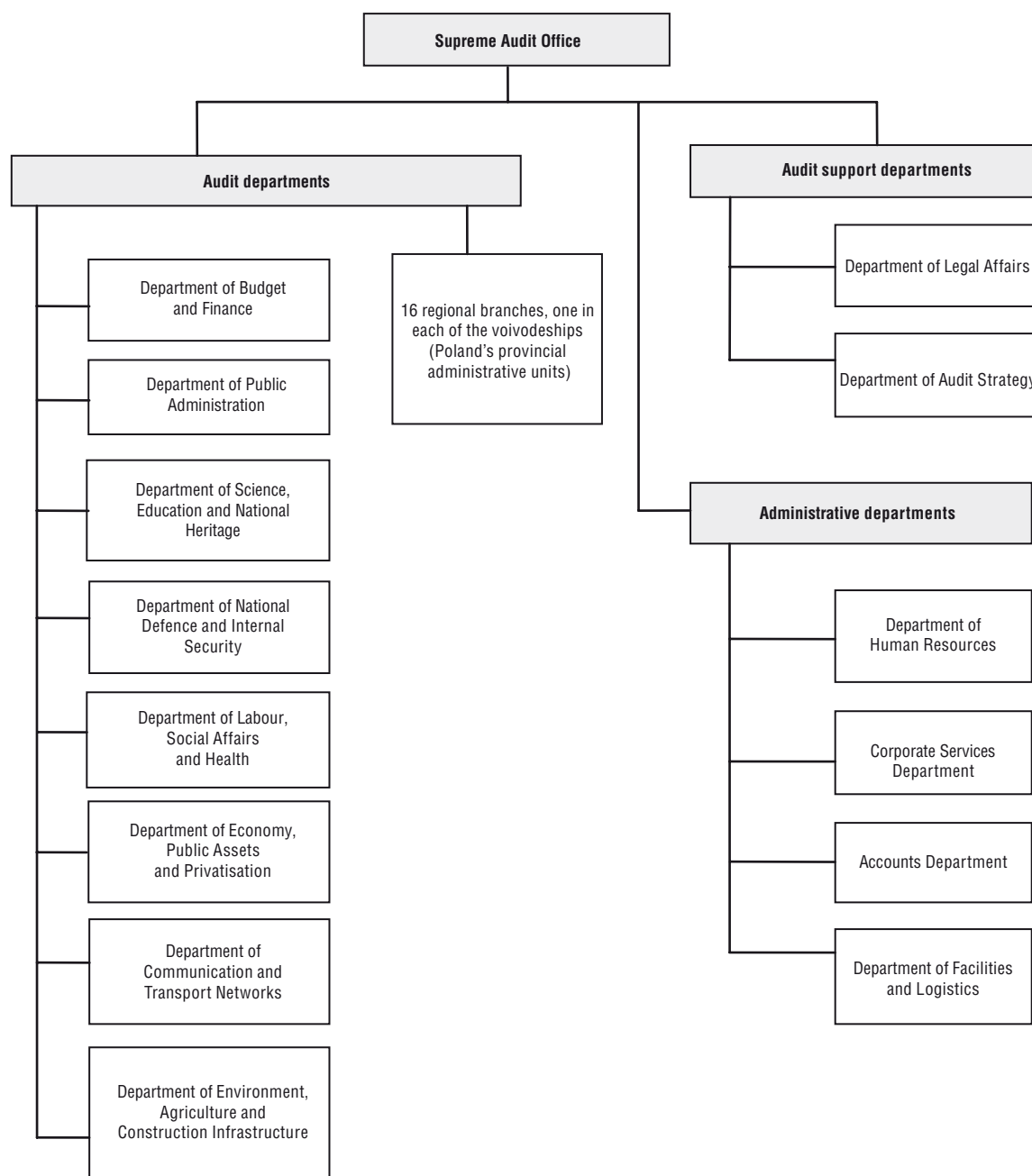
Currently the NIK employs over 1 600 staff²⁴ and is composed of a central office with 14 departments (eight of which are directly involved in audits of different areas of state activity) and regional branches in each of the 16 voivodeships (administrative regions of Poland), all of which are directly involved in auditing and which may initiate audits on their own. However, while the NIK has begun to undertake performance audits, there is no specific department responsible for performance audits.

As in most European countries, the NIK maintains close relations with parliament. As noted earlier, the NIK reports to the Sejm and the Sejm (with the consent of the Senate) can both appoint and dismiss the NIK President. The NIK co-operates closely with the various parliamentary committees, and most of the parliamentary committees have an established tradition of reviewing audit reports. Parliamentary committees hold many meetings annually in which matters related to the Supreme Audit Office are featured on the agenda, and NIK representatives are required to participate in these meetings. Moreover, the NIK is notified of all parliamentary committee meetings, and their representatives participate in them regularly. The NIK may also provide additional support to parliamentary committees, such as commenting on draft legislation or preparing analytical papers.

Every year, the NIK is required to submit three reports to the Sejm in addition to the results of the various audits it has carried out during the fiscal year (Article 204 of the Constitution):

- analysis of the execution of the state budget and the monetary policy guidelines (the NIK carries out audits in 400 entities within the state budget execution audit);
- opinion on whether to accept (grant discharge for) the government's accounts for the preceding fiscal year; and
- the annual activity report of the NIK.

Given that the performance-based budget will be legally binding in 2013, the NIK analysis of the execution of the state budget will be increasingly focused on performance. The types of audits conducted by the NIK include: regularity audits; performance audits; and composite audits, which include both regularity and performance issues. It should be noted that the Sejm and its bodies, in particular the parliamentary committees, may ask the NIK to conduct specific audits.

Figure 2. **Organisation chart of the Supreme Audit Office (NIK) of Poland**

Source: Supreme Audit Office of Poland, www.nik.gov.pl.

Box 14. Some audit-related statistics from the NIK 2008 Annual Report

- 165 planned audit topics
- 2 624 audited units
- 218 *ad hoc* audit topics
- 2 973 post-audit statements
- 172 pronouncements on audit findings presented to the Sejm
- PLN 16 767 million of financial irregularities found
- PLN 553.6 million of financial impact (roughly 2 PLN for every 1 PLN spent)
- 966 meetings of the Sejm committees and subcommittees attended by NIK representatives
- 43 *de lege ferenda* motions
- 9 audits conducted in parallel with other supreme audit institutions

The NIK is supportive of, and has been continuously involved in, the introduction of PBB reforms. This involvement is demonstrated, for example, by the inclusion of the NIK President's advisor in the Strategic Group to ensure the support of top management for the implementation of performance-based budgeting (see Section 1.1 above).

The NIK has been gradually introducing assessment of the performance-based budget for the past three years. However, the office noted that public institutions, and the NIK itself, have found these assessments challenging, as the Ministry of Finance has yet to determine all of the necessary legal standards for implementation and audit. The first pilot audit of the PBB in 2007 focused on scientific research and higher education. It proved difficult in practice, and the findings indicated that "the PBB was still mainly a paper exercise with no monitoring and impact on efficiency" which is to be expected at this point. Steps forward occurred in 2008, with more ministries introducing performance-based budgeting and the new definition of the "functions" in the PBB. As part of the report on the execution of the state budget, the NIK chose to examine two aspects of the PBB reform: i) tasks, sub-tasks and their relevance; and ii) proper formulation of objectives. The NIK concluded that decision makers were still struggling with the PBB system (particularly in terms of devising tasks and sub-tasks and record keeping which does not translate easily from the records kept for the traditional budget) and recommended streamlining the structure of tasks and sub-tasks. In 2009, the NIK noted a strong ministerial effort to improve the indicators, although monitoring, record keeping and reporting remained weak. In addition, the indicators did not always describe the genuine cost of a given task; some were defined as a percentage of budget execution, but some were simply descriptive. While several entities stand out as making significant progress (*e.g.* the Chancellery of the Sejm, the Polish Academy of Science, and the Ministry of Education), the NIK again concluded that it was difficult, if not impossible, to say whether efficiency has been enhanced, and recommended that the government undertake further analytical work to improve the tasks, sub-tasks and indicators.

It remains to be seen how the audit will progress for 2010, particularly in the light of the new law on public finance which is only just starting to be applied, and some of which will not be applied until 2013 at which point the NIK will carry out a full audit of the PBB. In 2011, the NIK is planning a strategic audit on PBB methodology (planning process, execution,

monitoring, reporting) and spending which should provide useful recommendations for advancing the reform.

5.4. Conclusions regarding reporting, accounting and audit

Reporting and accounting remain some of the greatest challenges faced by the Ministry of Finance. The ministry has already invested heavily in assessments for the development of an IT system for reporting and accounting for the PBB. The experience of many OECD countries has shown that reforming IT systems for reporting and accounting can be a very difficult and costly affair. Given the directions of Poland's reform and the continued existence of the traditional budget alongside the PBB, it might be useful to focus on building automated bridges between the traditional budget and the performance-based budget.

Internal audit in Poland is aligned with the EU Public Internal Financial Control framework. The Ministry of Finance plays a key role as the central harmonisation unit. A small Performance Audit Unit has also been set up within the Ministry of Finance, but its mandate – which pertains to performance audits at the “higher level” for the whole of public finance sector funds – remains somewhat unclear. The scope of internal evaluation of the performance budget (including its organisational, financial and methodological dimensions) still needs to be decided. The new Performance Audit Unit should be clearly tasked with developing guidelines for performance audits. Training may also be necessary to increase the capacity of the auditors to carry out performance audits.

The Supreme Audit Office (NIK) is supportive of efforts to introduce performance-based budgeting and is committed to its success. It will remain a key partner for the Ministry of Finance (and the parliament) in moving the reform forward and refining elements of the PBB, particularly in terms of indicators, through its continued assessments and recommendations. The PBB initiative dovetails nicely with the direction the NIK is already taking in terms of increasing performance audits.

Notes

1. Additional assistance, particularly with documents in Polish, was provided by Paulina Biernacka (consultant).
2. The Deputy Minister supervises and co-ordinates the work of the State Budget Department, the Budget Zone Financing Department, the Local Government Finances Department, the Paying Authority Department (dealing with EU funds) and the Department for Public Finance Reform. Each department is led by a director. Certain other departments are also involved in the reform such as, for instance, the National Economy Department.
3. The tasks of the NCPB include in particular: co-ordinating the elaboration of forms used by the entities of the public finance sector for preparing performance-based financial plans for the purpose of elaborating the justification to the draft budget act and report on the execution of the budget act; co-ordinating the works on the catalogue of budget tasks, as well as targets and measures of execution thereof; and ensuring the conformity of the budget tasks with strategies referred to in the act of 6 December 2006 on development policy.
4. According to the EU Stability and Growth Pact, EU countries that are not members of the euro zone annually submit convergence programmes to the Commission that ensure that the SGP deficit rules are not breached. The aim is to ensure more rigorous budgetary discipline through surveillance and co-ordination of budgetary policies within the euro area and the EU.
5. According to Article 114, Section 2 of the Public Finance Act, parts also include certain types of expenditures such as: general funds for local government units, general reserves, special-purpose reserves, servicing of the State Treasury debt, European Union funds, etc.

6. Annex 76 to the Ordinance of the Minister of Finance of 12 March 2010 on the detailed method, mode and deadlines for preparing the materials for the 2011 draft budget act stipulates: "This function comprises activities which are common for (of general character) tasks executed either within the scope of the whole part of the budget or the whole entity, which cannot be measured or linked to individual tasks or if it is not important enough, so that it would be economically justified. They concern issues within the scope of management and administrative and technical services of the budget holder. If the activities of such type are not common for tasks executed either within the scope of the whole part of the budget or the whole entity and they can be measured and linked with individual tasks, they are to be mandatorily presented within proper tasks within the scope of proper functions outside Function 22" (translation by the Polish Ministry of Finance).
7. This has happened rarely, for example in 1998 and 2000.
8. The "OECD Best Practices for Budget Transparency" (OECD, 2002) state that the executive's draft budget should be submitted far enough in advance for proper review by the legislature – at least three months prior to the start of the fiscal year.
9. However, if an MP or a committee would like to obtain specific information about the government's intentions for the budget bill, they have the right to submit a formal question or an interpellation to the government, or to invite government officials to participate in a committee meeting.
10. During budget deliberations, the government may also submit additional drafts of acts that are intended to introduce changes to tax or spending legislation.
11. Both houses of parliament can submit bills, including groups of 15 or more deputies, Sejm committees, and groups of 10 or more senators.
12. Although the chair may choose to resign.
13. Committee meetings are open to the public (although there are rare occasions when closed-door sessions are held to discuss issues which require confidentiality). However, this openness is strictly regulated by the rules. For instance, an MP must inform the chair in advance if he or she wishes to invite outside representatives. Accredited journalists can participate in committee sessions provided they do not interfere with the committee's work. Strict procedures are in place regarding lobbyists, and the average citizen cannot take part in a committee meeting uninvited.
14. A Public Finances Committee member can submit a minority motion (if his or her amendment has not been adopted by the committee). This motion is included in the report prepared for the second reading, and minority motions and amendments to the bill proposed during the second reading are put to a vote in the third reading of the bill.
15. During the parliamentary budget process, amendments may be withdrawn due to the results of the previous votes.
16. Certain institutions such as the Chancellery of the President, the Chancellery of the Sejm, the Chancellery of the Senate, the Supreme Audit Office, and the National Broadcasting Council (among others) draft their own budgets independent of the government, and these budgets (which comprise only a very small portion of total government expenditure) can only be amended by parliament.
17. In 2009, the Ministry of Finance outsourced two studies: "Performance Budget: The initial vision of an IT system" aimed at preparing the concept of an IT system that would support the servicing of the state budget in performance-based form, and "Preparation of description of business processes concerning the servicing of the state budget in performance-based form".
18. Only 42% of respondents indicated the need to have access to a central accounting system.
19. Additional regulations and guidelines can be found in the "Internal Audit Standards in Public Finance Sector Organisations", the *Auditors' Manual*, the "Charter of Internal Audit in Public Finance Sector Units", the "Code of Ethics for Internal Auditors in Public Budget Organisations", and the Regulation of the Ministry of Finance of 1 February 2010 on conducting and documenting internal audit.
20. Co-operation between internal audit and the NIK is regulated by the NIK Act of 23 December 1994, by the "Internal Audit Standards in Public Finance Sector Organisations", and by the "Charter of Internal Audit in Public Finance Sector Units".
21. According to Article 205 of the Constitution: "The President of the Supreme Chamber of Control shall not hold any other post, except for a professorship in an institute of higher education, nor perform any other professional activities" and "the President of the Supreme Chamber of Control

shall not belong to a political party, a trade union or perform public activities incompatible with the dignity of his office.”

22. According to Article 205 of the Constitution: “The President of the Supreme Chamber of Control shall not be held criminally responsible nor deprived of liberty without prior consent granted by the Sejm. The President of the Supreme Chamber of Control shall be neither detained nor arrested, except for cases when he has been apprehended in the commission of an offence and in which his detention is necessary for securing the proper course of proceedings. The Marshal of the Sejm shall be notified forthwith of such detention and may order an immediate release of the person detained.”
23. The NIK College drafts its own budget independent of the government, and it can only be amended by the parliament. The draft budget of the NIK is discussed and recommended by the Sejm’s Public Finances Committee and the State Audit Committee and put to a plenary vote as a part of the state budget.
24. Auditors follow a “Code of Ethics for NIK Auditors” which was introduced by the NIK in 2002. This code takes into account provisions of the “Code of Ethics” of the International Organization of Supreme Audit Institutions (INTOSAI).

References

- Blöndal, Jón R., Daniel Bergvall, Ian Hawkesworth and Rex Deighton-Smith (2008), “Budgeting in Australia”, *OECD Journal on Budgeting*, 8(2):133-196.
- European Commission (2006), “Welcome to the World of PIFC”, Directorate-General for Budget, European Commission, Brussels.
- Finansdepartementet (2007), *Att styra staten – regeringens styrning av sin förvaltning. Statens offentliga utredningar*, updated 2010, Ministry of Finance, Stockholm.
- Johnson, C. and C. Talbot (2008), “UK Parliamentary Scrutiny of PSAs: a challenge too far?” in Wouter Van Dooren and Steven Van de Walle (eds.), *Performance Information in the Public Sector*, Palgrave, London, pp. 140-156.
- Kasek, L. and D. Webber (eds.) (2009), *Performance-Based Budgeting and Medium-Term Expenditure Frameworks in Emerging Europe*, The World Bank, Poland, Warsaw Office, ISBN 978-83-88911-17-0.
- Küchen, T. and P. Nordman (2008), “Performance Budgeting in Sweden”, *OECD Journal on Budgeting*, 8(1):49-59.
- Ministry of Finance (2009), “Minister of Finance Regulation of 4 February 2009 amending the Internal Organization Regulation in the Department for Public Finance Reform, 28 October 2008”, Ministry of Finance, Warsaw.
- National Assembly (2009), “Rapport d’information déposé en application de l’article 145 du Règlement par la Commission des Finances, de l’Économie générale et du Plan relatif à la performance dans le budget de l’État”, Paris, www.assemblee-nationale.fr/13/rap-info/i1780.asp.
- Noman, Z. (2008), “Performance Budgeting in the United Kingdom”, *OECD Journal on Budgeting*, 8(1):75-90.
- OECD (2002), “OECD Best Practices for Budget Transparency”, *OECD Journal on Budgeting*, 1(3):7-14.
- OECD (2008), “Sequencing and Pacing of Performance Budgeting Reforms”, Summary of the 5th annual meeting of the SBO Network on Performance and Results, 27-28 October, www.oecd.org/dataoecd/21/14/42188165.pdf.
- Perczynski, P. and M. Postula (eds.) (2010), *Performance Budget in Poland*, Ministry of Finance, Warsaw, ISBN 978-83-930524-1-7.
- Robinson, M. and M.D. Francesco (2009), “IMF Informal Memorandum. Performance Budgeting: Strengthening implementation of the new framework”, International Monetary Fund, Washington DC.
- Supreme Audit Office of Poland (n.d.), *Annual Report*, NIK, Warsaw, www.nik.gov.pl/en/nik-audits/annual-reports.

ANNEX

Milestones of performance budget implementation in Poland (annex provided by the Ministry of Finance of Poland)

2008

- Analysis of legal acts for the purpose of performance budget implementation
- Elaboration of methodological foundations for multi-annual performance planning
- Preparation of assumptions for legal acts regulating the functioning of the performance budget, including multi-annual performance planning
- Preparation of projects co-financed from EU funds, aimed at implementation of the performance budget

2009

- Elaboration of performance budget methodology
- Elaboration of guidelines for preparing a report on execution of the budget in performance form
- Elaboration of assumptions for an IT system for servicing the performance budget

2010

- Elaboration of a concept of monitoring the execution of the budget in performance form
- Completion of a first stage of works on the performance budget reporting system, enabling the monitoring of public expenditures

2011

- Completion of works on an indicators database for functions of the state
- Completion of the second stage of works on a performance budget reporting system, enabling the monitoring of public expenditures
- Conducting the first monitoring and reporting on performance budget execution

2012

- Preparing the first parallel draft budget act (traditional budget and performance-based budget) for the 2013 budget year
- Implementation of the methodology for effective public finance management at the central level by means of multi-annual performance planning and completed database of indicators

2014

- Preparation of the report on the execution of the budget act comprising the execution of the performance budget in 2013 (in parallel to the traditional budget)
- Elaboration of a report on the *ex post* evaluation of the execution of the 2013 budget act, as an instrument supporting the preparation of the 2014 draft budget act

2015

- Elaboration of a report concerning the impact of performance budget functioning on public finance
- Financial settlement of the projects co-financed from the European Social Fund

Cyclical budget works (conducted annually 2008-15)

- Elaboration of the provisions concerning the performance budget for the purpose of an ordinance on the detailed method, mode and deadlines for preparing the materials for the draft budget act (the so-called Ministry of Finance's budget circular)
- Elaboration of information on the execution of the budget in performance form as presented in the justification to the draft budget act (last time for the 2012 budget in 2013)
- Elaboration of a report on the execution of the budget act in performance form (beginning in 2014 for the 2013 budget act)
- Elaboration of the materials necessary for the purpose of justification to the draft budget act (until 2011)
- Elaboration of the draft budget act in performance form parallel to the traditional budget (beginning from 2012)
- Works on the database of indicators (until 2011)
- Monitoring of the execution of the budget in performance form (beginning in 2011)
- Works concerning the implementation of an IT system to service the performance budget (2010-12)
- International co-operation on issues regarding performance budgeting and multi-annual financial planning
- Organisation of conferences and training, as well as providing expertise in the field of performance budget for the public administration
- Execution of the projects co-financed from EU funds (Operational Programme Human Capital financed from the European Social Fund) concerning the implementation of the performance budget.

Fiscal Transformation in Turkey over the Last Two Decades

by

Fatih Kaya and Selihan Yılar^{*}

Turkey has made significant progress over the last two decades regarding fiscal consolidation and a strong reform of fiscal policy. The highly fragile country of the 1990s, whose primary fiscal concern was to sustain its public finances in the short term, has become a successful transition model. Now the authorities are discussing the adoption of fiscal rules as a new anchor in public finances. A draft Fiscal Rule Law was prepared and submitted to the parliament in 2010. This article examines the fiscal policy framework of Turkey in the 1990s and 2000s and its striking economic and social consequences. The article also examines the attempts to adopt fiscal rules for Turkey.

JEL classification: H300, H500, H610

Keywords: Turkey, fiscal consolidation, reform of fiscal policy, sustainable public finances, fiscal rules, fiscal policy framework

^{*} Fatih Kaya and Selihan Yılar are specialists in the State Planning Organization of Turkey.

1. Introduction

Turkey is among the countries which performed fairly well during the last global crisis. Deterioration in the public finances was limited. In October 2010, the Turkish government announced its new Medium-Term Programme covering 2011 to 2013. According to this programme, general government deficit as a share of GDP, which reached its peak at 5.5% in 2009, is targeted to decrease to 1.1% of GDP by the end of 2013. Parallel to above-the-line estimations, general government debt stock is projected to decrease to 36.8% of GDP at the end of the Medium-Term Programme period from 45.5% in 2009 which is currently well below the EU average. Moreover, some authorities estimate a high real GDP growth rate of over 7%, while it is forecast at 6.8% in a cautious official medium-term scenario for 2010. In this context, exit from the crisis will be quicker than expected, and the Turkish government is not currently in search of any additional stimulus measures while many other countries are still adding new fiscal burdens to their public finances. Comprised of additional expenditures and mostly temporary tax rate cuts, the total stimulus package cost 3.3% of GDP in 2009, and the total fiscal burden of the package is gradually decreasing. Throughout the recent crisis, the Turkish government did not face a banking crisis, and there was no need to back up the financial sector. The nominal interest rate on the government's internal borrowing has been decreasing and stands currently at around 8%. According to the latest figures, the real interest rate of the total internal debt stock is below 1%. Taking all these achievements into account, credit rating agencies are on the verge of upgrading Turkey's credit rate to the investment grade.

All of these achievements are the result of a strong fiscal adjustment process, as evidenced by the fiscal space which enables the authorities to manoeuvre easily during a crisis. In the Turkish case, two main periods serve to illustrate this situation. The first period is the 1990s in which Turkey applied excessive deficit financing and experienced three big recessions mainly driven by public deficits. The second period covers the 2000s in which Turkey went through a serious fiscal transformation by means of a comprehensive reform agenda and adopted a tightened fiscal policy in line with certain overall fiscal limits. Between 2000 and 2008, Turkey implemented three stand-by agreements in collaboration with the International Monetary Fund. Moreover, alignment with the *acquis* of the European Union has always been a strong motive in creating a new fiscal management system.

In May 2008, Turkey finalised the 19th stand-by agreement, and the Turkish government chose to make its own way free from the IMF despite opposite expectations in the global economic downturn. In this process, the authorities initiated efforts to set up a new legally binding fiscal anchor for the general government sector with the aim of ensuring fiscal sustainability. Within this perspective, the draft Fiscal Rule Law was prepared and submitted to the parliament in the first half of 2010, and it is still on the agenda of the Turkish Grand National Assembly.

This article describes Turkey's fiscal performance and transformation over the last two decades, and tries to show a connection between fiscal stance and economic performance. In addition, implicit fiscal rules which have been applied in the 2000s and the draft Fiscal

Rule Law are examined. Turkish experience in this framework can serve as an example for other countries to draw lessons for their own public finances.

2. Fiscal stance and economic performance in the 1990s

Deficit financing is seen as a way of creating funds for a developing country with the aim of meeting social and physical infrastructure expenditures. However, in many developing countries – as is also the case in Turkey – there is a dilemma of limited domestic savings, and these countries (which do not have natural resources such as oil or natural gas) are generally dependent on external financing from the rest of the world since they are in a net importer position.

If deficit financing is applied excessively in this context, public deficits may have serious disruptive effects on the sustainability of the current account balance and, as an important component of the interest rates, the high risk premium will eventually make borrowing more costly. In this process, a high crowding-out effect on private investments may hamper economic growth. Thus, deficit financing as a political tool applied to promote development may itself turn out to be an obstacle to economic performance.

In the 1990s, the Turkish government applied a lax fiscal policy and an excessive deficit financing strategy in order to attain high growth performance. Till the end of this period, public deficits – which comprise the central government budget, local governments, the social security system, extrabudgetary and revolving funds, and state-owned enterprises (SOEs) – reached a peak of 11.7% of GDP.

Although the main determinant of declining public finances was the central government budget, the social security system and local governments – which initially had balanced budgets – also started to create deficits. Moreover, the management of public enterprises was totally irrational in the 1990s. The SOE system, which was seen as a practical way of implementing populist policies, ran a deficit of 1.2% of GDP on average.

Table 1. Fiscal outlook of Turkey in the 1990s

Per cent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public sector balance	-5.5	-7.5	-7.9	-7.7	-4.6	-3.7	-6.5	-5.8	-7.1	-11.7
General government	-2.5	-4.9	-4.9	-6.6	-4.3	-4.0	-6.6	-6.1	-6.2	-9.9
Central government ¹	-2.7	-4.5	-4.2	-5.7	-3.6	-3.5	-6.3	-5.8	-5.6	-9.3
Local governments	0.0	-0.2	-0.6	-0.5	-0.3	-0.2	-0.2	-0.2	-0.3	-0.3
Social security system ²	0.2	-0.1	-0.2	-0.4	-0.4	-0.3	0.0	-0.1	-0.3	-0.2
State-owned enterprises	-3.0	-2.6	-3.0	-1.0	-0.3	0.3	0.1	0.2	-1.0	-1.8
Public sector interest payments	3.8	4.6	4.6	6.2	8.1	7.1	8.7	6.7	9.6	11.5
Nominal interest rates	53.0	80.0	86.5	86.7	158.0	123.2	134.2	124.5	115.5	109.6
Interest payments as share of tax receipts	32.8	37.2	35.4	46.7	61.1	56.2	64.6	45.6	62.0	70.3
Public sector primary balance	-1.7	-2.9	-3.3	-1.5	3.5	3.4	2.2	0.9	2.5	-0.2
Public savings	2.6	0.7	-0.6	-0.7	-0.1	-0.1	-1.1	0.8	-1.4	-5.0
Saving-investment balance	-3.9	-5.0	-5.7	-6.1	-2.8	-2.9	-5.1	-4.2	-6.6	-10.0

1. Central government includes the consolidated budget, extrabudgetary funds and revolving funds.

2. The social security system includes social security institutions, the unemployment insurance fund and the general health insurance system.

Source: State Planning Organization of Turkey.

In this period, sustainability of the public finances was the primary concern for policy makers. The sustainability bias, political instability and institutional weaknesses resulted

in high borrowing costs. Nominal interest rates on domestic government borrowing were over 90% on average. Furthermore, throughout this period, government borrowing for the current year was always higher than the previous year's public debt stock (which brings to mind a well-known case of "Ponzi financing"). As a result of this deadlock, total interest expenditures paid by the public sector increased to 11.5% of GDP in 1999 (up from 3.8% in 1990). In addition, public sector interest payments as a ratio to tax receipts exceeded 68% at the end of the period.

As a consequence of this situation, public savings entered a negative phase starting in 1992. Declining public savings simultaneously resulted in the deterioration of the public saving-investment balance which ran a deficit of 10% at the end of the 1990s. Deterioration in the public saving-investment balance necessitated more external financing from the rest of the world in order to close the current account balance. Increasing dependency on highly mobile short-term external capital inflows increased the fragility of the Turkish economy.

The other important problem in Turkey in the 1990s was inflation. Lax fiscal and monetary policy together with a semi-independent central bank created an inflation rate of 60% on average. Inflation weakened Turkey's economic performance in many different ways. The most apparent was the instability of economic growth, as periods of rapid economic expansion alternated with periods of equally rapid decline in economic activity. However, the economic and social effects of inflation were much more far reaching. Growth rates were not only volatile but were also well below the average of the most successful emerging markets. By undermining confidence in the Turkish lira, inflation also resulted in high and unstable nominal and real interest rates, with dramatic consequences for society.

Speculative and arbitrage activities attracted more and more resources, and distorted the operation of financial markets and institutions. When the government had to pay real interest rates of over 30% for its debt stock, private capital moved away from job-creating activities into financial investments. When banks had to charge even higher real interest rates on their loans, the credit process was disrupted and enterprises that have limited access to external capital suffered. Ultimately, those who suffered most from a high inflation environment, high real interest rates, and unstable growth were the weaker segments of the population – those who could not invest in high-yielding assets and who have to rely on their payroll-based income.

Triggered by high volatility of short-term capital flows, uncertainties, and the sustainability of the public debt stock bias, Turkey experienced three major crises in the 1990s. The situation in the 1990s can be summarised below:

- Turkey could not achieve its development targets.
- Uncertainties created a highly volatile and fragile economic environment.
- Deficit financing without any pre-defined limits enabled governments to use resources for populist policies, and created a high crowding-out effect on private investments.
- The policy framework changed the economic behaviour of entrepreneurs and altered income source expectations from real investment returns to speculative gains.
- Inflation resulted in an unfair distribution of income, causing an excessive burden to fall on payroll-based workers.

Box 1. Institutional features of the fiscal management system in Turkey in the 1990s**A. Accountability and transparency**

- Limited scope of the budget: Only the so-called consolidated budget was submitted to the parliament, thus excluding a significant proportion of the total government expenditures. Approximately one-third of the general government expenditure was kept outside of the budget scope. Quasi-fiscal activities and contingent liabilities were totally disregarded, and not all external financing was included in the budget.
- Budget classification: A functional classification did not exist, and the programme-based classification which was initiated in the 1970s was not efficient. The budget classification was not compatible with international standards.
- Extrabudgetary funds: The number of extrabudgetary and revolving funds reached tremendous amounts. Total spending by means of funds was 3% of GDP on average in the 1990s.
- Public procurement system: Existing procurement procedures failed to prevent corruption and were far from efficient.
- Internal and external control: A rigid tradition of inspection hampered budget execution while providing little assurance of effective control or efficiency in the use of resources. The fragmented structure of various inspection boards resulted in a lack of co-ordination. External control had limited scope and technical capacity.
- Earmarking: By means of various legal arrangements, earmarking of revenues for certain expenditure programmes (so-called special revenues-special budget appropriations) reached significant amounts.
- Monitoring and reporting: Reporting on public accounts and debt management, which enables voters to assess the government's fiscal performance, was not sufficient.
- Tax expenditures: Tax exemptions and exceptions had broad coverage and a complicated structure due to numerous disorganised legal arrangements. The total fiscal burden of tax expenditures was not calculated.

B. Macro-level decision-making process and allocation of resources

- Multi-year budgeting: The consolidated budget was prepared on an annual basis and gave no indication of the consequences of current initiatives for subsequent years.
- Decentralisation: Agencies had little opportunity to access the policy formulation process. Line ministries were not provided with a binding ceiling in the budget preparation process. Therefore, the Ministry of Finance was the most powerful authority for determining the total budget appropriations and their allocation among various institutions.
- Decision-making process: Strategic decision making was neglected. There were no strategic plans or performance programmes for public agencies, and the link between development plans, annual programmes and the budget was missing. Since an efficient programme-based classification did not exist, the authorities could not make a sound assessment of expenditure programmes. Moreover, the highly volatile economic conjuncture discouraged policy makers from deliberating on longer-term horizons.

C. Social expenditures and government transfers

- Social expenditures: The budget had limited fiscal space for social policies. Interest payments increased to 40% as a share of total budget expenditures at the end of the period (as opposed to approximately 20% in 1990). Total unavoidable expenditures accounted for 80% of budget expenditures, thus undermining the quality of the budget and discouraging discretionary initiatives.
- Agricultural transfers: Agricultural transfers were mostly done as price and product supports.

Box 1. Institutional features of the fiscal management system in Turkey in the 1990s (cont.)**D. Social security system**

- Institutional structure: The social security system had a fragmented institutional organisation. There were three separate social security bodies: ES dealing with civil servants, BAG-KUR dealing with self-employed and employers, and SSK dealing with private sector employees.
- Populist decisions: Populist decisions, mostly on the early retirement age and amnesties, distorted the operation of the social security system and worsened the actuarial balances.

E. Public enterprises (state-owned enterprises)

- Economic activity: As a market leader/monopoly in oil refining, petro-chemistry, telecommunications, airlines, mining, energy production and distribution, iron and steel, and cement industries, the government was directly involved in economic activity.
- Populist decisions: Populist decisions (mostly on product/service prices and duty loss) worsened the financial balances of SOEs while distorting the operation of markets.

3. Fiscal consolidation, reforms and implicit fiscal rules in the 2000s

After experiencing severe and consecutive fluctuations in the 1990s, the need for a strong fiscal consolidation process supported by a strong reform initiative became unavoidable. In 1999, the Turkish government decided to implement a comprehensive economic programme in collaboration with the IMF. In this context, the government put the 17th stand-by arrangement into practice in December 1999.

Almost all stand-by arrangements designed and implemented with the support of the IMF have common objectives: a sound monetary policy with the aim of achieving price stability, which requires an operationally independent central banking system; privatisation; restructuring of the banking system; a comprehensive reform agenda which also covers the social security and health sectors; and a tightened fiscal policy to achieve sustainable public finances. In this framework, the core of the desired transformation is private sector oriented growth. Therefore the main priority of the fiscal policy is to increase funds in the total saving pool which can be used for private sector investments. To this end, the main emphasis is to decrease public borrowing requirements and debt stock by means of a high level of primary surplus together with privatisation proceeds.

When Turkey initiated the 17th stand-by arrangement in December 1999, there was a cloudy economic environment: the contagious Asian crisis and the catastrophic Marmara earthquake which affected the most industrialised region of Turkey with a 34.7% share in total GDP. Moreover, the banking system collapsed in the crises of November 2000 and February 2001. In these successive crises, 20 private banks declared bankruptcy, and a total cost of approximately EUR 15 billion was assumed by the Treasury in order to restore and stabilise financial markets.

As a result of an extraordinary liquidity shortage, interest rates rose to record levels. In December 2000, the Treasury annulled its internal borrowing auction due to the interest rate which was extraordinarily high and thus not declared to the public; and in March 2001, interest rates on internal government borrowing approached the level of 200%. Starting first in the financial sector, the crisis spread to the real sector and deepened. In 1999 and 2001,

the Turkish economy recorded real GDP growth rates of –3.4% and –5.7% respectively, which had a disruptive effect on tax performance.

Moreover, the terrorist attacks of September 2001 affected Turkey's foreign trade with neighbouring countries. Taking all these factors into consideration, a moratorium could have been seen as a foregone conclusion. However, the government put a series of austerity measures into practice and imposed new taxes starting from 1999. Together with privatisation proceeds and other one-off revenue collections, total returns from these new measures accounted for 3% of GDP in 2000. Thus Turkey achieved a high level of primary surplus in the first years of the 17th stand-by arrangement. In this framework, the primary surplus as a ratio to GDP was 4.3% in 2000 and 6% in 2001.

Except for the creation of a floating exchange rate regime as part of monetary policy, Turkey did not change its policy formulation throughout the crises. After the elections of November 2002, the new government continued its predecessor's policies. Turkey implemented three successive stand-by arrangements: the 17th stand-by arrangement (1999-2002), the 18th stand-by arrangement (2002-05), and the 19th stand-by arrangement (2005-08). Thus, the term “stand-by period” covers the time frame between December 1999 and May 2008.

Fiscal consolidation, which was the most significant component of the policy framework, was achieved through implicit fiscal rules and a strong reform initiative. In the stand-by period, Turkey employed all kinds of fiscal rules, among which the primary surplus rule was the most remarkable.

Thanks to the fiscal consolidation period, the public sector deficit of 12.1% of GDP in 2001 turned to surplus in 2005 and 2006. An average primary surplus level of 6% as a ratio to GDP was achieved between 2000 and 2008. This amount was equal to 3.8% according to the stand-by definition which was based on the GFS system (government finance statistics of the IMF). A certain amount of property sales, privatisation proceeds, mint revenues, dividend payments from state-owned banks, interest gains, central bank profits and the risk account were excluded in the calculation of the surplus together with some other minor adjustments. Privatisation revenues which were used as a below-the-line financing item amounted to approximately EUR 30 billion between 2000 and 2008. Total public sector interest payments decreased to 5.5% of GDP in 2008 from 18% in 2001. Interest rates were 19.2% in 2008, allowing the government to make borrowing auctions at a more reasonable cost.

In this framework, Turkey quickly decreased its debt stock to more sustainable levels. Calculated on the basis of European Union standards, the general government debt stock as a ratio to GDP decreased to 39.5% in 2008 (from 77.6% in 2001). As part of the pre-accession process, Turkey has fulfilled the Maastricht Treaty requirement regarding general government debt stock since 2004. Moreover, the public saving-investment balance was improved and public savings were positive, which enabled the private sector to use more funds for private investments. Thus the tightened fiscal policy encouraged private sector oriented growth.

In the first years of the stand-by period, there were several spending cuts on discretionary expenditure programmes. Some current expenditure items, wage and salary increases, and investments were seen as a primary source of possible savings. However, in the following years, the government found more fiscal space in the budget for alternative spending programmes as the weight of interest payments as a share of total central government

budget expenditures decreased to 22% in 2008 from 44% in 2000. In this framework, the government enlarged the scope of the health-care system, raised the wages and salaries of civil servants in the low-income group, accelerated government investment projects, increased social expenditures, initiated projects for rural development, and increased transfers to the real sector. In addition, the government had the opportunity to rearrange the income tax rate regime and the value-added tax in some sectors. Also, the corporate tax rate decreased to 20% from 33% and relieved the social security premium burden of employment for entrepreneurs. Thus social welfare in Turkey increased perceivably, and Turkey attracted more and more foreign direct investment as competitiveness increased.

Box 2. Implicit numerical fiscal rules in the stand-by period in Turkey

A. Deficit rules

- **Primary surplus rule:** The primary surplus rule was the backbone of the debt reduction strategy. The primary surplus of the public sector was monitored monthly in the programme reviews. With the aim of focusing on risky components of the public sector, a special definition of the so-called “consolidated government sector” was determined in addition to the national annual public sector statistics. Within this scope, the realisation figures of the central government budget, the extrabudgetary funds, the SOEs, the social security institutions, and the unemployment insurance fund were disseminated quarterly. In calculating the stand-by defined primary surplus, as well as other minor adjustments, some items were excluded: a certain amount of property sales, privatisation proceeds, mint revenues, dividend payments from state-owned banks, interest gains, central bank profits, and the risk account. Thus, an average adjustment of 2.2% was made as a ratio to GDP. In this context, an average primary surplus of 3.8% was attained between 2000 and 2008 in the public sector. While the primary surplus rule for the consolidated government sector remained unaltered throughout the stand-by period, alternative primary surplus targets for specific sub-sectors were determined.

B. Expenditure rules

- **Nominal ceilings for primary expenditures:** Annual nominal ceilings were determined for central government budget primary expenditures as a performance criterion in the 17th stand-by period. Annual nominal ceilings were applied in the 19th stand-by period for the central government budget and the total primary expenditures of the social security institutions.

C. Revenue rules

- **Revenue windfalls:** Windfalls due to revenue over performance were committed for saving.
- **Privatisations:** Privatisation proceeds were targeted nominally or as a ratio to GDP indicatively. In addition, this revenue source was mainly used as a below-the-line financing item, according to the debt reduction strategy.

D. Debt and borrowing rules

- **Short-term foreign debt stock:** Nominal annual ceilings were applied for short-term foreign debt stock.
- **Foreign borrowing:** Nominal annual ceilings were applied for foreign borrowing.

Table 2. **Fiscal outlook of Turkey, 2000-08**

Per cent of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Public sector balance	-8.9	-12.1	-10.0	-7.3	-3.6	0.1	1.9	-0.1	-1.6
<i>General government</i>	-7.3	-11.8	-10.8	-7.9	-4.1	-0.1	1.4	-0.2	-1.6
Central government ¹	-7.2	-12.4	-11.5	-8.4	-4.9	-0.8	0.7	-0.7	-1.8
Local governments	-0.3	-0.2	-0.1	-0.3	0.1	0.1	-0.1	-0.5	-0.6
Social security system ²	0.2	0.8	0.8	0.8	0.7	0.7	0.9	0.9	0.8
State-owned enterprises	-1.6	-0.3	0.8	0.6	0.4	0.1	0.5	0.1	0.0
Public sector interest payments	13.2	18.0	15.5	13.4	10.4	7.2	6.2	6.0	5.5
Nominal interest rates	36.2	99.6	62.7	46.0	24.7	16.3	18.1	18.4	19.2
Interest payments as share of tax receipts	74.0	96.8	90.9	75.8	59.8	40.2	34.1	33.2	31.5
Public sector primary balance	4.3	6.0	5.5	6.1	6.8	7.3	8.1	5.9	3.9
Public sector primary balance (IMF definition)	1.9	4.3	3.4	5.2	5.4	4.5	4.8	3.0	1.6
General government debt stock	n.a.	77.6	73.7	67.4	59.2	52.3	46.1	39.4	39.5
Public savings	-3.4	-7.1	-4.8	-4.1	-1.0	2.8	4.2	2.4	1.7
Saving-investment balance	-8.6	-11.2	-9.8	-7.8	-4.2	-1.2	0.6	-1.5	-2.5

1. Central government includes the consolidated budget, extrabudgetary funds and revolving funds.

2. The social security system includes social security institutions, the unemployment insurance fund and the general health insurance system.

Source: State Planning Organization of Turkey.

Reforms were the other dimension of the fiscal transformation. Irrespective of other specific legal arrangements, the public fiscal management system in Turkey was re-regulated by three main laws. The first, and the most important one, is the Public Financial Management and Control (PFMC) Law No. 5018 which was enacted in 2003 and fully in force by 2006. By setting the main framework of the fiscal management system, the PFMC Law established principles and merits, multi-year budgeting, budget scope, budget execution, performance management and strategic planning, internal control, accounting, monitoring and reporting.

The second important fiscal legislation was the Law on Regulating Public Finance and Debt Management No. 4749, enacted in 2002. This law set main procedures and principles, eliminated various disorganised legal arrangements on debt management and increased unity, determined pre-defined strategies for debt management, increased transparency with the help of standard reporting, and set boundaries for contingent liabilities.

Finally, the public procurement system was regulated by Public Procurement Law No. 4734, also enacted in 2002. In line with this legislation, the Public Procurement Authority was established, and effectiveness, transparency and competitiveness in the public procurement system were increased.

Box 3. Fiscal reforms in Turkey in the 2000s

A. Accountability and transparency

- Budget scope: As the PFMC Law was completely put into practice in 2006, the comprehensiveness of the central government budget was expanded: 33 institutions were included in the budget. In addition, local governments, extrabudgetary funds, revolving funds, and social security accounts were also attached to the budget memorandum. Contingent liabilities were shown in the budget as part of a newly established risk account, and all external financing was included in the budget.
- Budget classification: An analytical budget classification was established in 2004. This classification is based on international COFOG codes (Classification of Functions of Government) with administrative, functional and economical breakdowns.
- Extrabudgetary funds: The vast majority of extrabudgetary funds were abolished, leaving only five: privatisation fund, social solidarity fund, saving deposit insurance fund, defense industry support fund and promotion fund.
- Public procurement system: The public procurement system became more transparent and efficient. Outsourcing of services such as cleaning, security, transportation, consultancy, food and other supplementary services became more prevalent, rather than the employment of new personnel in the public sector.
- Internal and external control: The scope of external control was expanded, and the new internal control concept was initiated in line with the PFMC Law.
- Earmarking: In 2004, earmarking of revenues for certain expenditure programmes was abolished by Law No. 5217.
- Monitoring and reporting: Basic standards were determined for public accounts in line with international standards. Specific reporting formats were defined such as activity reports, fiscal position reports, debt management reports and borrowing strategy reports. Data coverage, periodicity and timeliness of the general government account were rearranged.

B. Macro-level decision-making process and allocation of resources

- Multi-year budgeting: The multi-year budgeting system was initiated in 2006 according to the PFMC Law. Starting the budget process, medium-term programmes (MTPs) have been prepared for a rolling three-year term, setting main principles and macroeconomic projections. On the basis of these MTPs, medium-term fiscal plans have been prepared by the Ministry of Finance in order to set the ceilings for budget proposals.
- Decentralisation: Agencies had more opportunity to lead their decision-making process. Strategy development units were created in line agencies and given responsibility for preparing strategic plans, performance programmes, budget proposals and activity reports, together with the function of improving the internal control system in the parent organisation.
- Decision-making process: A strategic decision-making system was put into practice. Agencies under the scope of the PFMC Law are now supposed to prepare their strategic plans and performance programmes.

C. Social expenditures and government transfers

- Social expenditures: The government had more fiscal space for alternative social programmes as the weight of interest payments in the budget decreased.
- Agricultural transfers: Agricultural transfers were mostly done as income support.

Box 3. Fiscal reforms in Turkey in the 2000s (cont.)

D. Social security system

- Institutional structure: Separate social security bodies were unified under the umbrella of the Social Security Institution.
- Retirement age: The retirement age was raised for a more sustainable actuarial balance.

E. Public enterprises (state-owned enterprises)

- Economic activity: The government completely withdrew from the sectors of textiles, milk, paper, forestry, mining, iron and steel, fertilizer, oil refining and distribution, petro-chemistry and cement. The government withdrew partially from telecommunications, airline industry, electricity production and distribution, sugar and meat production, and banking.

4. Attempts to adopt explicit fiscal rules

Fiscal rules, defined as numerical constraints on basic fiscal aggregates, set boundaries on the fiscal framework which governments commit to respect. In this context, fiscal rules are devised to resolve the conflict between economic and politico-bureaucratic rationality.

Fiscal rules have been employed in an increasing number of countries, and implicit fiscal rules have been seen as a means of fiscal consolidation in Turkey throughout the stand-by period. However, in order to determine a new fiscal anchor for the future, the Turkish government began to study the idea of permanent, legally binding fiscal rules when the stand-by period implemented with the collaboration of IMF came to an end.

After the 19th stand-by arrangement ended in May 2008, a new period in Turkish public financial management began. While most authorities expected the Turkish government to initiate a new stand-by arrangement with the IMF owing to the deepening global economic downturn, the government announced its new medium-term road map in which fiscal rules were enshrined. In September 2009, the Turkish government announced its Medium-Term Programme (covering the three-year period 2010-12) in which detailed features of the selected fiscal rule alternative were declared. This policy document was also considered as an exit strategy from the global crisis, with the fiscal rule assigned as the backbone of the sustainable fiscal policy.

Although the global economic crisis caused preparation to be prolonged and enthusiasm to be somewhat dampened, concentrated efforts were completed in the first half of 2010 and the draft Fiscal Rule Law was submitted to the parliament.

The draft Fiscal Rule Law comprises 12 articles, and in a broad sense it not only regulates the numerical design of the fiscal rule but also assigns responsibilities, clarifies the operation of the rule together with its basic parameters, and determines main principles and standard requirements for accounting, monitoring and reporting.

With reference to terms used in the literature, the selected fiscal rule alternative is a cyclically adjusted deficit rule for the overall balance of the general government sector. According to the draft law, the general government deficit is aimed to converge to 1% of GDP in the long term. In determining the current year's general government deficit ceiling, the numerical design of the fiscal rule takes into account the "deviation of previous year's deficit from the long-term target" and "deviations of GDP growth from the benchmark GDP growth rate". With the aim of supporting counter-cyclical fiscal policy, the fiscal rule seeks

to ensure convergence to the target deficit ceiling in the long term while making room for automatic stabilisers. Within this framework, central government budgets should also be prepared in line with the overall general government deficit targets for each year.

Box 4. The numerical design of the Turkish fiscal rule

$a_{(t)} \leq a_{(t-1)} - \gamma(a_{(t-1)} - a^*) - k(b_{(t)} - b^*)$ where:

$-\gamma(a_{(t-1)} - a^*)$ is the adjustment for the deviation of the previous year's deficit from the long-term deficit ceiling.

$-k(b_{(t)} - b^*)$ is the adjustment for the deviation of GDP growth from the benchmark GDP growth rate.

γ is the convergence pace coefficient.

$a_{(t)}$ is the general government deficit ceiling as a share of GDP for the current year.

$a_{(t-1)}$ is the previous year's general government deficit as a share of GDP.

a^* is the general government deficit ceiling target for the long term.

k is the cyclical adjustment coefficient.

$b_{(t)}$ is the real GDP growth rate estimation for the current year.

b^* is the real GDP growth rate benchmark.

As already mentioned, the general government sector in Turkey is composed of the central government budget, local governments, extrabudgetary funds, revolving funds, the unemployment insurance fund, the general health insurance system, and social security institutions. The draft Fiscal Rule Law also referred to the standards of the European System of Accounts (ESA95) in calculating the general government deficits. The general government sector was chosen as the scope of the fiscal rule for two main purposes: for coherence with the common EU requirements in line with the Maastricht Treaty; and for comprehensiveness, which is thought to improve the quality of public finances in a broad sense.

The long-term general government deficit ceiling [a^*] is determined as 1% of GDP by the draft Fiscal Rule Law, which means that the general government deficit will converge to it in the long term.

The general government deficit ceiling for the current year [$a_{(t)}$] is calculated by making two adjustments: the adjustment made by taking into account the previous year's general government deficit level, and the adjustment made by taking cyclical developments into account.

The adjustment for the previous fiscal year's deficit [$-\gamma(a_{(t-1)} - a^*)$] provides a gradual convergence to the long-term general government deficit ceiling. The coefficient [γ] determines the pace of gradual convergence. Mathematically, the coefficient [γ] can take values between 0 and 1 and, if it gets closer to zero, the speed at which the general government deficit converges to the long-term deficit ceiling will decrease and vice versa.

The government's enthusiasm or willingness is critical in determining the [γ] coefficient (the speed of convergence). In the draft Fiscal Rule Law, the value of this coefficient is determined as 0.33. In this way, 33% of the deviation of the previous fiscal year's general government deficit [$a_{(t-1)}$] from the long-term target of 1% is going to be compensated in the current fiscal year.

The cyclical adjustment part of the formula $[-k(b_{(t)} - b^*)]$ aims to reduce undesirable effects of cyclical fluctuations on the economy. Moreover, it seeks to ensure counter-cyclical fiscal policy. In this context, the cyclical adjustment coefficient $[k]$ is determined as 0.33 in the draft law. As a rule of thumb, it can be assumed that one percentage point deviation of real GDP growth creates a 0.33 percentage point increase or decrease in the general government deficit. Thus, this coefficient represents elasticity of general government expenditures and revenues in relation to the real GDP growth. The real GDP growth rate benchmark $[b^*]$ which will be the basis of the cyclical adjustment is determined as 5%. Therefore, the cyclical adjustment is calculated as 33% of the deviation of the current year's estimated real GDP growth rate from its benchmark value of 5%.

Depending on the current year's growth rate projection, the cyclical adjustment may increase or decrease the current year's general government deficit ceiling, which means that fiscal policy will be tightened when the estimated real growth rate is higher than the 5% benchmark, whereas the fiscal policy will be relatively loosened when the estimated growth rate is lower than the 5% benchmark.

Finally, the binding general government deficit ceiling for the current fiscal year is calculated by subtracting the cyclical adjustment and deficit adjustment from the previous year's general government deficit.

A simulation analysis will make it clear how the rule works. By using the data and projections published in the most recent Medium-Term Programme (covering the period 2011-13), general government deficit ceilings for 2011, 2012 and 2013 can be easily calculated. However, before making calculations there is one point which needs to be clarified. According to the draft Fiscal Rule Law, the general government deficit calculation will be based on the ESA95 definition, but ESA-defined general government data have not yet been published. Therefore, the overall general government deficit excluding privatisation proceeds is used in this simulation analysis (see Table 3).

Table 3. Simulation of the Turkish fiscal rule

Per cent of GDP

		2011	2012	2013
Previous year's general government deficit	$a_{(t-1)}$	4.0	3.2	2.5
Cyclical adjustment coefficient	k	0.33	0.33	0.33
Convergence pace coefficient	γ	0.33	0.33	0.33
Real GDP growth rate estimation for the current year	$b_{(t)}$	4.5	5.0	5.5
Real GDP growth rate benchmark	b^*	5.0	5.0	5.0
General government deficit ceiling target for the long term	a^*	1.0	1.0	1.0
Deficit adjustment	$-\gamma(a_{(t-1)} - a^*)$	-1.0	-0.7	-0.5
Cyclical adjustment	$-k(b_{(t)} - b^*)$	0.2	0.0	-0.2
Total adjustment		-0.8	-0.7	-0.7
Current year's general government deficit ceiling		3.2	2.5	1.8

In the most recent Medium-Term Programme (covering 2011-13), the ratio of the general government deficit to GDP is expected to be 4% in 2010. As mentioned before, the general government deficit ceiling in the long term $[a^*]$ is determined as 1% of GDP, and the

convergence pace coefficient of the deficit is determined as 0.33. This means that 33% of the difference between 4% and 1% will be compensated in 2011. Therefore the deficit adjustment is calculated as 1% of GDP in 2011.

While calculating the cyclical adjustment in line with the Medium-Term Programme projections, we saw that fiscal policy will be loosened, as the real GDP growth rate projection of 4.5% is below the benchmark level. In this way, the government will have the opportunity to increase the deficit by as much as 33% of the growth rate deviation. Therefore the cyclical adjustment is calculated as 0.2% of GDP in 2011.

Finally, the total adjustment is -0.8% of GDP, and the general government deficit ceiling is 3.2% of GDP in 2011 according to the formula.

In 2012, since the growth rate projection is equal to the benchmark level, the cyclical adjustment is zero. Similar to the year 2011, the formula suggests a fiscal tightening in 2013 owing to the cyclical developments in 2013.

Within this framework, growth rate projections will have a critical role in practice. If growth rate projections deviate too much from realisations, the cyclical adjustment component of the formula will be unrealistic. Taking the structural characteristics of Turkey into consideration with sharp booms and busts, the deviation will unavoidably be high in some periods. In addition to aiming for accurate projections, it is also important to allow prudence margins which will give policy makers enough flexibility to respond to unanticipated developments. There is no provision in the draft law on prudence margins, but neither is there any provision preventing them.

In addition to the general government deficit rule which could be considered as the backbone of the draft Fiscal Rule Law, there are also two other rules on budget balance. According to these two supplementary fiscal rules, revolving funds should have a balanced budget and the SOE system as a whole should not create borrowing requirements.

The draft Fiscal Rule Law also proposes that the Medium-Term Programme prepared by the State Planning Organization and the Medium-Term Fiscal Plan prepared by the Ministry of Finance be combined under the name of “Medium-Term Programme and Fiscal Plan”. This document is going to be the new basis of multi-year budgeting and fiscal rule implementation, and will include the general government deficit ceilings.

In order to ensure healthy monitoring and evaluation of the fiscal rule, general government data will be published quarterly, and the realisations of the fiscal rule will be announced to the public in the Fiscal Rule Monitoring Report by the Ministry of Finance by the end of April after the closing of each fiscal year. In this context, however, an independent monitoring authority which will be responsible for checking compliance with the fiscal rule is not foreseen in the draft law.

The Turkish Court of Accounts (TCA) is assigned as an audit authority to check accounts and their conformity with international standards. Moreover, the Plan and Budget Committee of the Turkish parliament will be informed about targets, updates and deviations in this process, thus increasing the accountability and transparency of the government.

5. Conclusions

Turkey made significant progress in fiscal management throughout the 2000s, both quantitatively and qualitatively. However, there is still much to be done in order to achieve the goal of a fiscal system that is governed more responsibly and transparently. The strategic management framework is still inadequate, since agencies try to interpret the system on the basis of the traditional input-oriented approach. Moreover, it is vital to establish a sound programme-based monitoring infrastructure together with a fully functioning internal control system in order to supervise performance outputs. Decision making is not based on a functional classification in the budget process, and there is still a missing link between nationwide policy documents and individual agency priorities. Therefore, the authorities should focus on the efficiency of implementation of legislated reforms in the forthcoming periods.

Irrespective of existing institutional deficiencies, and beyond the other progress in the reform agenda, fiscal consolidation itself created a significant transformation in the 2000s. First, the government had more opportunity to focus on social and physical infrastructure, as the interest burden of the budget lessened. In this context, total general government social expenditures (previously just below 10% of GDP) are now over 17%. Moreover, average completion time of the total investment programme is now around 4.5 years (12.5 years in 2001). In addition, fiscal space created through fiscal consolidation enabled the government to manoeuvre easily in the last global crisis. The general government deficit, which unavoidably reached 5.5% of GDP in 2009, is estimated to decrease to 1.1% of GDP in 2013; and the general government debt stock (which was 45.5% of GDP) is projected to decrease to 36.8% of GDP in 2013.

The second and maybe most important contribution of fiscal consolidation has been with regard to the real sector. Fiscal consolidation in the 2000s contributed to private sector oriented growth. Severe and consecutive fluctuations in the 1990s discouraged entrepreneurs from taking risks in the face of uncertainties. Therefore, the real sector found that speculative gains were the most secure and reasonable way of making profit due to the high interest returns of government borrowing. This phenomenon affected the mentality and perception of society, where economic agents mostly focus on the short term, and planning for the future was seen as futile. Taking all these factors into account, it could be said that the crowding-out effect of the policy chosen in the 1990s was rather far beyond the numerical results.

Keeping in mind that rules are more effective when they are put into force after basic fiscal consolidation is completed, and that a rule should not be introduced in an environment of heightened macroeconomic uncertainty, a fiscal rule which is designed to serve as a new anchor in fiscal policy will most probably be put into practice in Turkey as soon as the clouds of the current global economic crisis have completely dissipated. The selected fiscal rule alternative in Turkey is aimed to support ongoing reforms by means of its standard requirements for accounting, monitoring and reporting. Moreover, it will support counter-cyclical fiscal policy through its flexibility in the face of conjunctural changes. Therefore, the fiscal rule will determine the boundaries of discretionary fiscal policy in Turkey in the near future.

References

- European Commission (2006), *European Economy* No. 3/2006: Public Finances in EMU 2006, Office for Official Publications of the European Communities, Luxembourg, http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm.
- European Commission (2008), *European Economy* No. 10/2008: Public Finances in EMU 2008, Office for Official Publications of the European Communities, Luxembourg, http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm.
- Government of Turkey (2008), "Medium-Term Programme 2009-2011", Undersecretariat of the State Planning Organization, Ankara (also published in the *Official Gazette* No. 26920).
- Government of Turkey (2009), "Medium-Term Programme 2010-2012", Undersecretariat of the State Planning Organization, Ankara (also published in the *Official Gazette* No. 27351).
- Government of Turkey (2010a), "Medium-Term Programme 2011-2013", Undersecretariat of the State Planning Organization, Ankara (also published in the *Official Gazette* No. 27725).
- Government of Turkey (2010b), "Annual Programme 2011", Undersecretariat of the State Planning Organization, Ankara (also published in the *Official Gazette* No. 27732).
- IMF (2009), "Fiscal Rules – Anchoring Expectations for Sustainable Public Finances", *IMF Policy Paper*, December, Fiscal Affairs Department, International Monetary Fund, Washington DC, www.imf.org/external/np/pp/eng/2009/121609.pdf.
- Kaya, F. (2009), "Implementation of Fiscal Rules and the Turkish Analysis", Planning Expertise Thesis submitted to Undersecretariat of the State Planning Organization, Ankara.
- Kaya, F. (2010a), "Kamu Maliyesi Yönetiminde Yeni Dönem: Yasal Mali Kural Uygulamalarına Geçiş", pp. 406-421 in C. Aktan, A. Kesik and F. Kaya (eds.), *Mali Kurallar*, Ministry of Finance, Ankara.
- Kaya, F. (2010b), "Türk Kamu Mali Yönetiminde Örtük Mali Kurallar ve Ülke Tecrübelerinin Değerlendirilmesi", pp. 380-405 in C. Aktan, A. Kesik and F. Kaya (eds.), *Mali Kurallar*, Ministry of Finance, Ankara.
- Kopits, G. (2001), "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament", *IMF Working Papers* No. 01/145, September, International Monetary Fund, Washington DC, www.imf.org/external/pubs/ft/wp/2001/wp01145.pdf.
- Kopits, G. and S. Symansky (1998), "Fiscal Policy Rules", *IMF Occasional Papers* No. 162, July, International Monetary Fund, Washington DC.
- OECD (2007), "Fiscal Consolidation: Lessons from Past Experience", Chapter 4 in *OECD Economic Outlook* 81, June, OECD Publishing, Paris.
- OECD (2010), *OECD Economic Surveys: Turkey*, Volume 2010/13, OECD Publishing, Paris.
- Republic of Turkey (2009), "Pre-accession Economic Programme 2009", Undersecretariat of the State Planning Organization, Ankara.
- Schick, A. (2003), "The Role of Fiscal Rules in Budgeting", *OECD Journal on Budgeting*, 3(3):7-34.
- World Bank (2001), "Turkey – Public Expenditure and Institutional Review: Reforming Budgetary Institutions for Effective Government", *Economic Report* No. 22530-TU, August, The World Bank, Washington DC.

Reforming the Budgeting Process in China

by

Shulian Deng and Jun Peng^{*}

Despite many reforms implemented in China's public financial management over the past ten years, China's public budget still exhibits a glaring lack of accountability, most evident in the gap between the adopted budget and the final budget. This article examines the role played by public budgeting in ensuring good governance, and establishes a framework for how the legislature ensures accountability in the public budgeting process. The existing problems in the Chinese public budgeting process are analysed, and suggestions are made for reforming the budgeting process based on the outlined framework.

JEL classification: H610

Keywords: China, public financial management, public budget, budget process, government accountability, role of the legislature

^{*} Shulian Deng is associate professor and assistant dean in the School of Public Economics and Finance, Shanghai University of Economics and Finance. Jun Peng is associate professor in the School of Government and Public Policy, University of Arizona, and in the School of Public Economics and Finance, Shanghai University of Economics and Finance.

1. Introduction

The public budget, serving as a reflection of the collective public interest and as a legal constraint on government spending, is an effective tool in ensuring good governance and public interest. Within the first 30 years after the establishment of the People's Republic of China in 1949 – a period that was dominated by a planned economy – even though the Chinese government had a budget, this role of the public budget was nowhere to be found. The most important financial management tools at the time were mandatory plans, executive orders and rigid administrative control over state-owned enterprises. In that era, the public budget played a subsidiary role to the planned economy.

Since 1978 when China adopted the policy of “reform and opening”, the planned economy was gradually being dismantled and its commanding role in determining resource allocation was also being eroded. While the government's role in economic planning has been on the decline, its role in the provision of public goods and services to the general public, however, has taken on more prominence. The change in the role of government has also raised awareness about the role the budget plays in resource allocation and public management. This led to a series of budgetary reforms in China. The reforms started with the Chinese Budgetary Law, a brand new law specifically on the budget, which was passed in 1994.¹ In 2000, a departmental budget reform was begun to increase the government's control over the budget and budgetary transparency. In 2001, a centralised treasury management system was instituted. The aim was to provide a system that allows for sharing of fiscal information in the areas of budget formulation, economic and revenue forecasting, disbursement, cash management, and state asset and debt management. A State Procurement Law was passed in 2002, with full implementation beginning in January 2003. The law was intended to make procurement more centralised and transparent, and to reduce corruption. In 2005, another reform was implemented to institute a new classification system for revenue and expenditure in the budget. This series of budgetary reforms was aimed at establishing a mechanism for controlling and promoting the more efficient use of public funds. Since the implementation of various reforms, some positive – albeit limited – results have been achieved in setting up a basic infrastructure for a modern budget system, process and rules (Wong, 2007). Departments directly affiliated with the government have annually submitted their departmental budgets to the legislative body, something they were not required to do in the past. Budget classification has become more detailed and more in line with international practice, thus bringing some transparency to the budget. There has also been some improvement in the comprehensiveness of the budget by decreasing the number of funds that are beyond the normal budgetary process.

Despite all the achievements, the limitation of these reforms has become ever more evident. The most serious issue with all the reforms so far is that they have not turned the budget into a legally binding document on the government in terms of revenue collection and spending. This lack of any budgetary legal authority is evident in several aspects: there is a consistently wide gap between the original budget approved by the Chinese legislature (the National People's Congress) and the final budget; substantial additions

and subtractions are made by the government to the original budget figures without the approval of the legislative body, and funds are used for purposes other than those approved by the legislature; there is also rampant corruption and misuse of public funds for personal benefit. Such evidence clearly demonstrates the inadequacy in controlling government spending and the fact that budgetary reform has a long way to go in China before the public budget can play a role in society as intended. This article presents a framework for furthering budgeting reform in China that will enhance the role of the public budget in managing a modern society.

The article is divided into three sections. In Section 2, the importance of the public budget is discussed along with the role played by the legislature in the budgeting process in terms of accountability. In Section 3, problems in current Chinese budgeting practice are discussed, and then the reasons for the budgetary problems are analysed. In Section 4, recommendations are presented on how to build a framework to improve Chinese budgeting practice.

2. Public budgeting, process and legislative role

In this section, we provide a general theoretical framework for the public budgeting process, which will be used later to analyse the budgetary issues in China. We first examine the role of public budgeting and the role of the legislature in public budgeting. Second, we discuss how the role of the legislature is fulfilled in the budgeting process. Third, we review the literature on the worldwide trend in legislative budget activism.

2.1. The roles of public budgeting and the legislature in public budgeting

Public finance is a political system by which a society decides the kind and level of resources that should be collected as well as the kind and level of public goods and services that should be provided, and ensures that the resources are used as intended. The outcome of this decision process is the government budget. The budget is the single most important policy vehicle for government. It is an instrument that reflects government priorities and citizens' preferences (Rubin, 2006).

One of the most fundamental principles of public finance is the separation of the ownership of, decision making on, and management of public funds. Public funds belong to all taxpayers (collectively the entire society); the decision making on how the funds should be used resides with the legislative body elected by the taxpayers; and the management of the public funds is carried out by the government. The reason for the separation of ownership and decision making is that direct decision making by taxpayers on every issue is practically impossible and simply too costly; and the reason for the separation of decision making and management is to avoid the opportunism in a fiduciary relation, so that those who decide how the funds should be used and those who actually use them are not the same people. This separation of ownership from management, however, also introduces the principal-agent relationship and all the issues related to this relationship. Accountability becomes the paramount issue in terms of protecting the principals' interest. Therefore, prerequisites for the safeguard of the public interest are that the legislative body – considered in this case to be the guardian of the taxpayers' purse – has the final decision-making authority in a budget before it can be executed by the government, and that a budget so approved by the legislature is legally binding on the government. In this sense, the budget is a legal contract between the government and the legislature about what

the government should do in the new fiscal year (Wildavsky and Caiden, 2004), and the budget is a powerful tool of accountability for citizens to know how the government spends their money (Rubin, 2006; Lee, Johnson and Joyce, 2008). Henceforth, in theory at least, the legislature constitutes the most important element of external accountability to society in public financial management.

While the rationale for legislative involvement in public budgeting is clearly established, the next question is: what does the legislature need in order to fulfill its responsibility? Literature on legislative budgeting has identified three key elements in the institutional arrangements of the legislature that will make this possible: legal authority, organisational structure and capacity.

- **Legal authority:** for the legislature to have any real power in the budgeting process, the constitution or other statute should clearly state that the legislature has the authority to amend the budget submitted by the government and set the parameters of the amendment power, such as whether the legislature can revise the spending up or down.
- **Organisational structure:** to make the legislative budgeting process efficient and effective, a committee structure also needs to be in place. The most generic format of this committee structure has two components: a central committee component, with a budget or finance committee responsible for overall budgetary matters; and a subcommittee component, with multiple subcommittees responsible for various policy areas. This allows the legislature to have both control over the overall budget process and more specific in-depth inquiry into various government programmes.
- **Capacity:** the legislature also needs to have the capacity to analyse the government's budget. This capacity is dependent on three factors: time, information and expertise. First, the legislature needs a sufficient amount of time to review and analyse the government's budget proposal, especially at the central government level where the budget tends to be large and complicated. Second, the legislature also needs to have the necessary information on the cost of government programmes. The legislature can collect such information in two ways, either by itself or through some institutional arrangement with the government for sharing information. Third, the legislature also needs its own staff with substantial knowledge in specific programmes to review the government budget. Legislators simply do not have the time needed to review the entire budget by themselves. If any one of these three factors is absent, then a substantive review of the government budget is unlikely.

According to a report of the National Democratic Institute for International Affairs (Gustafson, 2003), most legislatures have between two and four months to deliberate on and pass the annual budget; most legislatures that are active in the budget process have strong and active committee systems, including vesting principal responsibility in a budget or finance committee or sharing power with multiple committees; and adequate staff and technical expertise are also critical for legislatures to fulfill their constitutional responsibilities. Stapenhurst (2004) also discusses five reasons why the legislature is not active in some countries, and two of the reasons are the absence of legislative budget research capacity and of specialised budget committees.

2.2. The budgeting process

The budgeting process should thus reflect the nature of public budgeting and the role played by the legislative body in terms of its decision-making and oversight authority.

The budgeting process can generally be divided into four stages: preparation, review and adoption, execution, and financial reporting and auditing. What follows is a brief discussion of each stage to see how the legislature exercises its control and oversight authority on the government in the public budgeting process.

2.2.1. The preparation stage

For practical reasons, it is widely acknowledged by budgeting experts and researchers that the initial preparation of a budget for a new fiscal year is best left to the government. The government is at the front line of providing goods and service and thus has a more intimate knowledge of the cost; and the government has more time and the whole bureaucracy to put the budget together. There are very few countries in which the legislature has the ability to put together a budget from scratch on its own without much help from the government.

In budget preparation, on the revenue side, the government forecasts revenue collection from every revenue source, and should detail in the budget proposal what it expects to collect from all sources. On the spending side, the government should also forecast spending for every single programme, large and small. The budget should detail spending for each agency as well as each office within each agency: number of positions, salaries and other administrative costs. The purpose of this level of detail in the information presented is to make it possible for the legislature to review and oversee government spending.

2.2.2. The review and adoption stage

Once the budget is prepared and submitted to the legislature, the legislative budgeting process begins. In this stage, the legislature will do a number of things to exercise its decision-making power: review the executive budget, gather more budget information from the government, seek public input about the budget through public hearings, revise the budget based on the legislative priorities, and finally pass the budget. The revisions to the budget include adding new legislative programmes, or adding to or subtracting from current spending for a particular programme proposed by the government. This ability to revise the budget lies at the heart of legislative oversight and decision-making power.

2.2.3. The execution stage

During the execution stage, the legislature exerts its oversight power over the government mainly in two ways: periodic reporting and revision to the adopted budget.

Once the budget is passed, it is legally binding on the government. The government will execute the budget and cannot make any changes to the budget without legislative approval. However, changes to the adopted budget are inevitable over the course of the fiscal year. These changes happen due to both revenue and spending. On the revenue side, as revenue collection is dependent on the underlying economic activity, the actual revenue collection will be different from projections. When there is a revenue shortfall, a deficit results, thus necessitating spending cuts or a revenue increase, if there is a balanced budget requirement. When actual revenue exceeds projected revenue, a budget surplus results, which can either lead to a spending increase or to savings by being put into a reserve for future use. All these actions that will result in changes to the adopted budget will require the approval of the legislature. On the spending side, as the spending figure in the adopted budget is also a projection of what the government plans to do in the future, the actual spending can also be somewhat different from the projected spending. First, the

government may have to spend more on a certain programme due to a legal requirement, such as more spending for welfare programmes during an economic downturn. Second, the government may find that it needs more money for some spending item but less money for others – for example, more money for travel but less money for office equipment. Changes therefore need to be made to the adopted budget by adding to or subtracting from certain programmes, or by a transfer of funds between programmes or within a programme. Again, all these changes will require specific legislative approval in order to take place.

A prerequisite for such legislative changes to the adopted budget over the course of the year is a periodic financial report from the government. Such periodic reporting (monthly, quarterly, and semi-annually) covers actual revenue collection and spending, as well as comparison with projected revenue and spending up to that point. Only in this way can the legislature and the public know if the budget is executed according to the plan and if any legislative actions are needed to deal with an emerging deficit or surplus.

Because of the inevitable changes, the final budget will certainly be different from the adopted budget. While such changes are inevitable, there are ways to minimise the size of the variance. First, the government can do a better job in forecasting both revenue and spending. This entails using advanced scientific models in projecting the economic growth, revenue growth and spending growth. Second, there should be a sizeable reserve fund to cover unanticipated fiscal events and thus avoid reduction in existing programmes to eliminate the deficit. If budget preparation is solid from the start, absent serious disruption to the economy, any changes to the adopted budget should be relatively small.

2.2.4. The financial reporting and auditing stage

Once the fiscal year ends, the government should present a comprehensive report on the results of its financial operation over the past year. To show its accountability to the public and the legislature, the government should not only report the final revenue and spending figures, but also compare them to their counterparts in the adopted budget and provide explanation on any major discrepancies between the two. This comparison should be for both revenue (breaking down into all major revenue sources) and expenditure (breaking down into all the major programmes or government departments). The purpose of this comparison is to hold government accountable to the budget adopted at the beginning of the fiscal year. In addition, the government should also provide a comprehensive account of its assets and liabilities, and whether the assets and liabilities have increased or decreased after one year's financial operation. This provides a long-term perspective on the fiscal health of the government. To be credible, this comprehensive financial report also needs to be independently audited by an agency outside the government. The legislature should also conduct its own audit of government spending to see if it is what it is said to be.

In this ideal budgeting framework, government action is constantly subject to legislative oversight and control through the budgeting mechanism. The legal authority for the public budget imposes firm constraint on government financial discretion so that the outcome reflects the collective wish of the majority of taxpayers.

2.3. The worldwide trend

Despite the theoretical underpinning of the importance of the legislative role in the public budgeting process, the legislature has not been playing as active a role as expected until more recently (Schick, 2002; Posner and Park, 2007). One important reason for the

relative hands-off approach by the legislature is the growth in the size of the state and of the complexity of its structures, financing mechanisms and expenditure agendas, which makes it increasingly difficult for the legislature to get a full picture of the government and to assess individual proposals for both spending and revenue.

This situation, however, has started to change over the last 20 to 30 years. A survey by the OECD (1998) found that there is a growing number of countries in which the legislature plays an increasingly active role in budget processes – by creating special budget committees with expertise in budgets and supported by legislative staff, by obtaining better information from the government on spending proposals and implementation, and also by becoming more active on the monitoring and audit side. Fölscher (2006) also found that more than a quarter of countries have revised their constitutions over the previous 15 years to give the legislature more powers.

Among developed countries, the best example of this trend can be seen in the United States. In 1974, the Congress passed the Congressional Budget Act of 1974. It established the Congressional Budget Office (CBO), a nonpartisan budget staff office to help the Congress in budgetary matters. Over the years, the CBO has grown into a very authoritative source of budget information, allowing the Congress to put together a budget on its own. In France, the National Assembly initiated a wide-ranging budget reform, including a reclassification of the budget, in order to support legislative oversight and an expansion of powers to amend expenditures (Stapenhurst, 2004).

In developing and transition countries, too, there is a trend toward legislative budget activism. In most Latin American countries, the government used to dominate the budget process, and legislatures largely served as “rubber stamps”. As Santiso (2004) points out, the financial reform in many Latin American countries occurred in two rounds. In the first round, Latin American countries undertook efforts to upgrade their public finance management and financial information systems to improve efficiency within the government. However, little attention was paid to the issue of accountability in budget management beyond the executive branch. In the 1990s, many Latin American countries introduced constitutional reforms to clarify and expand the power of the legislature with regard to the public budget (Petrei, 1998). For example, in Argentina, the Congress has the right to modify the total spending and debt amounts, and to make decisions that involve changes to the purposes for which the funds are to be used. If Congress increases the budget proposed by the executive branch, it must indicate the financing sources.

Recent changes in African practices concerning budgets and legislatures reflect similar trends. Legislatures have become more vocal in their oversight roles, holding members of the executive publicly to account through strengthened committees. South Africa and Uganda have passed acts on financial administration or the budget which give more influence to the legislature during the budget formulation and approval processes (Stapenhurst, 2004). In Eastern Europe, a notable example reflecting this trend is Poland. In 1997, a new constitution gave the Polish House of Representatives broad power to increase or decrease spending and revenues in the executive’s budget. The only limitation is that the changes may not increase the budget deficit (or decrease the surplus) proposed by the executive (Gustafson, 2003). To increase the legislature’s budgeting capacity, a research analysis unit was established in 1991 with six employees. By 1995, the number of staff had increased to 12, and the unit also contracted with the academic world to provide analytical services, thus substantially increasing the legislature’s ability to undertake in-depth analysis of the government budget (Stapenhurst, 2004).

3. Current issues with Chinese budgets

Although, on the surface, the overall public budgeting process in China looks somewhat similar to the framework discussed above, it deviates from it by a wide margin in substance. The most important result of this deviation is the huge discrepancy between the adopted budget and the final budget. In this section, we first present some evidence of this discrepancy, and then we analyse the budgeting process to search for reasons behind the discrepancy.

3.1. Existing problems

The most serious issue in China's budget that is easily observable is the huge gap between the adopted budget and the final budget. Such discrepancy is evident in both revenue and spending.

3.1.1. Revenue

In terms of revenue, since 2000 the Chinese central and local governments have consistently underestimated revenue growth by a substantial margin, as can be seen in Table 1.

Table 1. **Revenue growth estimates (per cent)**

	Budgeted growth	Actual growth	Actual versus budgeted growth
2000	8.4	16.9	201.20
2001	10.3	22.2	215.53
2002	7.7	15.4	200.00
2003	8.4	14.7	175.00
2004	7.0	21.4	305.70
2005	11.0	19.8	180.00
2006	12.0	22.4	186.67

Source: Ma, Caichen (2007), *Government Budget*, Northeast Publishing House, China.

While underestimation of revenue by itself is not a major concern (and one may even argue that this is a result of unprecedented economic growth over this period), consistent underestimation over many years indicates either very poor budgeting and forecasting skills, or a deliberate underestimation of revenue collection. Even though consistent underestimation of revenue collection by itself is not a major concern (again it can be argued that more conservative estimation of revenue is conducive to the long-term fiscal health of the government), it poses a serious problem for the integrity of the budget if the resulting surpluses fall outside the purview of the public budget. Unfortunately, this happens to be the case in China. The governments at all levels never explain how the surplus is treated, and there is every indication that such a surplus is spent in the year to boost spending beyond what is budgeted. It has been estimated that the correlation between a revenue surplus and additional government spending is as high as 95% (Sun and Tan, 2007). Such additional government spending is completely free from any legislative review and approval, and is thus utterly at the discretion of the government itself.

3.1.2. Spending

Deviation from the spending budget also runs deep and wide. This is shown in two main aspects: the budget office that allocates funds and the agencies that use the funds.

In China, the main agency that controls budget allocation at the central level is the Ministry of Finance (MoF). Since China's National Audit Office started auditing government agencies, it discovered year after year that the MoF either allocated more than the budgeted amount or did not allocate the fund set in the budget. For example, in 2006, the National Audit Office found that the MoF allocated to government departments an additional CNY 81.75 billion (Yuan renminbi) above the budgeted amount that had been approved at the beginning of the year, accounting for 12.5% of the approved budgeted amount (Li, 2007). Such additional allocation could be a result of the additional revenue mentioned above. From 2004 to 2006, the MoF was to allocate CNY 5.5 billion as subsidies to employees laid off from state-owned enterprises. In reality, it allocated CNY 285 million, accounting for only 5.2% of the budgeted amount (Li, 2007). These and many other changes from the approved budget were executed without any involvement of the Chinese legislative body.

The auditing of government agencies' budget execution also uncovered similar disregard of the budget. For example:

- In 2005, the National Audit Office found that the use of CNY 5.5 billion was in violation of the budget approved at the beginning of the year. Nine departments requested and received CNY 176 million over the budgeted amount (Li, 2006).
- In 2006, the use of CNY 35 billion was in violation of the budget, and 95% of that amount was due to mismanagement, such as transfer of allocations from their originally intended programmes (Li, 2007).
- In 2007, close to CNY 30 billion was misused, and mismanagement accounted for 98% of that amount (Li, 2008).

What is hidden in these audits and almost impossible to quantify is the level of corruption and waste of public funds. The amount of public funds used on official entertainment (such as banquets, gifts for the purpose of official bribes, international travelling for pleasure) is incalculable. These funds are spent purely for the government officials' personal benefit without any regard for public interest.

3.2. Reasons for budgetary problems

The main reason for all these problems is that the Chinese legislature, the National People's Congress (NPC), lacks substantive budgeting authority, due to many of the factors mentioned earlier.

- The NPC does not have the authority to amend a budget submitted by the government. As discussed earlier, the ability to revise a budget is the key to whether the legislative body has the final decision-making authority regarding a budget to safeguard the public purse. Even though the Chinese Constitution and the Budgetary Law bestow on the NPC the authority to review and approve the initial budget and the final budget, they do not elaborate on what this authority entails or whether the NPC can revise the budget. Therefore, legally it is not guaranteed that the NPC can revise a budget. As a matter of fact, since the establishment of the People's Republic of China, central and local government budgets have hardly ever been revised.
- The overall budgetary approval process also makes it impossible for the legislative review to be of any significance. This is because the budget year starts on 1 January whereas the NPC does not convene until early March, and later for people's congresses at the local level. By the time the budget is approved by the NPC, almost three months of the budget year have already elapsed. In other words, the government operates without a budget for

almost one-quarter of the fiscal year. At the local level, this kind of “budgetary vacuum” can last as long as half a year. The Budgetary Law stipulates that, during the period of “budgetary vacuum”, the government can operate on the basis of last year’s budget up to that point and then operate under the new budget when it is approved. In reality, such stipulation has very little effect in constraining government spending without any specific regulation and oversight. The “budgetary vacuum” severely diminishes the authority of legislative review and the legality of the budget in constraining government spending.

- The initial budget submitted by the government to the NPC is not comprehensive and lacks details. As a result, the NPC does not have enough information to evaluate the government budget. There are three problems with this information disadvantage. First, the government has a total monopoly on budgetary information. In a principal-agent relationship, the agent has a strong motive to use the information advantage for personal benefit. The NPC has no way of evaluating the accuracy of the information provided by the government, and its ability to review the government’s budget is thus completely controlled by the government. Second, the information contained in the budget is incomplete. The budget contains only part of government spending. Some extrabudgetary revenue and spending are not included in the budget submitted to the NPC and are thus outside public purview and oversight. Gao (1999) estimated the size of extrabudgetary funds to be 11-12% of Chinese GDP. Third, even for the part submitted to the NPC for review, the budgetary information is too general to be of any use. The information includes some verbal description and some summary tables on revenue and spending. Such a lack of detailed information makes it impossible to evaluate the overall budget, departmental budgets and individual projects, in terms of efficiency and effectiveness in resource allocation. Therefore, even if the Budgetary Law requires that changes to the budget be approved through the legislative process, the lack of detailed budget information renders this requirement all but meaningless in both theory and practice.
- The legislative committee does not have sufficient time and capacity to review the budget. The Finance and Economics Committee (FEC), a legislative committee within the NPC, is responsible for budgetary issues, among many other finance and economic issues.² The FEC consists of 32 NPC members, with only a handful responsible for budgetary matters. A subcommittee under the FEC, called the Budgetary Work Committee (BWC), consisting of about 20 staff members, is the primary unit within the NPC that is responsible for reviewing the government budget and monitoring budget execution.³ According to the Chinese Budgetary Law, the government has to submit the budget proposal to the FEC for review a month before the convening of the NPC conference. However, given the size and complexity of the budgets, and the small size of BWC staff, a thorough review of the budget proposals is unlikely with just one month’s lead time.
- The legislature as a whole does not have time to review the budget. The NPC convenes for 15 days every year. Of the 15 days, only one day is allocated to budget review. At the local level, only a few hours are typically reserved for budget review. To review and make sense of an entire central government’s budget in just one day makes it a very hollow process. Not only does the NPC lack the information to evaluate the budget, it also does not even have the time to evaluate the very limited information available to it. As a comparison, the United States Congress needs about eight months to pass a federal

government budget, and a state legislature needs about five to six months to pass a state government budget.

- The government is also not held accountable to the original budget at the end of the year. Even though the government publishes a final budget after the end of the fiscal year, it provides only very summary information and provides no comparison between the original and the final budget. It also provides no account of its total assets and liabilities. Even though a government agency, the National Audit Office, conducts audit on the government itself and has uncovered many irregularities in the government budget, the legislature does not have any involvement in *ex post* auditing, rendering it completely ineffective as an oversight mechanism and at the mercy of government bureaucracies.

As a result, the legislative approval of the budget remains largely a formality, and the budget approved does not impose any legal constraint on the government agencies, because the NPC knows very little about what is actually in the budget. The end result is that the government puts together the budget, reviews and approves the budget, and then executes the budget all by itself, with hardly any legislative or public involvement. In other words, decision-making power is not separated from the execution of the budget in China. Such concentration of budgetary power, however, does not happen by accident. It is actually enshrined in China's Budgetary Law, which emphasises the government's authority in the budgetary process. The very first article of the Budgetary Law stipulates: "This Law is enacted to strengthen the distributive and oversight functions of budget, improve state's management of budget, enhance the state's macro-management capacity, and ensure economic and social development." The first article reflects the dominant and central role played by the government (or the state) in budgeting. The law is enacted only for the government itself to better manage the public funds, without saying anything about how the public, through the NPC, should use the budget to oversee government spending.

The Budgetary Law also gives a substantial amount of discretion to the government during the execution of the budget. According to Article 53 of the Budgetary Law, budgetary amendment occurs only when total spending exceeds total revenue, or when changes are needed for the amount of debt to be raised in the original budget. That means that the changes to the budget should be reviewed and approved by the NPC only when there is a deficit. Therefore any other changes made to the budget will not require approval from the NPC, such as additional spending when there is budget surplus, and transfer of funds between different programmes. Since governments at all levels enjoyed budget surpluses year after year, the government could spend the surplus in any way it saw fit without any involvement of the NPC. While such discretion gives the government the opportunity to deal with changes more easily, it nonetheless increases the opportunity for arbitrary behaviour and corruption. If the government has this kind of discretion in budget execution, then the initial budget approval puts very little constraint on the government. Thus it is not hard to understand the huge variation between the original budget and the final budget.

4. Recommendations

Based on the previous analysis, improving the legal authority of the budget as well as accountability in the public sector requires major reforms to the budgeting process and rewriting of China's current Budgetary Law guiding the budgeting process. The fundamental reason why the budget is not adhered to and why the government changes it at will is that the budget in China is not legally binding. What follows is a list of some modest steps that

can be implemented fairly easily to change the current situation. The major theme of the reforms is to impose legal authority for the budget on the government.

1. The most important reform is to amend the Budgetary Law under the principle of balance of power. It should be firmly established that the people's congresses at all levels should have the decision-making power in the budgeting process, including reviewing and approving, amending, adjusting and vetoing the budget, as well as overseeing the execution of the budget. The government can only operate under the budget approved and amended by the people's congress. There should also be provisions requiring sanctions against violation of the budget and requiring audit, by an agency independent of the government, of budget execution.
2. To help the legislature fulfill this responsibility, steps should be taken to improve the capacity of the NPC to review the budget. Such capacity involves at least three components: committee, personnel and time.
 - Within the NPC, a standing Budget Committee should be established, dedicated to government budget review and monitoring. The Budget Committee can be formed by transferring part of the responsibility out of the FEC, and the BWC out of the FEC, into the new Budget Committee. There are some advantages to this institutional set-up. First, it accords a much higher priority to the budget than under the current setup, which is an appropriate attitude given the prominent role played by the budget. Second, the new committee dedicated to the budget will lead to a more effective review and monitoring of the government budget.
 - To make it more effective, this committee should also substantially expand the size of its staff to provide the committee members with more in-depth and more technical analysis of the government budget.
 - Even though the rank-and-file members of the NPC cannot spend much time on reviewing the budget during the annual conference, the new standing Budget Committee needs to have more than a month to review the budget. The government needs to submit the budget to the new Budget Committee at least three months before the annual conference.
3. The starting date of the fiscal year should be moved to a date after the conclusion of the annual conference of the people's congress at all levels. This is one of the prerequisites for endowing the budget with legal authority.
4. The government's budgeting capacity should be increased. How well the budget is prepared will have an impact on how well it is executed. This depends on the forecasting of both expenditure and revenue. For example, revenue and spending forecasting should be based on advanced econometric models rather than on simple "guesstimates". If large discrepancies exist between the original and final budgets, they should be published and discussed so as to improve the accuracy of models for future forecasting. More precise forecasting is a prerequisite to minimize the discrepancy between the original and final budgets. The government needs to set up a professional team to do scientific forecasting of revenue and expenditure. If this cannot be accomplished within the government, then this task should be outsourced to experts outside the government. While this step is not directly linked to the legislative role, it is nonetheless important because it brings credibility to the budgeting process and makes legislative review and oversight much easier.

5. The budget proposal submitted by the government should be comprehensive and detailed. To make the government accountable for what it spends, the budget should be as comprehensive and detailed as possible. To be comprehensive, the budget should include all government revenue sources and spending items, both on budget and off budget. To be detailed, it should provide information on spending at all different levels. It should not only provide summary information at the programme level or department level, but also break down spending information to levels lower than the department, such as each and every office in the department, including information on the number of positions for each office, salary, office spending, travel, utilities, etc. Only with comprehensive and in-depth fiscal information can the original budget serve to hold the government accountable and can the legislature exercise its oversight authority over the government.
6. With regard to the execution of the adopted budget, the government needs to furnish information periodically (publication at least once every month) to the National People's Congress about spending and revenue figures, and compare such actual revenue and spending figures to the projected revenue and spending figures based on the originally budgeted figures. The update and the comparison will tell the legislature whether the government is executing the budget according to the plan and if the government is running a surplus or deficit as of the reporting date. This will not only hold the government accountable for its spending, but will also give the NPC, or at least its standing Budget Committee, time to prepare for necessary changes to the original budget.
7. After the fiscal year ends, the government should publish a detailed report about actual revenue and spending figures, and this report should be part of a comprehensive annual financial report that includes not only annual revenue and spending figures, but also accumulated assets and debt. This will give the public both a short-term and long-term perspective on the fiscal health of the government. It should also include a table comparing the original and final budgets, and explanations of any major differences. The legislature should also conduct its own audit of government spending, or contract with other institutions outside the government to conduct the audit.

5. Conclusion

China has made great strides in public financial management over the last 30 years since it adopted the “reform and opening” policy in 1978. The limitations of the reforms adopted so far, however, have also been clearly evident as the public sector is growing larger and the scope and level of corruption and waste are growing ever wider and higher. In one sense, the path taken so far by China is somewhat similar to the one taken by some developing countries in Latin America: initial reform was aimed at improving the efficiency of government operation without paying too much attention to government accountability. Given the importance of the role played by the legislature in the budgeting process and the worldwide trend of a more active legislature in government budgeting, it is also time for China to start implementing a second round of budgetary reform to bring more accountability into public financial management.

Notes

1. The Budgetary Law lays down four basic principles of budgetary management: i) each level of government should be responsible for its own budget; ii) the budget should be balanced; iii) the central government will share revenue with subnational governments; and iv) once the budget is approved by the legislative body at each level of government, it cannot be changed without going through the legislative process.
2. The NPC meets as a full body only once a year for two weeks. Outside this period, it is up to the NPC Standing Committee, consisting of 160 members, to meet frequently to discuss legislative matters. Under the Standing Committee, there are several specialised committees, and the FEC is one of them.
3. In addition to budget review and monitoring, the FEC is also responsible for much other legislation and regulation with regard to finance, national economy, and social and economic development.

References

- Fölscher, Alta (2006), "A Balancing Act: Fiscal Responsibility, Accountability and the Power of the Purse", *OECD Journal on Budgeting*, 6(2):133-152.
- Gao, Peiyong (1999), *The Reform of Fees into Taxes: the Perception of Economists*, Economy Science Press, China, 费改税:经济学家如是说, 经济科学出版社, 1999.
- Gao, Peiyong (2008), "Concern about the Gap between China's Budget and the Actual Budget Results", *Journal of Foreign Taxation*, 2008(1), 关注预决算偏离度, 涉外税务 2008(1).
- Gustafson, Robert (2003), "Legislatures and the Budget Process", *NDI Legislative Research Series*, National Democratic Institute for International Affairs, Washington DC.
- Lee, Robert D. Jr., Ronald W. Johnson and Philip G. Joyce (2008), *Public Budgeting Systems*, Jones and Bartlett Publishers, Sudbury, Massachusetts, United States.
- Li, Jinhua (2006), *2005 Auditing Report on the Central Governments' Budget Execution and other Revenue and Expenditure*, China National Audit Office, <http://politics.people.com.cn/GB/1026/4553294.html> (accessed on 2 November 2009).
- Li, Jinhua (2007), *2006 Auditing Report on the Central Governments' Budget Execution and other Revenue and Expenditure*, China National Audit Office, http://news.xinhuanet.com/politics/2007-06/27/content_6297777.htm (accessed on 2 November 2009).
- Li, Jinhua (2008), *2007 Auditing Report on the Central Governments' Budget Execution and other Revenue and Expenditure*, China National Audit Office, www.audit.gov.cn/n1057/n1087/n524092/557707.html (accessed on 2 November 2009).
- Ma, Caichen (2007), *Government Budget*, Northeast Publishing House, China.
- OECD (1998), "The Role of the Legislature", OECD, Paris, PUMA/SBO(98)4.
- Petrei, Humberto (1998), *Budget and Control: Reforming the Public Sector in Latin America*, Inter-American Development Bank, Washington DC.
- Posner, Paul, and Chung-Keun Park (2007), "Role of the Legislature in the Budget Process: Recent Trends and Innovations", *OECD Journal on Budgeting*, 7(3):77-102.
- Rubin, Irene (2006), *The Politics of Public Budgeting: Getting and Spending, Borrowing and Balancing*, CQ Press, Washington DC.
- Santiso, Carlos (2004), "Legislatures and Budget Oversight in Latin America: Strengthening Public Finance Accountability in Emerging Economies", *OECD Journal on Budgeting*, 4(2):47-76.
- Schick, Allen (2002), "Can National Legislatures Regain an Effective Voice in Budget Policy?" *OECD Journal on Budgeting*, 1(3):15-42.
- Stapenhurst, R. (2004), "The Legislature and the Budget", *WBI Working Paper No. 33035*, World Bank Institute, Washington DC.
- Sun, Yudong, and Yun Tan (2007), "An Empirical Analysis of Additional Revenue and Spending in China's Budgetary Management", paper presented at the Third International Seminar on the Opportunities and Challenges in Public Administration in the 21st Century.

- Wildavsky, Aaron, and Naomi Caiden (2004), *The New Politics of the Budgetary Process*, Fifth edition, Pearson Longman, New York, United States.
- Wong, Christine (2007), "Budget Reform in China", *OECD Journal on Budgeting*, 7(1):33-56.

How To Attain Value for Money: Comparing PPP and Traditional Infrastructure Public Procurement

by

Philippe Burger and Ian Hawkesworth*

Governments increasingly use public-private partnerships (PPPs) to pursue value for money. However, value for money is (or at least, should be) the driving force behind traditional infrastructure procurement. Therefore, any project, whether it is a PPP or a traditionally procured project, should be undertaken only if it creates value for money. It seems that the choice between using a PPP or traditional procurement should be simple: governments should prefer the method that creates the most value for money. However, in practice the value-for-money objective is very often blurred, and the choice between using a PPP and traditional infrastructure procurement may be skewed by factors other than value for money. Some factors skew choice towards traditional procurement, while others skew it towards PPPs. Drawing on the results of a questionnaire sent to all OECD and some non-OECD countries, this article considers the various factors that may skew this choice and thereby undermine the pursuit of value for money. The results of the questionnaire point especially to differences in the range and complexity of the ex ante and ex post value-for-money tests that some governments apply to PPPs and traditionally procured infrastructure projects. However, accounting standards, political preferences for or against PPPs, and the strength of public sector unions also play, among others, a role in skewing incentives and affecting choice in some countries. The findings of the questionnaire are augmented by four case studies setting out the procurement processes for PPPs and traditional infrastructure procurement in France, Germany, Korea and the United Kingdom. With the focus on the attainment of value for money and by exploring the issues raised in the responses to the questionnaire, this article sets out some good practices that will align the requirements for these two types of procurement and remove possible perverse incentives that favour one over the other.

JEL classification: H400, H440, H540, H570

Keywords: value for money, public-private partnerships, PPPs, traditional public procurement, infrastructure, public choice

* Philippe Burger is professor of economics and head of the Department of Economics at the University of the Free State, South Africa. Ian Hawkesworth manages the OECD public-private partnership network. He is an administrator in the Budgeting and Public Expenditures Division, Public Governance and Territorial Development Directorate, OECD. An earlier version of this article was presented at the annual meeting of the OECD network of senior PPP officials, Paris, 12-13 April 2010.

1. Introduction

Since the early 1990s, but more so since the early 2000s, there has been a significant increase in the use of PPPs by OECD countries. Countries such as Australia, France, Germany, Korea and the United Kingdom increasingly use PPPs to deliver services that they previously delivered through traditional public procurement. For most of the last decade, PPPs in the United Kingdom constituted approximately 12% of total annual capital expenditure (cf. EIB, 2004:5; KPMG, 2007:4), with other countries following suit. The drive to use PPPs is increasingly premised on the pursuit of value for money (cf. OECD, 2008).¹ As it includes both qualitative and quantitative aspects and typically involves an element of judgment on the part of government, a precise measure for value for money does not exist (see the Appendix for a discussion). Nevertheless, value for money can be defined as what a government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime. Thus, the value-for-money concept attempts to encapsulate the interests of citizens, both as taxpayers and recipients of public services. As such, value for money should in principle also be the driving force behind traditional infrastructure procurement. Therefore, any project, whether it is a PPP or a traditionally procured project, should be undertaken only if it creates value for money. With value for money being the objective, PPPs and traditional infrastructure procurement are merely two modes to deliver value for money.

Therefore, as a matter of principle it seems that the choice between using a PPP or traditional procurement should be simple: governments should prefer the method that creates the most value for money. However, in practice the choice is not always as simple. In practice, the value-for-money objective is very often blurred, and the choice between using a PPP and traditional infrastructure procurement may be skewed by factors other than value for money. Some factors skew choice towards traditional procurement, while others skew it towards PPPs. This article considers the various factors that may skew this choice and thereby undermine the pursuit of value for money. Factors may include: the legal and institutional set-up that procuring entities face; the range and complexity of the *ex ante* and *ex post* value-for-money tests to which PPPs and traditionally procured infrastructure projects are subjected; the roles in the procurement process of the parliament, the finance ministry, the PPP unit and the procuring entities; and the accounting standards applied to both PPPs and traditionally procured infrastructure projects. Political preference for or against PPPs may also play a role in skewing incentives and affecting choice, together with issues such as the availability of skilled staff, the strength of public sector unions, inability to quantify and price project risks, and the general complexity of some projects.

With the focus on the attainment of value for money and by exploring the issues raised above, this article sets out to compare the two methods of procurement. It used a questionnaire sent to OECD and selected non-OECD countries to collect information on traditional infrastructure public procurement and the procurement of services through public-private partnerships. The results are presented in Section 3. These results are

further augmented in Section 4 by four case studies covering procurement processes in France, Germany, Korea and the United Kingdom. Using the information from Sections 3 and 4, Section 5 suggests good practice that will align the requirements for these two types of procurement and remove possible perverse incentives that favour one over the other. As there might be good reasons why requirements could differ, aligning requirements does not necessarily mean identical requirements for both PPPs and traditionally procured projects. Rather, alignment means that, for the same type of project, the same level of detail and information is available to assess value for money, whether that project is a PPP or a traditionally procured investment project. It also means that the scope and volume of institutional and legal requirements as applied to PPPs and traditional procurement respectively, as well as *ex ante* and *ex post* value-for-money assessments required from each type, do not create incentives to prefer one type of procurement to the other. Alignment furthermore requires that accounting standards do not affect the choice between PPPs and traditional infrastructure procurement.

Given an overview and comparison of the institutional and other aspects of PPPs and traditional procurement in the countries surveyed, this article also sets out to consider the process and requirements whereby a government decides whether a project should be procured through a PPP or traditional procurement. Due to the novelty of PPPs in many countries, clear criteria do not exist generally to guide the choice between these procurement options. The article considers some frameworks used to guide this choice and then sets out a list of criteria that could guide governments in deciding the mode of procurement. In addition, the article considers measures that might reduce the preference for one type of procurement over another, where such a preference is caused by the characteristics of the *ex post* value-for-money assessment. Lastly, the article suggests a unified framework that could be used to structure the selection of procurement options.

2. Defining PPPs and traditional procurement

A clear definition as to what constitutes a public-private partnership does not exist. The OECD (2008) defines a public-private partnership as:

... an agreement between the government and one or more private partners (which may include the operators and the financiers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners (OECD, 2008, p. 17).

Within this relationship, the government specifies the quality and quantity of the service it requires from the private partner(s).² The private partner may be tasked with the design, construction, financing, operation and management of a capital asset to deliver a service to the government or directly to end users. Furthermore, the private partner will receive either a stream of payments from the government or user charges levied directly on the end users, or both. If the government is also responsible for a stream of payments to the private partner for services delivered, these may depend on the private partner's compliance with government specifications for quality and quantity. For the purposes of this article, the PPP concept includes both "pure PPPs" – i.e. projects where the main source of revenue for the private partners is the government (in the form of regular payments or a

unit charge) – and concessions (where the main source of revenue is user charges levied by the private partners on the beneficiaries of the services).³

A key element of the definition mentioned above is the role of risk. To ensure that the private partner operates efficiently and delivers value for money, it is necessary to transfer a sufficient amount of risk. In principle, risk should be carried by the party best able to manage it. In this context, “best” means the party who can manage the risk at least cost. To manage it may mean the party best able to prevent a risk from realising (*ex ante* risk management) or the party best able to deal with the results of realised risk (*ex post* risk management), whichever option (*ex ante* or *ex post*) is the cheapest. Some risks can be managed and are hence called endogenous risks. However, not all risks can be managed, and cases may exist where one or more parties to a contract are unable to manage a risk. To those parties, such unmanageable risks are exogenous risks; an example is uninsurable *force majeure* risk that affects all parties, while political and taxation risk is exogenous to the private party and endogenous to government.⁴

Box 1. Different country definitions of public-private partnerships

Korea defines a public-private partnership project as a project to build and operate infrastructure such as road, port, railway, school and environmental facilities – which have traditionally been constructed and run by government funding – with private capital, thus tapping the creativity and efficiency of the private sector.

South Africa defines a public-private partnership as a commercial transaction between a government institution and a private partner in which the private party either performs an institutional function on behalf of the government institution for a specified or indefinite period, or acquires the use of state property for its own commercial purposes for a specified or indefinite period. The private party receives a benefit for performing the function or by utilising state property, either by way of compensation from a revenue fund, charges or fees collected by the private party from users or customers of a service provided to them, or a combination of such compensation and such charges or fees.

The **United Kingdom** defines a public-private partnership as “...arrangements typified by joint working between the public and private sectors. In their broadest sense they can cover all types of collaboration across the private-public sector interface involving collaborative working together and risk sharing to deliver policies, services and infrastructure” (HM Treasury, 2008). The most common type of PPP in the United Kingdom is the private finance initiative (PFI). A PFI is an arrangement whereby the public sector contracts to purchase services, usually derived from an investment in assets, from the private sector on a long-term basis (often between 15 to 30 years). This includes concessions and franchises, where a private sector partner takes on the responsibility for providing a public service including maintaining, enhancing or constructing the necessary infrastructure.

The **State of Victoria (Australia)** defines a public-private partnership as relating to the provision of infrastructure and any related ancillary service which involve private investment or financing, with a present value of payments for a service to be made by the government (and/or by consumers) of more than AUD 10 million during the period of a partnership that do not relate to the general procurement of services.

Traditional infrastructure procurement represents the acquisition by government of infrastructure such as roads and buildings (i.e. hospital buildings, school buildings). Usually the government specifies the quantity and quality of the service, while the infrastructure is constructed by private companies to whom the construction is typically awarded through tender. Once the construction is finished, the asset is transferred to and operated by government.⁵ This mechanism includes so-called “build and deliver” contracts. Therefore,

both PPPs and public procurement typically involve the private sector. The key distinction is the allocation of risk and the role of risk as an efficiency driver.

In the case of a PPP, the transfer of the appropriate type and amount of risk is key to the success of that PPP. Most often these same risks are also present in traditionally procured projects. However, in a traditionally procured project the transfer of risk to the private parties involved is very limited and usually does not extend beyond the construction phase of the project (an example of the risk transferred is the inclusion in the contract of penalties for late delivery). PPP contracts, however, tend to integrate the construction and operational aspects of the project in a single contract. This ensures that the private partner has an incentive to incur additional construction cost if those costs reduce future operating and maintenance cost, but only if the present value of the operating and maintenance cost saving exceeds or equals the increase in the present value of the additional construction cost. This incentive does not exist in traditional procurement. However, as the discussion below will indicate, despite the fact that PPPs may yield this benefit compared to traditional procurement, not all projects are suitable candidates for PPP project status. The success of a PPP depends critically on the risk transferred (and transferrable), the competition among private parties, and the nature of the service to be delivered. It may also depend on the need for innovation, as well as the complexity of the project.

2.1. The increasing importance of public-private partnerships

Although governments increasingly use PPPs, these arrangements still constitute a relatively small component of total public sector investment. The United Kingdom figure of 12% mentioned above is one of the largest. Some countries also informally state that they do not foresee PPPs exceeding 15% of total public investment, one reason being the rather cumbersome process of creating a PPP (OECD, 2008). However, notwithstanding difficulties, countries such as Australia, Germany, Korea and South Africa, as well as France, Portugal and Spain, increasingly use PPPs. As noted above, there is a divergence in definitions regarding what constitutes a PPP. This also leads to different figures regarding the number of PPPs in the world. As such, not all the figures are comparable, but they do give an indication of the wide extent to which countries use PPPs. According to Deloitte (Ireland) (2009), infrastructure projects constitute the largest sector by number of deals internationally, followed by health care and education, while the United Kingdom is by far the leading country implementing projects, followed by the rest of Europe in second place. Furthermore, PPP activity reached a peak during the period 2003-07, before slowing down due to the onset of the international financial crisis and recession.

Table 1 comprises data collected by the Public Works Financing “International Major Projects Survey” (PWF, 2009, p. 2). It includes projects that represent various combinations of public and private sector risk taking and represents cumulative data since 1985. According to Public Works Financing, road PPPs represent almost half of all PPPs in value (USD 307 billion out of USD 645 billion) and a third in number (567 out of 1 747). Second is rail and third is water. The PWF database also confirms that Europe represents about half of all PPPs in value (USD 303 billion) and a third in number (642).

Table 1. **Global public-private partnership deals by sector and region since 1985¹**

		Roads		Rail		Water		Buildings		Total	
		Number of projects	Cost (USDm) ²	Number of projects	Cost (USDm) ²	Number of projects	Cost (USDm) ²	Number of projects	Cost (USDm) ²	Number of projects	Cost (USDm) ²
United States	Total planned and funded since 1985	77	61 844	41	58 334	187	20 001	164	10 986	469	151 926
	Funded by 10/09	35	16 913	27	10 950	136	15 024	158	9 421	356	52 308
Canada	Total planned and funded since 1985	31	18 103	7	9 780	29	3 029	91	12 529	158	43 531
	Funded by 10/09	20	11 058	1	2 000	14	457	49	9 572	84	23 114
Latin America ³	Total planned and funded since 1985	272	101 236	69	51 184	153	17 163	19	1 729	513	171 222
	Funded by 10/09	140	61 652	26	10 355	79	9 865	8	521	253	82 393
Europe	Total planned and funded since 1985	339	320 375	102	157 293	218	34 178	306	90 369	965	602 215
	Funded by 10/09	193	156 692	55	54 579	171	24 657	223	66 975	642	302 903
Africa and Middle East	Total planned and funded since 1985	21	10 886	16	12 479	101	28 166	10	1 186	148	52 717
	Funded by 10/09	13	5 691	4	4 668	45	17 835	4	957	66	29 151
Asia and Far East	Total planned and funded since 1985	295	92 662	93	101 826	180	50 745	37	11 358	605	256 591
	Funded by 10/09	166	54 640	40	55 676	119	37 452	21	7 201	346	154 969
World	Total planned and funded since 1985	1 023	605 106	328	390 896	868	153 282	627	128 157	2 858	1 278 202
	Funded by 10/09	567	306 673	153	138 228	564	105 290	463	94 647	1 747	644 838

1. This database comprises data collected by the PWF International Major Projects Survey. It includes all projects that are being planned, built or are operated in 131 countries. According to PWF (2009, p. 3): "PWF's survey aims to describe projects where governments are seeking to franchise the delivery of public works infrastructure services to private, for-profit companies outside of a regulated, public utility structure. That delegation of control can take the form of long-term service contracts, concession arrangements involving finance, construction and long-term operations of facilities under term-limited contracts; private development and ownership of facilities; and divestiture of infrastructure assets."

2. Cost USDm (million) refers to nominal dollars, converted to USD at time of financial close.

3. Latin America includes Mexico, Latin America and the Caribbean.

Source: Public Works Financing (2009), *Public Works Financing Newsletter*, Vol. 242, October, www.PWFinance.net.

3. Survey results

3.1. Background information

The survey was conducted during January 2010. Questionnaires were sent to senior PPP and finance ministry officials in 31 countries. A total of 22 countries responded: Australia (federal government and government of New South Wales⁶), Austria, Canada, Chile, Czech Republic, Denmark, France, Germany, Greece, Hungary, Ireland, Italy, Korea, Mexico, Netherlands, New Zealand, Norway, Slovak Republic, South Africa (an enhanced engagement country), Spain, Switzerland and United Kingdom. Four of the countries (France, Germany, Korea and the United Kingdom) also served as case studies comparing PPP and traditional infrastructure procurement processes. These case studies can be found in Section 4 below.

Of the 22 countries surveyed, 20 indicated that they do use PPPs in their country at the level of government for which they answered the questionnaire (the exceptions are Switzerland at the federal level and New Zealand). In 13 of the countries, answers pertain to the national/federal government and in seven to the general government (see Table 2).

Table 2. To which level of government do your answers in this survey apply?

National/federal government	13
Provincial/state government	0
National/federal and provincial government levels	0
All levels of government, <i>i.e.</i> national/federal, provincial and municipal government	7
Total	20

Table 3 indicates the percentage of public sector investment that takes place through PPPs and the number of countries to which each range applies. For instance, in nine of the 20 countries, PPPs constitute between 0% and 5% of public sector investment in infrastructure. Furthermore, in nine countries, PPPs constitute between 5% and 15% of total public sector infrastructure expenditure.

The number of PPPs in countries varies significantly. It ranges from one at the federal level in Canada, to three each in Austria, Denmark and Norway, to 670 in the United Kingdom.⁷ In between are France with 330,⁸ Korea with 252, Mexico with 200, Germany with 144, Chile with 60, South Africa with 50, New South Wales (Australia) with 35, Hungary and the Netherlands with nine each, and Ireland with eight.

Table 3. What percentage of public sector infrastructure investment takes place through PPPs?

Range	Number	Country
0%-5%	9	Austria, Canada, Denmark, France, Germany, Hungary, Netherlands, Norway, Spain
> 5%-10%	7	Czech Republic, Greece, Ireland, Italy, Slovak Republic, South Africa, United Kingdom
> 10%-15%	2	Australia, Korea
> 15%-20%	0	
> 20%	2	Chile, Mexico
Total	20	

3.2. The problem statement

As argued in the introduction to this article, even though value for money should be the overriding criteria in the choice between using a PPP or traditional infrastructure procurement (TIP), the choice is very often blurred in practice. More specifically, the choice between using a PPP and TIP may be skewed by factors other than value for money, with some skewing it towards traditional procurement, while others skew it towards PPPs. To ascertain the extent to which there are grounds for considering whether or not such skewing exists, the questionnaire requested respondents to consider whether or not they think that:

- the rules in place impede attaining the maximum value for money by creating incentives to prefer traditional infrastructure procurement (TIP) over PPPs; or
- the rules in place impede attaining the maximum value for money by creating incentives to prefer PPPs over traditional infrastructure procurement (TIP).

In four countries, respondents reported that they do not have enough data to make the assessment (see Table 4). In seven of the remaining 16 countries (i.e. almost half), respondents argued that rules indeed did to a large or to some extent impede attaining value for money by creating incentives to prefer TIP projects over PPPs. However, the opposite is not true – i.e. in 15 of the 16 countries, respondents reported that rules do not impede attaining value for money by creating incentives to prefer PPPs to TIP projects. Hence, on the basis of these results, it would seem that a bias might exist in favour of traditional infrastructure procurement.

Table 4. Do you think that the rules in place impede attaining the maximum value for money by creating incentives to prefer one form of procurement over the other?

	TIP over PPPs	PPPs over TIP
Yes, to a large extent	2	0
Yes, to some extent	5	1
No	9	15
Not enough data to make assessment	4	4
Total	20	20

3.3. Legal framework and institutional set-up

This sub-section explores the extent to which the legal and regulatory framework, as well as the institutional set-up for PPPs, differs from that under which traditionally procured infrastructure projects operate. In eight of the 20 countries, the government passed specific PPP laws and regulations to regulate PPPs (see Table 5). In seven of the countries, sector-specific laws also apply to both PPPs and TIP.

In most countries, both traditional infrastructure procurement and PPPs are managed and regulated in terms of existing laws and regulations pertaining to procurement, contract law and the budget law. However, Table 5 also shows that, in some countries, procurement law applies only to traditional infrastructure procurement (TIP) and not to PPPs. This raises the question as to whether or not in some countries a specific PPP law replaces procurement law. Hence, Table 6 juxtaposes the use of procurement law as applied to PPPs with the existence of a specific PPP law. Table 6 shows that in nine countries there is only

a procurement law that applies to PPPs, and no PPP law, while in six countries there is a specific PPP law, while public procurement law does not apply to PPPs. In three countries, the procurement law and a specific PPP law both apply to PPPs, while in two countries neither a PPP law nor a procurement law applies to PPPs. In view of this situation, a recommendation for countries with a separate and specific PPP law, but where procurement law does not apply to PPPs, would be for the government to consider the degree to which the requirements for TIP and PPPs are aligned. They need to do so to ensure that what is demanded from line departments using these two forms of procurement does not create incentives to prefer one form of procurement to the other based on grounds other than value for money, efficiency and effectiveness.

Table 5. What constitutes the legal framework for PPPs and traditional infrastructure procurement?

	PPPs	TIP
Procurement law	12	17
Contract law, concession law, budget law	15	12
Specific PPP law or regulations	8	n.a.
Sector-specific laws (<i>e.g.</i> for transport or health care)	7	7
Other	2	1
None	0	0

Table 6. Combination of procurement law and specific PPP law and regulations

Procurement law applied to PPPs	9
Procurement law as well as specific PPP law or regulations applied to PPPs	3
Specific PPP law or regulations	6
Neither	2
Total	20

The questionnaire also set out to establish whether or not the legal and regulatory framework reported in Tables 5 and 6 is uniform across all levels of government (*e.g.* national/federal, provincial and municipal). In Austria, federal procurement law applies, but there are also nine different procurement laws for the nine Austrian provinces. In Australia, there is no uniform framework, but national guidelines and policies exist to facilitate PPP policy harmonisation. Canada reported that civil law applies in Quebec while common law applies elsewhere; in addition, there are variations in regulatory regimes between jurisdictions (*e.g.* from province to province; provincial *versus* federal). The Netherlands reported that it does not have a regulatory framework; Hungary does not have one for PPPs. Denmark reported some differences (also at local level), while France, the Slovak Republic and South Africa reported slight differences between levels of government, usually with respect to municipalities. The remaining countries all apply the same framework to all levels of government, both for PPPs and TIP.

Differences between PPPs and traditional procurement also exist in terms of which institutions are involved in infrastructure procurement. Table 7 shows that the finance ministry and the procuring line departments are usually involved in both PPP and TIP projects. Provincial governments are also involved in both PPPs (six countries) and TIP (eight countries). Furthermore, in 11 countries municipalities are involved in TIP, and in 10 countries they are also involved in PPPs. The latter fact indicates the increasing use of PPPs to deliver municipal services in many countries. In addition, more countries

report municipal involvement in TIP and PPPs than provincial involvement. This is also an indication that, with respect to their spheres of activities, municipalities in many countries have a higher degree of independence from central government compared to provinces. This independence very often follows from the existence of own sources of revenue such as municipal service charges. In two countries, legislative and parliamentary committees also play a role in infrastructure procurement through PPPs, while the committees' role regarding TIP occurs in three countries. Ten countries reported that they have a specific ministry that is also involved in TIP, while in six countries a specific ministry is also involved in PPP projects.

Table 7. Which of the following institutions are involved in infrastructure procurement in the case of PPPs and TIP?

	PPPs	TIP
The entity responsible for formulating the government's budget (<i>e.g.</i> Ministry of Finance)	15	14
Line ministry	16	17
Specific ministry/entity responsible for public procurement	6	10
Relevant government agencies (<i>e.g.</i> regulatory agencies)	5	7
Legislative/parliamentary committees	2	3
Other	3	4
Provincial authorities (in the case of provincial procurement)	6	8
Municipal authorities (in the case of municipal procurement)	10	11
PPP unit in the Ministry of Finance	9	n.a.
PPP unit in the line ministry	8	n.a.
PPP unit in a separate agency (<i>e.g.</i> Partnerships UK)	4	n.a.

Many countries also have PPP units (Table 8). These units mostly provide technical assistance and contribute to policy formulation, while in some countries they are also responsible for the approval of PPP projects (OECD, 2010) (also see the discussion below). PPP units take different forms, with 13 units present in the finance ministry and six being independent agencies. The first row in Table 8 summarises the second and third rows but eliminates a double count (*i.e.* cases where there is both a unit located in the finance ministry and an independent unit). It shows that in 14 countries there is a PPP unit in the finance ministry and/or an independent PPP unit acting as an agency. There are ten countries with sector-specific units in the procuring/line departments. Table 7 showed that, in nine countries, PPP units in the finance ministry are involved in the PPP procurement process, while in four the independent agencies are involved. In eight countries, sector-specific units in the procuring/line departments are involved in the PPP procurement process.

Table 8. Does your government have a PPP unit?

A central unit (unit in the Ministry of Finance and/or unit acting as an independent agency)	14
A unit located in the Ministry of Finance	13
A unit acting as an independent agency	5
Sectoral units (<i>e.g.</i> transport, health) located within line ministries	10
No	4

Table 9 juxtaposes the responses of countries on whether or not they have a PPP unit with their responses on whether or not they have a specific PPP law. The left column refers to combinations of a PPP unit and a PPP law, while the heading of the next column refers

to the existence of a specific PPP law. Therefore, the second row, second column indicates that in six countries there is no PPP law but there is a PPP unit, while the third row, second column indicates that in no country is there a PPP law but no unit. Thus, the existence of a PPP law always corresponds to the presence of a PPP unit. However, the reverse does not hold true, i.e. the presence of a PPP unit does not necessarily mean there is a PPP law (in six countries, there is a PPP unit but no PPP law).

In Table 9, the headings of columns three to five indicate to what type of PPP unit the numbers in that column refer. Therefore, the third row, third column indicates one country where there is a PPP law but no unit located in the finance ministry. The fourth row, third column indicates that in seven countries there is both a PPP law and a PPP unit in the finance ministry. Furthermore, in seven countries there is a PPP law but no PPP unit as an independent agency, while in eight countries there is neither a PPP law nor a PPP unit acting as an independent agency.

Table 9. **PPP laws and PPP units**

	Specific PPP law or regulations	Unit located in the Ministry of Finance	Unit acting as an independent agency	Sectoral units (<i>e.g.</i> transport, health) located within line ministries
No PPP law, no PPP unit	6	6	8	6
No PPP law, PPP unit	6	6	4	6
PPP law, no PPP unit	0	1	7	4
PPP law, PPP unit	8	7	1	4
Total	20	20	20	20

3.4. *Ex ante value-for-money assessment*

Significant differences between countries exist with regard to the degree to which PPP and TIP projects are subjected to *ex ante* value-for-money assessments. Though most projects, be they PPPs or TIP, are subjected to *ex ante* value-for-money assessments, the type of assessments differ quite substantially. Table 10 indicates that an *ex ante* process to ascertain value for money is done for all PPPs and TIP projects in, respectively, 11 and 7 countries. Furthermore, for both PPPs and TIP projects, five countries do *ex ante* value-for-money assessments for projects above a specified threshold, while in respectively three and zero countries these assessments are done on an *ad hoc* basis. This means that only one country does not do *ex ante* value-for-money assessments for PPPs, while in eight countries these assessments are not done for TIP. The results of Table 11 indicate that more rigour is required from PPP projects compared to TIP. As noted in the introduction to this article, the higher degree of rigour required from PPPs may in itself create a preference towards traditional procurement. However, the point is not that the requirements for PPPs be watered down, but the opposite: that the rigour of the requirements for TIP be aligned with those of PPPs so as to eliminate any possible incentive other than value for money, efficiency and effectiveness to prefer TIP over the PPP option.

In countries where there are *ex ante* processes for PPPs and TIP, these processes are largely the same for all sectors of the economy (see Table 11).

Table 10. Is there an *ex ante* process to ascertain value for money (this may include a whole-of-life/net-present-value approach) for PPPs and TIP?

	PPPs	TIP
Yes, for all	11 ^a	7 ^d
Yes, for those above a threshold	5 ^b	5 ^e
Yes, on an <i>ad hoc</i> basis	3 ^c	0
No	1	8
Other	0	0
Total	20	20

a. Australia, Austria, Canada, Denmark, France, Germany, Ireland, Korea, South Africa, Spain, United Kingdom.

b. Czech Republic, Hungary, Netherlands, Norway, Slovak Republic.

c. Chile, Greece, Mexico.

d. Australia, Austria, Canada, Denmark, Germany, Mexico, United Kingdom.

e. Hungary, Ireland, Korea, Netherlands, Norway.

Table 11. Is this formal process the same for all sectors in the case of PPPs and TIP respectively?

	PPPs	TIP
Yes	17	9
No	1	2
Other	1 ^a	1 ^b
No response to this question because no formal process exists (i.e. answered "no" in Table 10)	1	8
Total	20	20

a. Varies in Mexico depending on the type of mechanism used (i.e. Pidiregas is different from PFI projects).

b. Respondent did not know.

One of the most notable differences between PPPs and TIP projects exists with regard to the methods/processes that are applied to ascertain value for money. PPP projects usually require that procuring entities put together a public sector comparator (PSC). In 17 of the 20 countries, the government uses a public sector comparator, while one of the three exceptions (the United Kingdom) uses public sector guidelines and an *ex ante* value-for-money test that fulfils very much the same role as a PSC (see Table 12). In 12 of the 20 countries, TIP projects are subjected to cost-benefit analyses. TIP projects may also be subjected to cash-flow estimates over the project cycle (three countries) and central guidelines (five countries). However, in countries where TIP projects are not subjected to cost-benefit analysis, projects commence following a needs analysis and costing by the line department which has to be approved by the finance ministry as part of the annual budgeting cycle. What is notable, though, is that more countries require a PSC than require a cost-benefit analysis. Again, this situation points to a discrepancy in the rigour required from PPPs and TIP projects. As such, there might be an incentive to rather pursue TIP, not because it will necessarily yield the highest value for money, but simply because the process to create a TIP is simpler. Furthermore, in the absence of cost-benefit analyses, it might even be possible to pass projects that might not have demonstrated value for money if they had been properly scrutinised in a rigorous manner.

A contrast also exists with regard to the discount rate that line departments or the finance ministry apply when using a whole-of-life/net-present-value approach to assess *ex ante* value for money in the case of PPPs and TIP projects. While almost a similar number of countries use a single prescribed rate for either all PPPs or all TIP projects (respectively nine and seven – see Table 13), seven countries use rates set on a project-by-project basis for PPPs, in contrast to the two who do so for TIP projects. In six countries, the discount rate that is applied to PPPs is the same as the rate applied to TIP projects (see Table 14).

Table 12. **What method/process is used to ascertain value for money in the case of PPPs and TIP?**

PPPs		TIP	
Public sector comparator	17 ^a	Cost-benefit analysis	12 ^b
Public interest test	2	Cash-flow estimates over the project cycle	3
Central guidelines	5	Central guidelines	5
Other	2	Other	3

a. Australia, Austria, Canada, Chile, Czech Republic, Denmark, France, Germany, Greece, Hungary, Ireland, Korea, Mexico, Netherlands, Slovak Republic, South Africa, Spain.

b. Australia, Austria, Canada, Denmark, Germany, Hungary, Ireland, Korea, Mexico, Netherlands, Norway, United Kingdom.

Table 13. **What discount rate does the government use when it applies a whole-of-life/net-present-value approach in the case of PPPs and TIP?**

	PPPs	TIP
Single prescribed rate for all projects	9 ^a	7 ^c
Rate set on a sector-by-sector basis	1	1
Rate set on a project-by-project basis	7 ^b	2 ^d
Other	2	2
No response to this question because no formal process exists (i.e. answered "no" in Table 10)	1	8
Total	20	20

a. Czech Republic, Denmark, France, Greece, Hungary, Ireland, Korea, Mexico, United Kingdom.

b. Australia, Austria, Chile, Germany, Netherlands, South Africa, Spain.

c. Denmark, Hungary, Ireland, Korea, Mexico, Netherlands, United Kingdom.

d. Canada, Germany.

Table 14. **If the government uses a single prescribed rate for all projects, or if it uses a discount rate on a sector-by-sector basis, are these rates the same for both PPPs and TIP?**

Always	6
Often (> 50% of the time but less than 100%)	0
Rarely (< 50% of the time but more than 0%)	0
Never	0
Other	1 ^a
No response to this question because no formal process exists (i.e. answered "no" in Table 10 and do not use either a single prescribed rate or a rate set on a sector-by-sector basis [first two rows of Table 10] for both PPPs and TIP)	13
Total	20

a. Respondent did not know.

The questionnaire also posed an open question to respondents to ascertain how the government makes the choice between using PPPs and traditional infrastructure procurement. Except for a few cases (e.g. the United Kingdom, the state of New South Wales in Australia), it is clear that only a small number of countries apply criteria to all prospective projects to establish which mode of procurement will yield the highest value for money. In several countries, traditional procurement is simply the default option for procurement, and whether or not a project is selected as a candidate PPP project depends on the discretion of the line department. Hence, it is not always clear how a project becomes a PPP candidate. As one respondent noted:

In theory there is some kind of value for money but in practice, there is no formal test applied to all infrastructure procurements. The decision to procure as a PPP has been largely driven by champions inside individual government departments/agencies. Once a department/agency decides to look at procuring as a PPP, they would do a value-for-money analysis to support the decision.

Once a project is selected as a PPP candidate, the proposals of prospective private partners are compared to a PSC. Thus, all prospective PPP projects are generally measured against an alternative public sector option (PSO). However, prospective TIP projects are not compared to an alternative private sector option. An alternative private sector option is unfortunately not always viable, as the government cannot be expected to credibly forecast the range of innovative designs and risk management procedures which competing private partners can invent. Hence, there is unfortunately no credible (or at least very limited) scope for governments to create a “private sector comparator”. As Section 5 below argues, the problem is not insurmountable. The discussion in Section 5 will show that the governments of the United Kingdom and the Australian state of New South Wales apply a set of criteria that guide public sector managers to assess which mode of procurement will likely deliver the most value for money. Such a set of criteria could help governments select a procurement mode in a systematic manner.

3.5. Role of the finance ministry and parliament in the approval process

The sequencing of decision making regarding the creation of a project, and more specifically where in this sequence the choice between a PPP and traditional procurement as method of procurement is made, may impact the decision on whether or not the project is actually going ahead. The key question is whether or not the government first decides on the procurement of an asset before it chooses the mode of procurement. Table 15 reports that, in 11 countries, the government always first decides on the procurement of an asset before it chooses the mode of procurement. In three more countries, this is done often, while in four countries this is done rarely or never. In the case of the two countries falling in the “other” category, one has TIP as a default option and requires that, if a project takes the PPP route, the proposal justifies why TIP is not preferred. The second country in the “other” category stated that whether or not the government first decides on the procurement of an asset before choosing the mode of procurement is decided on a case-by-case basis.

Table 15. Does the government first decide on the procurement of an asset before it chooses the mode of procurement (the latter being the choice between PPP and TIP procurement)?

Always	11 ^a
Often (> 50% of the time but less than 100%)	3 ^b
Rarely (< 50% of the time but more than 0%)	3
Never	1
Other	2
Total	20

a. Australia, Austria, Denmark, France, Germany, Greece, Ireland, Korea, Netherlands, South Africa, United Kingdom.

b. Canada, Italy, Mexico.

Closely linked to the question about sequencing is a question about budgeting. When line departments present their new project proposals to the cabinet/chief executive/finance ministry, etc., the question is whether or not they have to show that their projects can be funded within their multi-year expenditure budget estimates. Both for PPPs and TIP projects, 15 countries reported that line ministries always have to demonstrate that the proposed projects can be funded, while for three more countries this has to be done often for both PPPs and TIP projects (see Table 16).

Table 16. When the line ministries present their new project proposals to the cabinet/chief executive/finance ministry, etc., do they have to show that the project can be funded within their multi-year expenditure budget estimates in the case of PPPs and TIP?

	PPPs	TIP
Always	15	15
Often (> 50% of the time but less than 100%)	3	3
Rarely (< 50% of the time but more than 0%)	0	1
Never	0	0
Other ^a	2	1
Total	20	20

a. In the case of Norway, a ministry is permitted to present a proposal that cannot be funded within current budget limits. Such proposals will be handled in the cabinet budget process. In the case of Austria, limited applicability for PPP since only one exists.

The decision about whether or not to procure the asset (prior to deciding the mode of procurement) involves the allocation of the capital needed for the project in the normal budgetary cycle. Only when funds are allocated can the government commit to procuring the asset through either a TIP or a PPP. This sequencing prevents a situation where, although an asset cannot be procured due to a lack of allocated funds in the budget, the procuring department sets the project up as a possible PPP because the acquisition of the asset will not appear on the government books. If the sequencing described in Table 16 does not exist, there is a danger that – even though initially a PPP project proposal is presented as an alternative to public procurement (it may even include a public sector comparator) – the actual choice is not between a PPP and traditional public procurement, but between a PPP and no procurement. The absence of the sequencing also creates a way to put pressure on a finance ministry in subsequent years to fund payments to private partners originating in the PPP agreements.

The role of the finance ministry may extend further than just the approval of the annual government budget and the budgets of the individual line departments. The Ministry of Finance may also have a formal, gatekeeping role with respect to the approval of specific projects (even when these projects fall within the existing approved budget envelope of the responsible line ministry). The term “gatekeeping” means that if approval is not obtained, the project cannot proceed. Again, this may differ between PPPs and TIP projects. Table 17 notes that in ten countries all PPP projects or all PPP projects above a threshold are subject to such approval, while TIP projects in eight countries are subject to such approval. It should also be noted that seven of the ten countries mentioned for PPPs require approval for all projects, while in the case of TIP it is only three of the eight. Again, this indicates that the requirements imposed on PPPs are more stringent than those imposed on TIP projects.

Table 17. Does the Ministry of Finance have a formal gatekeeping role with respect to the approval of specific projects (even when these projects fall within the existing approved budget envelope of the responsible line ministry) in the case of PPPs and TIP?

	PPPs	TIP
Yes, for all	7 ^a	3 ^c
Yes, for those above a threshold	3 ^b	5 ^d
Yes, on an <i>ad hoc</i> basis	4	5
No	2	4
Other	4	3
Total	20	20

a. Australia, Austria, Chile, Greece, Mexico, South Africa, United Kingdom.

b. Canada, Korea, Slovak Republic.

c. Austria, Greece, Mexico.

d. Canada, France, Korea, Norway, United Kingdom.

The approval entailed by the gatekeeping role, both in the case of PPPs and TIP projects, may relate to: i) the size of the project (in financial terms); ii) value for money; iii) whether correct procedures have been followed in the project development; and iv) an assessment of whether or not the project adheres to the intention of the original budget appropriation. Table 18 reports the results. It is worth noting that, in 14 countries, approval for PPPs is granted on the basis of value for money, while only 7 countries use that criterion for approving TIP projects. Again, Table 18 demonstrates that PPPs have to fulfil more rigorous requirements compared to TIP projects. And again this supports the notion that incentives might exist over and above value for money that affect which mode of procurement is used.

Table 18. If approval by the Ministry of Finance is required, it is given with respect to which of the following?

	PPPs	TIP
The size of the project (in financial terms)	13	10
Value for money	14 ^a	7 ^b
Whether correct procedures have been followed in the project development	11	6
Assessment of whether the project adheres to the intention of the original budget appropriation	11	10
Other	3	1

a. Australia, Canada, Chile, Czech Republic, Denmark, France, Greece, Hungary, Ireland, Korea, Mexico, Slovak Republic, South Africa, United Kingdom.

b. Australia, Canada, Denmark, Hungary, Ireland, Korea, United Kingdom.

Furthermore, PPPs and traditionally procured projects may also differ in terms of the moment in the procurement process of a specific project when the approval of the finance ministry is required for the process to go ahead. As Table 19 shows, this difference exists particularly in the later phases of the procurement process, i.e. after project preparation but before the tender process, and after the tender is complete but before contract signature.

Table 19. At what moment in the procurement process of a specific project is the approval of the finance ministry required for the process to go ahead?

	PPPs	TIP
Before project preparation	6	6
During project preparation	6	5
After project preparation, before the tender process	12	8
After tender is complete, before contract signature	13	6
Not required	0	2
Other	0	1

In addition to the gatekeeping role of the finance ministry, the government might also have a PPP unit that fulfils such a role. Table 20 reports that only six units fulfil this function for all PPP projects, while only one does so for projects above a threshold. Many, if not most, of these units do not fulfil this gatekeeping role alone, but do so together with the finance ministry.

Table 20. Does the PPP unit have a formal gatekeeping role with respect to the approval of specific projects (even when these projects fall within the existing approved budget envelope of the responsible line ministry) in the case of PPPs?

Yes, for all	6 ^a
Yes, for those above a threshold	1
Yes, on an <i>ad hoc</i> basis	1
No	7
Other	1
Not answered by those who answered “no” to the question in Table 8	4
Total	20

a. Australia, Chile, Greece, Mexico, South Africa, United Kingdom (for all PFI projects).

Again, as with the finance ministry, the approval entailed by the gatekeeping role may relate to: i) the size of the project (in financial terms); ii) value for money; iii) whether correct procedures have been followed in the project development; and iv) an assessment of whether or not the project adheres to the intention of the original budget appropriation. Table 21 reports that, in eight countries, approval is granted on the basis of whether or not a project represents value for money.

Table 21. If approval by the PPP unit is required, it is given with respect to which of the following?

The size of the project (in financial terms)	5
Value for money	8 ^a
Whether correct procedures have been followed in the project development	7
Assessment of whether the project adheres to the intention of the original budget appropriation	5
Other	2

a. Australia, Chile, Czech Republic, France, Greece, Korea, Mexico, United Kingdom.

In the cases where the PPP unit has a gatekeeping role, that role might exist at various stages of the PPP procurement process. The process itself may comprise four broad phases: i) before project preparation; ii) during project preparation; iii) after project preparation but before the tender process; and iv) after the tender is complete but before contract signature. It should be noted that the largest number of countries (seven and five) give approval after project preparation but before the tender process, and after the tender is complete but before contract signature (see Table 22).

Table 22. At what moment in the procurement process of a specific project is the approval of the PPP unit required for the process to go ahead?

Before project preparation	3
During project preparation	4
After project preparation, before the tender process	7
After tender is complete, before contract signature	5
Not required	1
Other	0

In addition to the procuring department and the finance ministry (and the PPP unit in the case of PPPs), parliament may also have to approve specific PPPs and TIP projects. This approval is in addition to the regular annual budgeting process. Only in Denmark and Norway is approval required in all cases for both PPPs and TIP projects, while in Germany approval is often required. In five countries, approval is rarely required for PPPs, while in four countries approval is rarely required for TIP projects. This means that, in the majority of countries, parliament plays no role in the approval of specific PPP or TIP projects.

Table 23. In addition to the regular annual budgeting process, is parliament formally involved in the approval of specific projects in the case of PPPs and TIP?

	PPPs	TIP
Yes (always)	2	2
Often (> 50% of the time but less than 100%)	1	1
Rarely (< 50% of the time but more than 0%)	5	4
No	12	13
Total	20	20

3.6. Accounting issues

The accounting for PPPs may in itself create incentives to prefer PPPs to traditionally procured infrastructure projects. For instance, in the case of a PPP, the assets and the associated debt incurred to purchase the assets of the project will probably appear on the books of the private partners. In the case of traditional procurement, the assets and their associated liability – i.e. the public debt incurred to purchase the assets – appear on the government books. This means that, compared to the accounting for PPPs, government expenditure in the fiscal year when the asset is acquired will be much higher in the case of traditional procurement. Since the government is not paying for the asset when it is initially purchased under a PPP, it may create the (false) impression that the government is not paying for the asset at all. However, to think that the government is not paying for the asset at all under a PPP is to ignore the future payment commitments and contingent liabilities of the government to the private partners in subsequent years. This ignorance regarding the future liabilities and payment commitments may create a false incentive to procure the project through a PPP (for more on this, see OECD, 2008). Therefore, to pre-empt this false incentive from arising, the government must decide clear criteria that determine on whose books the asset will appear. Table 24 reports the criteria used in the countries surveyed.

Table 24. What criteria are used to decide whether or not an asset involved in a PPP project appears on the government books?

Eurostat ^a criteria	9 ^b
Criteria set by the IPSASB (International Public Sector Accounting Standards Board)	2
IFRS criteria (International Financial Reporting Standards)	3
National GAAP criteria (Generally Accepted Accounting Principles)	6 ^c
Assets appear on the books of the party who carries the majority of risks	6 ^d
Assets appear on the books of the party who has control over the asset	4
Other	7

a. Twelve of the countries in the sample are EU members.

b. Czech Republic, France, Greece, Ireland, Italy, Netherlands, Slovak Republic, Spain, United Kingdom.

c. Australia, Canada, Denmark, France, Korea, South Africa.

d. Australia, France, Netherlands, Slovak Republic, Spain, United Kingdom.

However, establishing clear criteria that set out on whose books the assets and associated debt liabilities will appear might not be sufficient. The criteria (more importantly) also need to provide for the contingent liabilities⁹ and costs¹⁰ associated with PPPs. The absence of such criteria may create incentives towards the use of PPPs as a procurement option, rather than TIP. Table 25 reports that such provisions exist in 13 of the 20 countries.

Table 25. Have accounting mechanisms been put in place that formally account for the contingent liabilities and costs generated by PPP projects?

Yes	13 ^a
No	7
Total	20

a. Australia, Austria, Chile, Czech Republic, France, Germany, Greece, Hungary, Mexico, Netherlands, South Africa, Spain, United Kingdom.

3.7. Ex post value-for-money assessment

Though necessary to ensure the success of a project, the *ex ante* assessment of value for money is not sufficient to ensure that a project will deliver value for money. A further requirement is the conducting of *ex post* value-for-money assessments that determine whether or not value for money has actually been delivered. Again, there is the possibility that PPPs and traditional infrastructure procurement might differ.

Procuring line ministries, the finance ministry or the PPP unit may conduct *ex post* value-for-money assessments of projects as measured against specific pre-specified performance benchmarks. These benchmarks are usually defined for each project, either when the project commences or during the lifetime of the project. The extent (depth) and frequency with which *ex post* value-for-money assessments are made may also differ, not only between countries, but also between PPPs and traditionally procured infrastructure projects. Table 26 shows that, in three countries, all PPP projects are subjected to *ex post* value-for-money assessment, while in no country are all TIP projects subjected to *ex post* value-for-money assessment. However, for eight countries a selection of PPP projects (either with or without a set frequency) is subjected to *ex post* value-for-money assessment. In respectively four and seven countries, no such assessments are made for PPPs and TIP projects. With regard to such *ex post* value-for-money assessments, it should be noted that a general tendency also exists to apply more stringent requirements to PPPs than to TIP projects. Again, the argument is not that the requirements applied to PPPs should be relaxed, but rather that the requirements applied to TIP projects should be tightened.

Table 26. Do line ministries, the finance ministry or the PPP unit conduct *ex post* value-for-money assessments of projects as measured against specific pre-specified performance benchmarks (defined for each project either when the project commences or during the lifetime of the project) in the case of PPPs and TIP?

	PPPs	TIP
Yes, for all projects and with a set frequency (<i>e.g.</i> annually or every two years)	0	0
Yes, for all projects, but no set frequency	3 ^a	0
Yes, for a selection of projects, with a set frequency	1 ^b	2 ^e
Yes, for a selection of projects, but no set frequency	7 ^c	8 ^f
No	4 ^d	7 ^g
Other	5	3
Total	20	20

a. Australia, Chile, Ireland.

b. Mexico.

c. Czech Republic, France, Greece, Hungary, Italy, Korea, South Africa.

d. Austria, Netherlands, Slovak Republic, United Kingdom.

e. Germany, Ireland.

f. Australia, Chile, France, Greece, Hungary, Italy, Korea, Mexico.

g. Austria, Czech Republic, Netherlands, Slovak Republic, South Africa, Spain, United Kingdom.

In addition to procuring line ministries, the finance ministry or the PPP unit doing *ex post* value-for-money assessments, the supreme audit institution may also conduct value-for-money audits, both for PPPs and for traditionally procured projects. In this case, there is not much difference between the extent (depth) and the frequency with which these are done. Table 27 shows that, respectively, 12 and 14 countries require that a selection of PPPs and TIP projects with no set frequency be subjected to *ex post* value-for-money assessments, while in a further seven countries for PPPs and six countries for TIP projects no such *ex post* value-for-money assessments are done. Furthermore, the overlap between the PPPs and TIP

categories in Table 27 is very high, i.e. 11 of the countries are included in both groups of 12 and 14, while four are included in both groups of six and seven countries that reported a “no”.

Table 27. Has the supreme audit institution done value-for-money audits in the case of PPPs and TIP?

	PPPs	TIP
Yes, for all projects and with a set frequency (<i>e.g.</i> annually or every two years)	0	0
Yes, for all projects, but no set frequency	0	0
Yes, for a selection of projects, with a set frequency	0	0
Yes, for a selection of projects, but no set frequency	12	14
No	7	6
Other	1	0
Total	20	20

3.8. Elements of integrity that may influence the choice between PPPs and traditional infrastructure procurement

In addition to the above-discussed *ex ante* and *ex post* value-for-money assessments, governments may also use other tools. The OECD developed a toolbox to enhance the integrity of public procurement (OECD, 2009). The enhancement of such integrity will contribute to an improvement in value for money in projects. The questionnaire asked respondents which of the following tools are used in the procurement cycle in the case of, respectively, PPPs and TIP projects:

- post-award risk assessment of financial vulnerability of contractors;
- limits on the size of projects;
- project risk indicators (quantifying risk);
- guidelines for risk allocation in projects (between government and private providers/contractors);
- provision for estimated risk in budget submitted to parliament;
- other.

Table 28 reports the results. It should be noted that, while 14 countries report the use of project risk indicators, only six countries report the use of such indicators in the case of TIP. Even though in the case of TIP projects the government retains more risk compared to PPPs, where risk is shared, the government might nevertheless benefit from identifying these risks in the case of TIP projects. It should also be noted that, in five countries, an assessment of post-award risk assessment of the financial vulnerability of private providers is made, while only one country does this assessment for TIP projects. This reflects the fact that, in the case of a TIP project, the government's relationship with the private party only lasts during the construction phase of the project, while in the case of a PPP the relationship is a long-term relationship usually lasting up to 25-30 years. However, even in the case of PPP projects, one would have expected more countries to conduct these assessments. Only in three countries (for both PPPs and TIP projects) are there limits on the size of projects.

Table 28. Which of the following tools are used in the procurement cycle in the case of PPPs and TIP?

List compiled using OECD (2009), "Enhancing Integrity in Public Procurement: A Toolbox"
(www.oecd.org/governance/procurement/toolbox)

	PPPs					TIP				
	Yes	No	Sometimes	Not answered	Total	Yes	No	Sometimes	Not answered	Total
Post-award risk assessment of financial vulnerability of private providers	5	7	4	4	20	1	10	4	5	20
Limits on the size of projects	3	9	2	6	20	3	10	3	4	20
Project risk indicators (quantifying risk)	14	2	0	4	20	6	5	3	6	20
Guidelines for risk allocation in projects (between government and private providers/ contractors)	12	2	3	3	20	2	7	3	8	20
Provision for estimated risk in budget submitted to parliament	3	9	1	7	20	4	7	2	7	20
Other	1	4	0	15	20	0	5	0	15	20

3.9. Other elements that may influence the choice between PPPs and traditional infrastructure procurement

As discussed in further detail in Section 5 below, several studies have been undertaken for Australia, the United Kingdom and the United States to establish whether or not PPPs deliver improved value for money compared to traditional procurement (cf. Allen Consulting Group, 2007; Arthur Andersen and Enterprise LSE, 2000; Fitzgerald, 2004; Haskins, Gale and Kelly, 2002; Mott MacDonald, 2002; National Audit Office, 2003; and University of Melbourne, 2008). These studies compared the performance of PPPs to that of traditional infrastructure procurement, especially comparing the actual cost and time spent putting the project into operation. All of these studies show that PPPs outperform traditional procurement in terms of both cost and time overruns. The most significant outperformance occurs with respect to cost.

To obtain a notion as to whether the findings in Australia, the United Kingdom and the United States also apply to other countries, the questionnaire asked respondents about on-time delivery and about delivery within budget. Respectively eight and ten countries reported that they do not possess enough data to ascertain whether or not PPPs outperform TIP projects with regard to on-time delivery or keeping expenditure within budget (see Table 29). However, with regard to on-time delivery, the remaining 12 countries all reported that, compared to TIP projects, PPPs perform better. In the case of actual expenditure remaining within budget, nine reported that PPPs outperform TIP projects and one reported that performance is the same for PPPs and TIP projects.

Table 29. Based on the general experience using PPPs and TIP by the government in your country, and compared to TIP, how do PPPs perform with regard to time and cost?

	On-time finalisation of the construction phase and commencement of service delivery	Actual expenditure remaining within budget
Better	12 ^a	9 ^b
The same	0	1
Worse	0	0
Not enough data to make the assessment	8	10
Total	20	20

a. Australia, Canada, Czech Republic, France, Germany, Ireland, Korea, Mexico, Netherlands, Norway, South Africa, United Kingdom.

b. Australia, Canada, Chile, France, Germany, Mexico, Netherlands, South Africa, United Kingdom.

Tables 30 and 31 summarise responses to questions that seek to identify factors that might render PPPs more attractive compared to TIP projects (Table 30), or *vice versa* (Table 31). Earlier in this article, it was mentioned that governments need to account for PPPs in a way that will not create an incentive to prefer the PPP route simply because it allows for not recording the liabilities on the government books. While, according to the survey, debt not being recorded on the government books does not make PPPs more attractive relative to TIP in nine countries, four countries nevertheless responded that it does make PPPs more attractive, while four more countries responded that it sometimes does create such an incentive.

Table 30. **Do the following make PPPs more attractive in comparison to TIP?**

	Yes	No	Sometimes	Not answered	Total
The project generates debt that is not on the balance sheet of the government	4 ^a	9	4 ^b	3	20
The project requires a high level of constant maintenance	10 ^c	2	5 ^d	3	20
The project requires a high level of service delivery performance	12 ^e	0	4 ^f	4	20
The project requires skills that are more readily available in the private sector compared to the public sector	9 ^g	2	6 ^h	3	20
Strong public unions in the public sector in the relevant sector	0	11 ⁱ	3	6	20
Other	2	2	1	15	20

a. Chile, Ireland, Mexico, Norway.

b. Hungary, Italy, Korea, Slovak Republic.

c. Canada, Chile, France, Germany, Greece, Ireland, Italy, Korea, South Africa, United Kingdom.

d. Australia, Czech Republic, Hungary, Mexico, Slovak Republic.

e. Australia, Canada, Chile, Czech Republic, France, Greece, Italy, Korea, Mexico, Netherlands, South Africa, United Kingdom.

f. Denmark, Hungary, Ireland, Slovak Republic.

g. Australia, Canada, Chile, Czech Republic, France, Greece, Italy, South Africa, United Kingdom.

h. Hungary, Ireland, Korea, Mexico, Slovak Republic, Spain.

i. Canada, Chile, Czech Republic, Denmark, France, Greece, Hungary, Korea, Mexico, Netherlands, South Africa.

The questionnaire also considered the extent to which the availability of skills in the private sector *vis-à-vis* the public sector affects the preference towards either the PPP or the TIP option. *A priori* it is not clear whether the availability of skills will necessarily bias the choice towards a PPP. A government may not possess the necessary skills to manage a project itself. As such, it might prefer to use a PPP. However, skills are also needed to manage the public sector oversight of the private partner in the case of a PPP. Thus, if the requisite skills are not available in the public sector, the procuring department may be wary of using a PPP, as it may fear the disadvantage it has relative to the private sector.¹¹ However, Tables 30 and 31 indicate that the absence of skills makes the use of PPPs more attractive relative to TIP projects. Nine countries reported that if the project requires skills that are more readily available in the private sector, it makes PPPs more attractive (with six more reporting that it might sometimes be the case) (see Table 30). For the opposite – i.e. that the absence of skills makes TIP more attractive relative to PPPs – 12 countries reported that it does not, while none reported that it does (Table 31).

Table 30 also shows that if a project requires high levels of constant maintenance and service delivery performance, it might render PPPs more attractive relative to TIP. With regard to the opposite, 12 countries indicated – for when a project requires high levels of both constant maintenance and service delivery performance – that it does not make TIP more attractive relative to a PPP (see Table 31).

Table 31. **Do the following make TIP more attractive in comparison to PPPs?**

	Yes	No	Sometimes	Not answered	Total
The project is politically/strategically important (<i>e.g.</i> defence)	9 ^a	4	4 ^b	3	20
The project is complex in management and design	2	8	5	5	20
The project risk is difficult to quantify and measure (<i>e.g.</i> large IT investments)	9 ^c	3	4 ^d	4	20
The project requires a high level of constant maintenance	1	12 ^e	2	5	20
The project requires a high level of service delivery performance	0	12 ^f	3	5	20
The project requires skills that are more readily available in the private sector compared to the public sector	0	12 ^g	3	5	20
Strong public unions in the public sector in the relevant sector	5 ^h	4	3 ⁱ	8	20
Other	3	2	0	15	20

a. Chile, Czech Republic, Ireland, Korea, Mexico, Netherlands, Norway, South Africa, Spain.

b. Australia, Denmark, Hungary, Italy.

c. Czech Republic, Germany, Greece, Ireland, Korea, Mexico, Netherlands, South Africa, United Kingdom.

d. Australia, Canada, France, Hungary.

e. Australia, Canada, Chile, Denmark, France, Greece, Ireland, Italy, Korea, Netherlands, South Africa, United Kingdom.

f. Australia, Canada, Chile, Denmark, France, Greece, Ireland, Italy, Korea, Netherlands, South Africa, United Kingdom.

g. Australia, Canada, Chile, Czech Republic, Denmark, Greece, Ireland, Italy, Korea, Netherlands, South Africa, United Kingdom.

h. Czech Republic, France, Mexico, Netherlands, South Africa.

i. Australia, Ireland, Korea.

The presence of strong public unions may also create an incentive towards either a PPP or traditional procurement. Where a government holds a perception that the presence of strong public sector unions affects negatively its ability to deliver value for money, it may prefer to use a PPP (assuming of course that private sector unions are not as strong). However, strong public sector unions may also object to the use of PPPs. Very often the use of a PPP will require a special agreement regarding public sector staff, particularly in cases where public sector staff become redundant as a result of a PPP replacing a service previously delivered by the government.¹² Table 30 indicates that, in only three countries, the presence of strong public sector unions sometimes renders PPPs more attractive relative to TIP, while in 11 countries it does not. This contrasts with Table 31, which indicates that in five countries the presence of strong public sector unions renders TIP more attractive to PPPs, while in three countries this is sometimes the case.

It is sometimes said that complex projects do not make for good PPPs. If a project is rather complex, it becomes extremely difficult for PPP contracts to cover important future contingencies. As a result, a government might prefer to use traditional procurement instead of a PPP. The same goes for projects that face high probabilities of redundancies due to technological change. This explains why PPPs are more prevalent in less complex areas such as roads and other infrastructure. It also explains why, in projects such as health care and education, PPPs usually deal with the infrastructure and management of facilities and less with the direct health service or teaching. However, only two countries report that complexity makes TIP more attractive relative to PPPs, with five reporting that it might sometimes be the case (see Table 31). Eight countries reported that complexity does not make TIP more attractive relative to PPPs.

Complexity and redundancy are very closely linked to cases where it is difficult to quantify and measure project risk (*e.g.* large IT investments).¹³ Also, in these cases it becomes extremely difficult for PPP contracts to cover important future contingencies. However, in contrast to complexity that does not seem to affect the attractiveness of TIP relative to PPPs in so many countries, ten countries reported that a difficulty to quantify and measure risk makes TIP more attractive relative to PPPs (see Table 31).

In cases where a project is politically or strategically important (*e.g.* defence), a government might prefer to use traditional procurement and not a PPP. In some countries, there is even a prohibition on the private sector delivering these services. In nine countries, the political or strategic importance of a project might render TIP more attractive relative to PPPs, while in three countries this might sometimes be the case.

Lastly, political preferences towards private sector service delivery may have contributed in the past towards a preference for procurement through PPPs, while political preferences towards public sector service delivery may have contributed towards a preference for procurement through traditional infrastructure procurement. Which of these two statements holds true for a particular country very much depends on the influence of ideology in individual countries. This influence very often plays itself out through the political system. Table 32 shows that political preferences towards private sector service delivery contributed to a large extent in the past towards a preference for procurement through PPPs in only one country. In six countries it did so to some extent, while in 12 it did not. However, this situation contrasts sharply with the opposite proposition that political preferences towards public sector service delivery contributed in the past towards a preference for procurement through TIPs: in four countries, it did so to a large extent, in nine to some extent (making a total of 13 countries where it did so to either a large or some extent) and, in seven countries, it did not contribute towards a preference for procurement through TIP.

Table 32. **Political preferences**

	Yes, to a large extent	Yes, to some extent	No	Other	Total
Have political preferences towards private sector service delivery contributed in the past towards a preference for procurement through PPPs?	1 ^a	6 ^b	12	1	20
Have political preferences towards public sector service delivery contributed in the past towards a preference for procurement through TIP?	4 ^c	9 ^d	7	0	20

a. Korea.

b. Austria, Canada, Denmark, Hungary, Ireland, Norway.

c. Czech Republic, France, Norway, South Africa.

d. Australia, Austria, Canada, Germany, Hungary, Ireland, Italy, Mexico, Netherlands.

3.10. Concluding discussion on the survey results

Traditional infrastructure procurement is usually the default option because it is the much older procurement option in most countries (the exception being countries where concessions have been a common procurement method for a long time). Therefore, due to their novelty, the PPP option is still treated in many countries as the “add on” procurement option. The novelty of PPPs in many countries also means that more uncertainty exists with regard to their potential and the risks that they hold. This would explain why, in many of the surveyed countries, more is required from potential PPP projects compared to traditional procurement. Introducing PPPs in most countries also meant the *de novo* design and implementation of a new type of procurement method and system; policy makers had a clean slate on which to design it and then implement it. This very often means that PPP procurement processes fulfil many of the textbook requirements about what would constitute good procurement. For instance, one of the key aspects of good PPP design is a whole-of-life approach to project implementation. Most *ex ante* value-for-

money assessments for PPPs have a whole-of-life approach built into them. However, not all countries follow a whole-of-life approach towards traditional procurement, indicating that more is required from PPPs. In addition, processes to change traditional public infrastructure procurement practices might suffer from inertia meaning that, unlike the newly designed PPP practices, traditional public infrastructure procurement practices might not fulfil all the textbook requirements about what would constitute good procurement.

The survey also indicated that, in some countries, finance ministries (together with PPP units) play a larger role in the approval of projects compared to TIP projects, while PPPs are also in general subjected to more *ex post* value-for-money assessments. Because more is required from PPPs in these countries, an incentive exists to prefer the TIP route instead. However, processes are not the only factor that might render traditional procurement more attractive relative to PPPs and hence create an incentive to take the traditional procurement route. The survey also indicates that, in a significant number of countries, the existence of strong public sector unions as well as political preferences towards public sector service delivery also contributed to rendering TIP more attractive than PPP procurement. Nevertheless, incentives may also operate in the opposite direction. For instance, in some countries, having the debt that a PPP entails off the government books still creates an incentive to prefer the PPP route. Furthermore, if projects require skills that are more readily available in the private sector, or if the project requires a high level of constant maintenance, PPP procurement may also become more attractive compared to TIP. However, overall and on balance, the respondents to the survey felt that the rules in place impede attaining the maximum value for money by creating incentives to prefer traditional infrastructure procurement to PPPs (with not much support found for the opposite proposition).

4. Four country case studies

4.1. Background information

To augment the findings of the questionnaire, this section presents four case studies covering the procurement process for PPPs and TIP in France, Germany, Korea and the United Kingdom. The information in this section, including the table and two figures, originate from the relevant PPP authorities in the four countries.¹⁴ The four authorities were given a list of questions for brief response:

1. Describe the procurement process that a traditional infrastructure project (TIP) undergoes.
2. Describe the procurement process that a public-private partnership (PPP) undergoes.
3. Describe the *ex ante* value-for-money criteria and tests to which a TIP is subjected.
4. Describe the *ex ante* value-for-money criteria and tests to which a PPP is subjected.
5. Describe the *ex post* value-for-money criteria and tests to which a TIP is subjected.
6. Describe the *ex post* value-for-money criteria and tests to which a PPP is subjected.
7. To what extent is the playing field for PPPs and TIP equal or unequal in terms of criteria, tests and processes?

4.2. France

4.2.1. Describe the procurement process that a traditional infrastructure project (TIP) undergoes

The TIP and PPP procurement processes in France follow standard EU procurement laws, i.e. open competition and application of MEAT principles (“most economically advantageous tender”). Table 33 summarises the key elements of TIP and PPP contracts in France. The first row indicates the legal framework covering TIP and PPPs in France, while the second row indicates the long-term or short-term nature of the contracts as well as the scope of their objectives. The third and fourth rows indicate the role of the private sector as well as the extent to which risk is transferred to the private sector.

Table 33. **A comparative analysis of French public procurement tools**

TIP	PPPs	
Procurement contract (call for tender: open or restricted)	Partnership contracts (competitive dialogue or negotiated procedure)	Concessions/build-operate-transfer (BOT) (negotiated procedure)
Law No. 85-704 of 12 July 1985 relating to public works management and its relation to private project management	Order No. 2004-559 of 17 June 2004 on partnership contracts	Law No. 93-122 of 29 January 1993
Short-term; one object (allotment)	Long-term; multiple object	Long-term; multiple object
No financing; successive tenders; no service provided (object is pieces of infrastructure); payment by public authority	Pre-financing and financing; design-build-operate-maintain; service provided to public authority; payment mostly by public authority; third-party revenues possible	Financing; design-build-operate-maintain; service provided to users; payment by users; third-party revenues possible
Construction risk transferred only by pieces	Construction risk transferred; performance risk transferred; demand risk may be transferred	Construction risk transferred; performance risk transferred; demand/traffic risk transferred

Source: Mission d'appui aux PPP, France.

4.2.2. Describe the procurement process that a public-private partnership (PPP) undergoes¹⁵

In France, a PPP is defined as a long-term contract (typically 15 to 35 years) whereby a public entity awards to a commercial firm a DBFO contract (design, build, finance and operate/maintain) for a public asset. Payments are spread over the life of the contract and are linked to performance objectives; they cover operating costs, reimbursement of debt linked to equipment financing, and investors and private partner return on equity linked to the risk taking. A PPP is subject to a comparative preliminary assessment on both legal and economic grounds.

Public authorities may award PPP contracts through one of two alternative options:¹⁶

- Ordinarily by way of a competitive dialogue procedure, for projects where the public authority is objectively not able to either identify the best means to satisfy its needs, or to evaluate which technical, legal or financial solutions are best suited (derived from EU Directive No. 2004/18/CE defining complexity). The object of the dialogue, therefore, is to define the technical means and legal/financial structure to best address the public authority's needs and will generally involve: i) risk matrix fine tuning; ii) discussion of legal, financial and/or technical clauses; iii) contract wording (drafts and finalisation); and iv) elimination of candidates by means of successive short lists.

- In limited circumstances by way of a tender procedure, for projects launched in a context of particular urgency (specific for partnership contracts).

In broad terms, the competition procedure would typically involve the following stages (for a competitive dialogue):

- the preparatory stage, including scope definition, public sector comparator, preparation of the tender documents package, official issue of a tender notice (*avis d'appel public à la concurrence* or AAPC) and prequalification of candidates;
- the competitive dialogue proceedings proper, including distribution of bidding packs (in particular, tender rules and draft contract), dialogue iterations management, and dialogue iterations conclusions and decisions;
- the final stage, including distribution of the final offer pack, invitation to submit final offers, examination/clarification of final offers, preferred bidder selection, finalisation of contract, approvals, signature and associated controls (legal, budgetary, etc.) (*contrôle de légalité*).

Any aspect of the project may be discussed to allow the public authority to finalise its requirements and for the candidate to finalise its offer, provided the characteristics of the project as initially presented in the tender notice remain unchanged. The award will ultimately be made to the “most economically advantageous” offer with respect to the criteria set out in the tender process (described in more details below). Strict conditions of equality apply to each candidate. The public authority must not provide any candidates with information likely to place them at an advantage against others, and must not reveal to other candidates any indication on solutions or any confidential information proffered.

The procurement timetable clearly varies from project to project, and there is no overall limit on the length of the competitive dialogue phase. Looking again at the three basic stages set out above, an indicative timetable for a given project might be as follows, depending upon the size and complexity of the underlying deals:

- Preparatory stage:
 - from AAPC to prequalification submissions: one-and-a-half months;
 - confirmation of prequalified consortia: one to two months.
- Competitive dialogue proper:
 - from confirmation of prequalified consortia to launch of competitive dialogue proceedings: one to three months;
 - competitive dialogue: four to twelve months.
- Final stage:
 - from conclusion on the last iteration of the competitive dialogue to submission of final offers: two to four months;
 - examination/clarification of final offers to execution/contract finalisation, entry in force of contract (e.g. due diligences): two to six months.

4.2.3. Describe the ex ante value-for-money criteria and tests to which a TIP is subjected

Traditional procurement complies with the CMP (*code des marchés publics*) and with a law on public programme management (Law No. 85-704 of 12 July 1985). Both texts do not provide for any compulsory standard value-for-money criteria before, during and after the procurement process.

4.2.4. Describe the ex ante value-for-money criteria and tests to which a PPP is subjected

The Mission d'appui aux PPP (MAPPP) has developed a methodology which is described in detail in a PPP guidance book (currently being revised). The methodology is based on the idea that, even if uncalculated, value for money nevertheless does exist in a project realised through traditional procurement. The methodology comprises a comparative assessment of value for money, and more precisely an assessment of comparative value for money: the best realisation mode of a project (traditional or PPP) being the one for which value for money is the maximum. In 2010, the MAPPP made the methodology more sophisticated to take into account the time savings in investment realisation that can be derived from PPP use and that are confirmed by statistical observations. The subject has been widely discussed at the EPEC level – the European PPP Expertise Centre based within the European Investment Bank in Luxembourg, and which co-ordinates PPP systems throughout EU member states.

The need for methodological sophistication and complements is the consequence of the new PPP law of 28 July 2008 that introduced the criterion of economic efficiency. This methodology takes into account what are generally referred to as non-financial benefits associated with PPPs. In particular, concerns about sustainability and ecology are part of the approach.

4.2.5. Describe the ex post value-for-money criteria and tests to which a TIP is subjected

Same as 4.2.3 above, i.e. none.

4.2.6. Describe the ex post value-for-money criteria and tests to which a PPP is subjected

The law of 28 July 2008 introduced rules of monitoring applicable to PPPs. It includes reporting on contract realisation/life, and in particular on the value of the variables on which the preliminary value-for-money calculation has been established. This reporting begins at the end of the competition process, before contract signature: the public authority in charge is obliged to provide the MAPPP with data describing the competition process and, in particular, the financial assumptions and parameters included in the preferred bidder's offer. Such data are examined by the MAPPP and consolidated in a short report to the Minister of Economy and Finance.

4.2.7. To what extent is the playing field for PPPs and TIP equal or unequal in terms of criteria, tests and processes?

PPPs are now mostly on an equal playing field regarding tax issues, eligibility for public subsidies and insurance coverage obligations. However, the procedure remains more demanding and more tightly controlled than traditional public procurement, with in particular the requirement for a preliminary assessment showing the grounds for taking the PPP route (no such requirement exists for projects launched as traditional public procurement, *marchés publics* or concessions).

4.3. Germany

The following applies to projects conducted by the administration at the levels of the central government and of the federal states.

4.3.1. Describe the procurement process that a traditional infrastructure project (TIP) undergoes

The government department responsible for a particular public sector function and the ministry responsible for preparing and executing the budget determine: the staffing level (Point 1) required for the function in question; and the infrastructure (Point 2) needed for that level of staffing. The government department responsible for the function then instructs a building authority at the federal (i.e. central) government level or the federal state level to draw up a plan showing the required scope of the building project. The plan also includes an estimate of the costs to be funded from the budget (Point 3).

Once the department responsible for the administrative function and the ministry in charge of preparing and executing the budget have officially recognised the necessity of the project as outlined in the plan, the building administration of the federal government or the federal state specifies in detail how the building project will be carried out. This specification forms the basis of the procurement procedure. The construction to be procured is divided into construction phases and types of work including overall planning and construction supervision (Point 4). The parcels of work are then put out to tender on this basis. The successful bidder for each is awarded the contract and receives payment once the work is completed (Point 5). When the construction is complete, the building administration signs it over for use to the government department responsible for the administrative function (Point 6). A public sector company responsible for real estate management, or a special administration set up for the purpose, takes care of operation and maintenance (Point 7).

4.3.2. Describe the procurement process that a public-private partnership (PPP) undergoes

Points 1 and 2 of the procedure are identical to those described in sub-section 4.3.1 above. When it comes to Point 3, an analysis is carried out of different variants apt to meet the need. The main component is the PPP suitability test, which investigates whether or not the PPP variant is possible, legally permissible and potentially more efficient. If possible efficiencies are identified, the PPP suitability test is followed by a provisional economic feasibility analysis. This compares the estimated costs of building, financing, operating and maintaining the variants under consideration. Regarding Points 4 and 5, the construction project as a whole is put out to tender on the basis of an output specification, including financing and operation. As regards Point 7, operation and maintenance are carried out by the contractor.

4.3.3. Describe the ex ante value-for-money criteria and tests to which a TIP is subjected

Where conventional procurement is used, the government department responsible for carrying out the administrative function undertakes a cost-benefit analysis of the project before it approves the plans detailing the staffing levels and space required. Once the scope of the building project has been approved, the cost of the investment is estimated using the outcomes of comparable contracting procedures.

4.3.4. Describe the ex ante value-for-money criteria and tests to which a PPP is subjected

Initially, the procedure followed for PPPs is the same as that described in sub-section 4.3.3, but with one special feature: a PPP suitability test is carried out before the cost is estimated. This test answers the question of whether it is at all possible to achieve

higher efficiency by procuring with PPP instead of the traditional procedure (also see sub-section 4.3.2).

4.3.5. Describe the ex post value-for-money criteria and tests to which a TIP is subjected

The investment on offer and the operational and maintenance service on offer must be available in the ordinary course of business at an appropriate price which is usual for the location.

4.3.6. Describe the ex post value-for-money criteria and tests to which a PPP is subjected

Same as sub-section 4.3.5 above.

4.3.7. To what extent is the playing field for PPPs and TIP equal or unequal in terms of criteria, tests and processes?

There is no real difference. Within the legal framework where PPP is a permissible alternative, all of the criteria are neutral and only serve to assess the economic efficiency of the different alternatives.

4.4. Korea

4.4.1. Describe the procurement process that a traditional infrastructure project (TIP) undergoes

The National Finance Act requires that the Ministry of Strategy and Finance (MoSF) conduct a preliminary feasibility study (PFS) for any large-scale investment project that exceeds KRW 50 billion and that requires a central government subsidy of more than KRW 30 billion. Based on general research on large-scale development projects and using the PFS, the MoSF verifies the feasibility of the project with regard to (among others) its economic feasibility, policy analysis, investment priority, proper timing and financing methods.

If a project turns out to be feasible as a result of the PFS, the competent authority carries out a feasibility study. A feasibility study focuses mainly on technical viability, whereas a PFS largely reviews economic and policy adequacy. While a feasibility study is carried out by the concerned competent authorities, every PFS is carried out by the PIMAC (Public and Private Infrastructure Investment Management Center, within the Korea Development Institute, KDI), entrusted by the MoSF, to ensure consistency. After a feasibility study, the competent authority prepares the basic and detailed design and selects contractors through an open competitive bidding process.

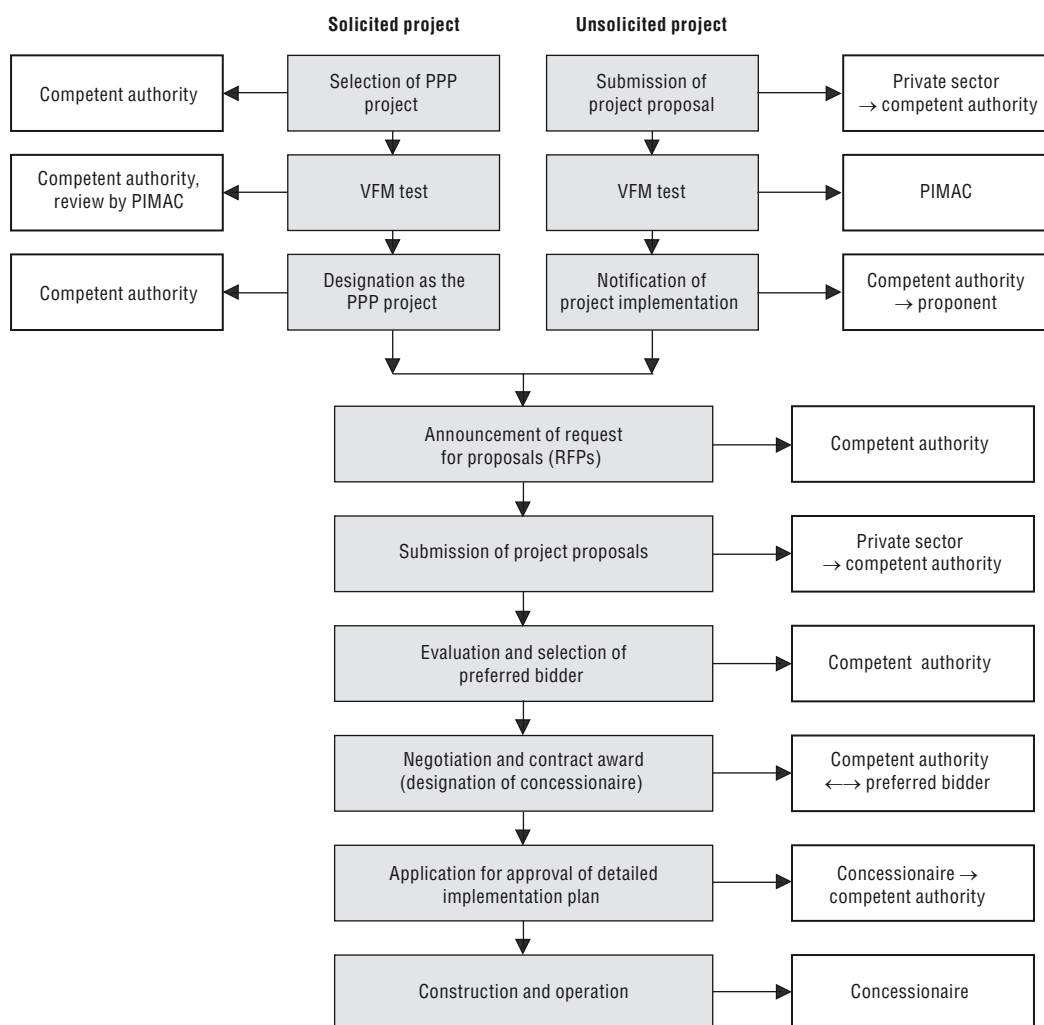
4.4.2. Describe the procurement process that a public-private partnership (PPP) undergoes

The PPP Act and the Enforcement Decree regulate the general procurement procedure for PPP projects. The Basic Plan for PPP formulated under the PPP Act provides a detailed implementation process set by project types and initiation, and defines the roles of associated parties in each step such as the competent authority, the private company, the finance ministry (Ministry of Strategy and Finance, MoSF) and the PIMAC.

The procurement procedure is designed to secure or enhance the value for money of PPP projects. A PFS is also required for PPP projects that exceed KRW 50 billion and require a central government subsidy of more than KRW 30 billion. Procurement procedures for

build-transfer-operate projects (BTO) (concession type) are described in Figure 1. Both solicited and unsolicited projects are eligible for BTO projects. After conducting a value-for-money test to evaluate its potential as a PPP project, a competent authority announces a request for proposals (RFPs) and evaluates proposals for selection. A competent authority negotiates with a preferred bidder for contract terms. After a PPP contract is awarded, the concessionaire commences construction.

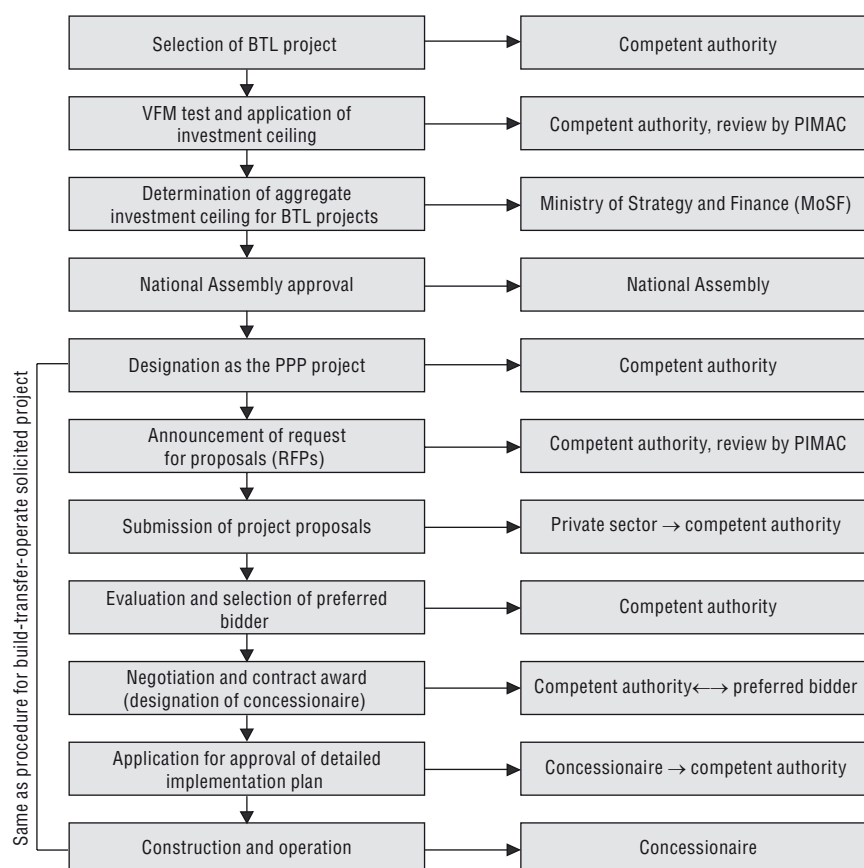
Figure 1. **The PPP procurement process for build-transfer-operate projects (BTO) in Korea**



Source: Public and Private Infrastructure Investment Management Center (PIMAC), Korea.

A build-transfer-lease project (BTL) (service contract type) is initiated by the competent authority, reviewed by the MoSF to decide on an aggregate investment ceiling for BTL projects, and then approved by the National Assembly. The subsequent procedure after the RFP announcement is the same as with BTO projects.

Figure 2. **The PPP procurement process for build-transfer-lease projects (BTL) in Korea**



Source: Public and Private Infrastructure Investment Management Center (PIMAC), Korea.

4.4.3. Describe the ex ante value-for-money criteria and tests to which a TIP is subjected

The main analysis of the preliminary feasibility study (PFS) includes an economic analysis, a policy analysis, and a balanced regional development analysis. The backbone of the economic analysis is a cost-benefit analysis. The economic benefits and costs of a project are estimated on the basis of forecast demand and costs. Policy analysis examines the effects of the projects in qualitative and quantitative terms. The policy analysis includes consistency with higher-level policies, project risks and other project-specific considerations. Balanced regional development analysis evaluates the project from the perspective of a regional dimension. The regional backwardness index, which is a composite index of eight characteristics for local entities, has been developed by the PFS guideline.

To synthesise the results of economic, policy, and balanced regional development analyses, a technique called analytic hierarchy process (AHP) is applied in the PFS. AHP is a multi-criteria decision-making approach that enables the combination of quantitative and qualitative analyses into a decision under a hierarchical structure. Lastly, the MoSF takes a decision on budget allocation for large-scale fiscal projects based on the results of the preliminary feasibility studies.

4.4.4. Describe the ex ante value-for-money criteria and tests to which a PPP is subjected

As is the case for TIP, a PFS is required for PPP projects that exceed KRW 50 billion and require a central government subsidy of more than KRW 30 billion. For PPP projects, a further analysis is conducted that compares the value for money associated with the PPP procurement option with value for money associated with a public sector comparator (PSC). This PSC replicates the case in which the project had been procured as a traditional fiscal investment method. The value-for-money test examines not only quantitative aspects (e.g. costs, demands, revenue) but also qualitative aspects (e.g. service quality, efficiency in contract execution and management, effects of risk transfer, impacts on the public sector and market, and project-specific issues).

4.4.5. Describe the ex post value-for-money criteria and tests to which a TIP is subjected

Ex post value-for-money assessment is not a required process, but is often reviewed for selected TIP projects (not many). The effects of cost overrun and construction delay of selected projects are evaluated. To analyse the cost overrun prevention effect, the total construction costs of projects announced on RFPs and those realised are compared. To assess the construction delay prevention effect, the estimated construction period on RFPs and actual construction duration are compared for completed projects.

4.4.6. Describe the ex post value-for-money criteria and tests to which a PPP is subjected

Similar to TIP projects; see sub-section 4.4.5 above.

4.4.7. To what extent is the playing field for PPPs and TIP equal or unequal in terms of criteria, tests and processes?

The institutional setting for infrastructure project evaluation provides a level playing field for PPPs and TIP. A PFS is required for both TIP and PPP projects that exceed a certain threshold size. A value-for-money test ensures that a PPP option is selected only when it has value for money compared to a PSC.

4.5. United Kingdom**4.5.1. Describe the procurement process that a traditional infrastructure project (TIP) undergoes**

Traditional procurement for infrastructure in the United Kingdom follows a procurement process in line with standard EU procurement laws. This process follows the values of open competition and award of contracts based on the MEAT principles (“most economically advantageous tender”).

4.5.2. Describe the procurement process that a public-private partnership (PPP) undergoes

PPP infrastructure procurement in the United Kingdom follows the same procurement process as that of traditional projects described above.

4.5.3. Describe the ex ante value-for-money criteria and tests to which a TIP is subjected

Before going forward with any infrastructure project in the United Kingdom, a full economic analysis is completed that compares the value for money that is expected to be

achieved through each of the options available. This analysis is completed in line with the HM Treasury *Green Book* (see www.hm-treasury.gov.uk/data_greenbook_index.htm).

4.5.4. Describe the ex ante value-for-money criteria and tests to which a PPP is subjected

Again, prior to going forward with any infrastructure project in the United Kingdom, including PPPs, an analysis in line with the HM Treasury *Green Book* is completed. For PFI projects, a further analysis is then completed that compares the value for money associated with the PFI procurement option with value for money associated with a public sector comparator. This public sector comparator replicates the case in which the project had been procured through a traditional route (see the HM Treasury value for money assessment guidance at www.hm-treasury.gov.uk/ppp_vfm_index.htm).

4.5.5. Describe the ex post value-for-money criteria and tests to which a TIP is subjected

See below.

4.5.6. Describe the ex post value-for-money criteria and tests to which a PPP is subjected

The Office of Government Commerce (OGC) recommends that all projects go through the gateway review process. Gateway 5 aims to assess whether the expected benefits have been realised, whether the contract is operating smoothly, and whether there is a plan in place to improve the value for money that is being achieved by the project (see the OGC Gateway process, www.ogc.gov.uk/what_is_ogc_gateway_review.asp).

The National Audit Office (NAO) also completes around 60 value-for-money reports each year in which an ex post evaluation of a project is completed. These reports relate to a wide range of projects that include both traditionally procured infrastructure and infrastructure procured through a PPP. In addition, the NAO has also published a framework to be used to evaluate the implementation of PFI projects (see www.nao.org.uk/publications/0506/pfi_framework.aspx).

4.5.7. To what extent is the playing field for PPPs and TIP equal or unequal in terms of criteria, tests and processes?

HM Treasury policy ensures that there is a level playing field for the PPP and traditional procurement options. The *Green Book* analysis completed for all projects ensures that the procurement route that will provide the best value for money is used. Further to this, the value-for-money analysis completed for PFI projects will ensure that the PFI procurement route is only chosen where this route offers the best value for money when compared to a traditional procurement method.

5. General discussion

5.1. Introduction

Any project, whether it is a PPP or a traditionally procured project, should be undertaken only if it creates value for money. As such, PPPs and traditional infrastructure procurement (TIP) are merely two modes to deliver value for money. Hence, the choice of procurement mode should also depend on which mode delivers the most value for money. However, as the discussion in this article and the results of the questionnaire indicate, the value-for-money objective is very often blurred, and the choice between using a PPP and traditional

infrastructure procurement may be skewed by factors other than value for money. Indeed, overall and on balance, the respondents to the survey felt that the rules in place impede attaining the maximum value for money by creating incentives to prefer traditional infrastructure procurement to PPPs (with not much support found for the opposite proposition).

What seems to be needed is the alignment of what is required from PPPs and TIP. This does not mean that requirements are identical for PPPs and traditionally procured projects. However, alignment does mean that:

- For the same type of project, the same level of detail and information is available to assess value for money, be that project a PPP or a traditionally procured infrastructure project.
- The scope and volume of institutional and legal requirement as applied to PPPs and traditional procurement respectively, as well as *ex ante* and *ex post* value-for-money assessments required from each type, do not create incentives to prefer one type of procurement to the other.

In the light of the small percentage that PPPs constitute in some countries, it might seem unreasonable to undertake such an alignment. However, the question is whether or not governments foresee that PPPs might play a bigger role in the future.¹⁷ If governments foresee an expanding role for PPPs (say, in excess of 10% of total public sector infrastructure investment), the PPP option will become sufficiently important in the pursuit of value for money to require an alignment of procurement option requirements. Bringing about an alignment prior to such an expansion will only serve in the interest of delivering maximum value for money.

The discussion in Section 3 above indicated that there are marked differences between the *ex ante* and *ex post* value-for-money assessment processes that PPPs and traditional infrastructure projects undergo. In general, more strict requirements are imposed on PPPs compared to traditional procurement. Section 4 above demonstrated the extent to which countries such as Korea and the United Kingdom have gone to align TIP and PPP procurement processes, while this section discusses several options to align the two procurement options. It focuses both on the *ex ante* and *ex post* value-for-money assessment processes that PPPs and traditional infrastructure projects undergo. With regard to *ex ante* value-for-money assessment, the article notes that, in general, once candidate PPP projects have been identified as candidates, they are compared to a public sector alternative. However, in many countries this occurs only once they have been identified as candidates. How they get to be candidates is not always clear, with many countries still not having a process in place to select the optimal method of procurement (be that a PPP or traditional infrastructure). Sub-section 5.2 below proposes a list of criteria to select the optimal method of procurement.

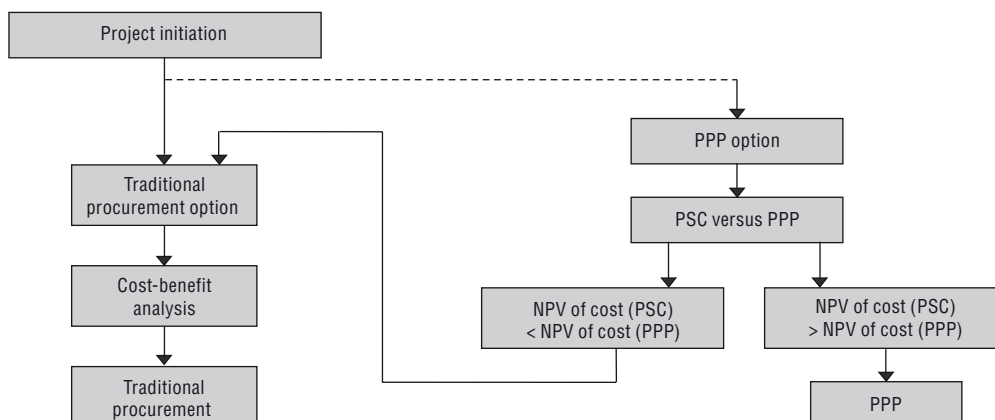
In Sub-section 5.3 below, the focus shifts to the *ex post* value-for-money assessment processes. It argues that traditional procurement processes might do well to incorporate some of the features of PPP projects, such as a whole-of-life approach to value-for-money assessment as well as reporting project results on a whole-of-life project-by-project basis. This requires that data be recorded and reported on a whole-of-life project-by-project basis. Recording data on a whole-of-life project-by-project basis will subsequently allow for an *ex post* assessment of both PPPs and traditionally procured projects. Sub-section 5.3 also deals with so-called optimism bias, defined as the propensity of officials to systemically underestimate project construction and operation costs and underestimate project benefits.

Dealing with optimism bias ensures a more robust comparison between procurement options, which will render *ex post* value-for-money assessments more reliable – i.e. if a PPP outperforms a TIP, it would be clear that this is not due to an optimism bias but to the actual improvements in value for money and efficiency. Introducing the measures proposed in Sub-section 5.3 not only aligns PPP and traditional procurement but also introduces sound financial management, particularly in countries where traditional infrastructure procurement projects are currently not subjected to cost-benefit analysis or any other form of whole-of-life project-by-project analysis.

In addition to value for money being assessed on a whole-of-life project-by-project basis, Sub-section 5.4 proposes that value for money be assessed prior to taking the decision about which mode of procurement will be used. Both the PPP and TIP mode require that the public sector option be a viable one, irrespective of the procurement mode ultimately used. Even in the case of a PPP, the public sector option (frequently in the form of a public sector comparator) always needs to be a real and credible alternative to private delivery. A public sector option that does not deliver value for money should not be the benchmark for a PPP, even if that PPP itself can deliver value for money. It should also be noted that such a whole-of-life project-by-project approach does not necessarily imply a significant increase in the bureaucratic activity needed to create a process. For instance, the United Kingdom has shown that its value-for-money instrument – a spreadsheet developed to assess the value for money of a public sector option and a PFI option – need not be overly elaborate to nevertheless contain the key elements required to assess value for money.

5.2. Ex ante value-for-money assessment and the choice between PPPs and traditional procurement

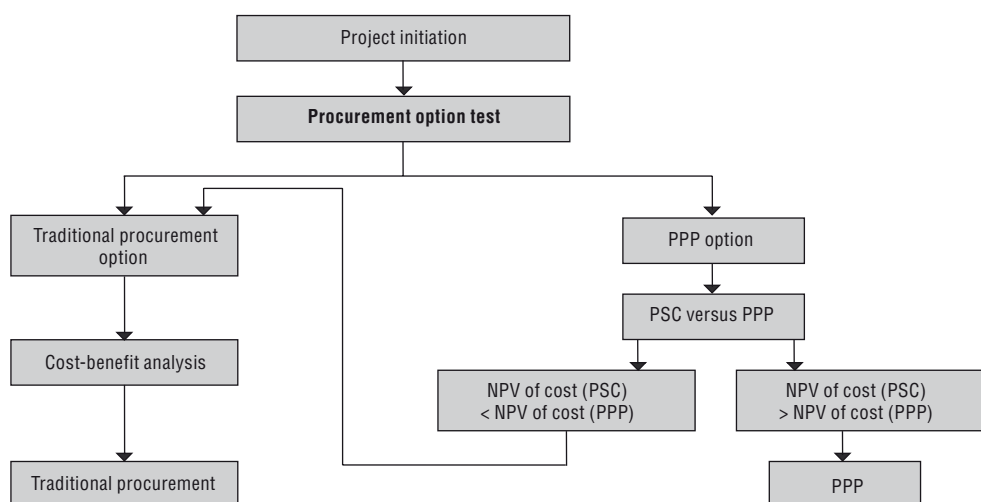
In many countries, traditional procurement is the default procurement option, while procurement through the PPP option represents the exception or is only undertaken when, as one of the survey's respondents noted, there is someone acting as a champion for setting up the project as a PPP. This also very often means that there are no clear criteria to decide which procurement option to use. Therefore, what is needed is a set of criteria to decide which mode of procurement will yield the highest value for money. As shown in Section 3 above, most countries currently using PPPs use a public sector comparator (PSC) to compare the value for money of potential PPP projects to the value for money that traditional procurement could offer. The hypothesis tested in such a comparison is that traditional procurement could deliver more value for money than the PPP option. Ideally, what holds true for PPPs should also hold true for TIP projects – i.e. the question should be asked whether the value for money of projects selected for traditional procurement could not be enhanced if they took the PPP route. However, as argued in Section 3, a government cannot always be expected to credibly forecast the range of innovative designs and risk management procedures which competing private partners can invent. There is unfortunately limited or no scope for government to create a “private sector comparator”. As an alternative, governments could rather consider the use of a procurement option test to decide between the traditional procurement and PPP options.¹⁸ Figure 3b contrasts a procurement process that includes this procurement option test with one (Figure 3a) that treats the PPP option as the exception (indicated by the dotted line) and traditional procurement as the default.

Figure 3a. **The procurement choice with traditional procurement as the default option**

NPV = net present value

PPP = public-private partnership

PSC = public sector comparator

Figure 3b. **The procurement choice with a procurement option test**

NPV = net present value

PPP = public-private partnership

PSC = public sector comparator

From existing literature as well as existing criteria applied by governments, it is possible to distil the criteria to include in the procurement option test (cf. Miller *et al.*, 2009; Estache, Iimi and Ruzzier, 2009; HM Treasury, 2008; Love *et al.*, 2008; Grimsey and Lewis, 2007; Luu, Ng and Chen, 2003; Kumaraswamy and Dissanayaka, 2001). The literature on the criteria to use when choosing between different methods of procurement predates the general use of PPPs. For instance, Love *et al.* (2008:755-6) as well as Luu *et al.* (2003) list criteria originally set out in NEDO (1985). These criteria are:

- Is early completion important?

- Is on-time completion of the project important?
- Is cost certainty (and therefore whether or not a firm price is needed prior to a commitment being made) important?
- Is price competition important in the selection of the construction team?
- Is flexibility and the ability to make changes to the project once work commences important?
- Is the project complex (i.e. is it specialised, technologically advanced and in need of high levels of servicing)?
- Is quality important?
- Is the government the only party who needs to be responsible for design and cost, or should designers and consultants also carry part of the risk?
- Is the transfer of the risk of cost and time slippage important?

Later criteria very often represent a variation on the above (Miller *et al.*, 2009:89). In addition, that report notes that the Department of Commerce in New South Wales (Australia) uses procurement choice criteria aimed at obtaining the best value for money and managing procurement risk. The department's approach focuses on factors such as value for money, the cash flow rate, timeliness, quality of design, and quality of construction. Miller *et al.* (2009) also highlight the importance of innovation in the design of a project as a determinant of what procurement method is selected.

HM Treasury (2008) highlights several aspects that favour either the selection of private finance initiatives (PFIs), concessions or traditional procurement, as well as variations on these options such as strategic infrastructure partnerships (SIPs), integrators and alliancing. In the case of PFIs, HM Treasury (2008:19) highlights the following criteria that favour their use:

- Major capital investment is required.
- The nature of the service allows outputs to be clearly defined, and risk allocation between the public and private sectors can be made and enforced.
- The capital value of the project exceeds GBP 20 million so that procurement cost is not disproportionately large relative to the size of the project.
- The technology involved is stable and not subject to fast and frequent change.
- Planning horizons are long, and the project is foreseen to operate into the long term.

In the case of concessions, HM Treasury (2008:20) adds that the project should be able to operate independently and that a market (i.e. demand) for the service should exist, with the concessionaire being able to influence that demand.

Using the above criteria as well as the prerequisites for a successful PPP identified in OECD (2008) (where success means a PPP that delivers improved value for money compared to traditional procurement), this sub-section seeks to identify criteria that governments can use as part of their procurement option test (i.e. when deciding between using PPPs and traditional procurement).

The requisites identified in OECD (2008) include risk transfer and competition. OECD (2008) argues that, to obtain value for money in a PPP, sufficient risk must be transferred to the private partner. The risk transferred should be endogenous risk, i.e. risk that can be managed by the private partner (as opposed to exogenous risk that cannot be managed). Risk is defined as the probability that the actual outcome will deviate from the expected

(estimated) outcome. Where the outcome is profit, carrying the risk means that the private partner has the incentive to manage revenue and cost in such a manner that the actual profit is as close as manageable to the expected profit.

However, effective risk transfer requires competition in the bidding process (i.e. competition for the market) and competition or contestability while in operation (i.e. competition or contestability of the market).¹⁹ Competition ensures that the government has a choice between possible private partners, both during the bidding process and during the operational phase. Should a private partner not deliver value for money during the operational phase, the effective transfer of risk will mean that its profit will fall (or it might even make a loss). If the lack of value for money persists, the private partner will either go out of business or, via the step-in rights of the government and the financiers, be replaced by a competitor.

The possible threat of a competitor appearing puts pressure on the private partner to deliver the value for money. If the private partner is aware that no such competitor exists, the pressure will not exist. In these circumstances, if the private partner runs into financial trouble, the government might have to either:

1. cease delivering the service;
2. take over the service and deliver the service itself;
3. bail the private partner out; or
4. renegotiate the contract to ensure the private partner's profits.

If the service that the PPP delivers is seen by the public as an essential service, only options (2), (3) and (4) exist. However, since critics might interpret a takeover as an admission of PPP failure, a takeover might be politically unpalatable. A takeover might also be ruled out if the government does not have the requisite skills to manage the project itself. This will leave bailout and renegotiation as the only alternatives – options (3) and (4). With a bailout, the government in essence takes over the accumulated losses of the private partner. This means that the government, in effect, carried the risk all the while. With renegotiation, the government ensures the private partner's profit. Again, this means that, in effect, the government absorbs the losses that the private partner would have suffered. Furthermore, if the private partner knows that competition is absent and that options (3) and (4) are the only two real options on the table, it will also know that it has an implicit government guarantee. Such an implicit guarantee might cause moral hazard, meaning that the private partner will not manage its risk to ensure the highest value for money – it might not even outperform traditional procurement.

Therefore, in deciding between traditional procurement and a PPP, a government should address the following criteria in the procurement option test:

- a) **Defining, identifying and measuring risk:** Can the risks of the project be clearly defined, identified and measured? To ensure an effective transfer of risk to the private partner, the risks that the private partner will be required to carry should be clearly defined, identified and measured. If risk cannot be defined, identified or measured, there is room for conflict in the contract, particularly when the risk realises. In addition, potential private partners might *ex ante* also be unwilling to take on risks that are not clearly defined, identified and measured.
- b) **The transfer of risk:** Can the right types of risk be transferred to the private partner to ensure value for money? For instance, if the only risk that is transferred is construction

and delivery-of-asset risk, while demand-side and supply-side operational risks are not transferred, then the right types of risks might not have been transferred to ensure the attainment of value for money. If for some reason these operational risks cannot be transferred, or if potential private partners are not willing to take them on, then entering into a PPP does not make much sense. Furthermore, the government needs to transfer endogenous risks, i.e. risks that the private partner can manage. If it also transfers exogenous risks (risks that are exogenous to both the government and the private sector), it needs to compensate the private partner for carrying these exogenous risks (such a payment is akin to an insurance premium). However, exogenous risk does not serve as a driver of efficiency and value for money.

- c) **The size of risk:** Is the risk large enough to make a difference to the value for money being delivered? If the probability is small that actual costs and revenues will deviate from expected (estimated) costs and revenues by a significant amount relative to the profit margin of the private partner, then there is relatively not much risk to manage. As such, entering into a PPP to ensure value for money does not necessarily make much sense.
- d) **Willingness to accept risk:** How large is the appetite of the private partner for risk? If the probability for actual costs and revenues to deviate from expected (estimated) costs and revenues is significant relative to the profit margin of the private partner, but the private partner is unwilling to take on that risk, then the government might be left with too much risk. An example is a toll-road where the government guarantees revenue if traffic falls below a certain level. If that minimum level is relatively close to the expected level of traffic, then not much risk is transferred. As such, entering into a PPP to ensure value for money does not necessarily make much sense.
- e) **Competition for the market:** What is the potential level of competition for the market? If competition levels are limited, the government might encounter the problems discussed above that relate to the lack of competition. Competition for the market is also important when the government follows the traditional procurement route and puts out a project on a tender. However, because a PPP usually integrates both the construction phase and the operational phase of the project – something that is not usually done with a traditionally procured (build-and-deliver) project – competition plays an even bigger role to ensure value for money in the case of a PPP. As such, a PPP might not be the best option when competition is limited, as it might not deliver the best value for money.
- f) **Competition in the market:** What is the potential level of competition in the market? Again, if competition levels are limited, the government might encounter the problems discussed above. If all competition disappears once a contract has been awarded, the next question is whether or not the market will be contestable – i.e. is it likely that, if required, competitors will enter the market? If competition and contestability do not exist, a PPP might not be the best option as it will probably not deliver better value for money.

Additional criteria also need to be added:

- **Whole-of-life contracts:** How large are the benefits from combining the construction phase and the operating phase of a project in one contract? Estache *et al.* (2009:15) mention that combining these two phases depends on the presence of positive externalities between the construction and operating phases. As mentioned above, PPP contracts integrate the construction and operational aspects of the project in a single contract. This ensures that the private partner has an incentive to incur additional construction cost if it reduces future operating and maintenance cost, but only if the present value of the operating

and maintenance cost saving exceeds or equals the increase in the present value of the additional construction cost. This incentive does not exist in traditional procurement. However, in a PPP the size of this incentive depends on the extent to which there is scope for future cost saving, as well as the size of additional construction cost to facilitate this future cost saving – i.e. it depends on the extent of the trade-off. Where this scope and trade-off are limited, there is less need to integrate the construction and operating phases of the project and hence less need to enter into a PPP contract. For instance, in projects where there is not a large capital and construction phase, the scope to integrate is limited, thus also limiting the value-for-money benefit that a PPP can bring.

- **Dealing with cost and quality trade-offs:** Related to the previous point is the relationship between cost and quality. Estache *et al.* (2009:9-10) discuss the case where the private partner has an incentive to incur construction cost that would reduce future cost in the operating phase. However, such future cost reductions may also, in some cases, lead to a decrease in quality. Because the overriding objective of the private partner is to maximise profit, quality might hold a lower priority for the private partner than for the government (for whom service delivery objectives might hold the highest priority). As such, Estache *et al.* (2009:10) argue that the bundling of the construction and operating phases should preferably not be undertaken if a reduction in future cost leads to a relative large reduction in quality. It should be noted, however, that this point is valid only if the quality of future output cannot be defined clearly in the contract (or if the government fails to define it clearly) and if the payment to the private partner has not been linked specifically to the attainment and maintenance of the required level of quality. Hence, the questions are: can the quantity and quality of project outputs be clearly defined, quantified and measured, and can the private partner be kept to those levels by rendering the payment it receives dependent on the attainment and maintenance of the required level of quality? To ensure sufficient risk transfer to the private partner usually means that the private partner is paid if it delivers the quantity and quality set out in the PPP contract. Any significant and persistent shortfall from this will result in lower revenue earnings for the private partner. However, if the quantity and quality of the outputs cannot be clearly defined, quantified and measured, the effective transfer of risk to the private partner will be undermined. With no effective transfer of risk, the driver of improved efficiency and value for money will be absent, and integrating the construction and operating phases in a PPP might then very well cause a reduction in quality of service.
- **The importance of innovation:** How much innovation is required? Where profit depends on improved efficiency and the delivery of improved value for money, and where these improvements will depend on design innovation in a still non-existent project, the government might seriously consider entering a PPP. Leaving design to the private partner also very often means that either the government cannot specify the design itself or, if it can, that it nevertheless realises that, by specifying the design, it runs the danger that its design might not be the most efficient. As such, traditional procurement is appropriate if a contract can specify the design and quality of the asset clearly *ex ante*, while it cannot do so for the quality of the output; the reverse holds for a PPP contract (cf. Estache *et al.*, 2009:32). However, it should be noted that, for innovation to take place, the answers to criteria (a) through (f) above must also point towards a PPP for the project in question.
- **The availability of public sector skills:** Closely related to the above is the availability in government of the skills required to operate an asset. Therefore, a PPP is a better option if the government does not itself possess the requisite skills to construct and operate the

project. However, if the government then opts for a PPP, it will nevertheless need skilled staff to monitor the private partner and to manage its own responsibilities and risk.

- **Rapidly and significantly changing technology:** Though innovation is often key to the preference for a PPP, the United Kingdom experience also highlights the need to be careful about selecting projects for PPP/PFI status where the technology involved in these projects is subject to frequent and significant change. Technology affects the nature of the asset, during both the construction and operating phases of a project. Rapidly and significantly changing technology means that the project faces significant (construction and operating) supply-side risks as well as redundancy risks. Changing technology might also influence consumer preferences, thus affecting demand-side risk. As such, the risk generated by rapid and significant change might render the specification of well-defined output and service delivery levels in a PPP contract very difficult. This problem is further aggravated by the long-term nature of PPP contracts (typically 25-30 years).
- **Need for flexibility:** Guasch (2004) notes that, in Latin America and the Caribbean, up to 30% of PPP projects were renegotiated within the first two years of the contract. Estache *et al.* (2009:31) note that in Latin America contractors initiate renegotiations in 50% of rail transactions and 13% of road transaction, with the government initiating no renegotiations in rail projects but initiating renegotiations in 42.6% of road projects. A further 7.4% of road project renegotiations are initiated by both parties. HM Treasury (2003a) reports that 22% of PFI contracts have undergone modifications during their construction stage. Thus, in general, changes to PPP contracts are not the exception. In principle, PPP contracts could allow for flexibility and therefore allow changes to be made regarding output and design. However, the degree of flexibility affects the allocation of risk: the more rigid the contract, the more risk the government carries, whereas if the contract is more flexible, the private partner carries more risk. Nevertheless, the private partner will probably only be willing to carry the additional risk if the government pays it to do so. Of course, renegotiation usually means that the government can only bargain with the party with whom it concluded the contract. This may put the private partner in a virtual monopolistic position and, as such, may mean that the renegotiated terms of the contract could undermine the initially agreed value for money. The difficulty that the government will face is to distinguish between genuine and purported costs of redesign and altering the capital and output. Hence, the larger the possibility that a contract may have to be substantially renegotiated, the less are the benefits of integrating the construction and operating phases of the project and the less benefit a PPP might deliver relative to traditional procurement.

The choice between a pure PPP (depending on the government for its revenue stream) and a concession (depending on user charges levied directly on the beneficiaries of the service) adds further criteria:

- **Sufficiency of demand:** Is demand (and thus the user charges levied by the private partner) expected to be sufficient over the lifetime of the project to ensure that the private partner generates the revenue required for it to maximise its profit? This question is not so much about demand risk as about the expected level of demand.
- **The presence of externalities:** How big are the externalities and the public goods component of the service delivered and, therefore, how large is the free-rider problem? The free-rider problem means that demand is not fully revealed. The extent of the free-rider problem, and thus the extent to which demand is not revealed, will also limit the extent to which user charges can be levied. Ensuring the desired level of service delivery

might require that the government either pays for the service in total (and thereby rules out user charges; this renders the PPP a pure PPP) or subsidises the private partner (and thereby augments the user charges that the private partner levies). Paying in full or subsidising the private partner will then ensure the desired level of service delivery. However, it should also be noted that payment by the government reduces the demand risk that the private partner faces. Thus, in the limiting case where there is no demand risk left, the pursuit of value for money will depend on the supply-side operating risks transferred to the private partner. If these are not present or are limited, using a PPP makes less sense.

- **The need for subsidisation:** In some projects, demand might exist and there might be the possibility to levy user charges, but the government might also have to consider the distributional aspects of the project. For instance, in the case of some healthcare or school projects the possibility might exist to levy user charges, but the government might also wish to support less well-off beneficiaries by subsidising them (*e.g.* by giving them vouchers).

The application of a procurement option test suggests that arbitrary criteria such as “PPPs should not exceed 15%” of public sector infrastructure investment hold little value. Rather, the question is which method of procurement delivers the highest value for money, irrespective of the percentage of public sector procurement that PPPs constitute.

To conclude, this sub-section suggests that, early in the procurement process, a project should be subjected to a procurement option test. This test should guide the government in selecting which mode of procurement is likely to deliver the most value for money, be it a PPP or traditional procurement. This sub-section also sets out the criteria that might constitute such a test (Box 2 below summarises the criteria).

5.3. Ex post value-for-money assessment and the choice between PPPs and traditional procurement

In a study of 258 public sector transportation infrastructure projects from across the world, spanning the period 1927-98, Flyvbjerg, Holm and Buhl (2002) compared actual construction cost (measured at the time of project completion) and estimated construction cost (measured at the time that the decision to construct the infrastructure was taken). They found that in 86% of all projects actual costs exceeded estimated cost, and that on average this excess equalled 28% (Flyvbjerg *et al.*, 2002:282). Rail projects registered the largest excess (44.7%), followed by fixed-link projects such as bridges and tunnels (33.8%) and road projects (20.4%) (Flyvbjerg *et al.*, 2002:282).^{20, 21} They also found that the underestimation of costs did not decrease during the 70-year period covered by their sample.

Flyvbjerg *et al.* (2002:286-290) subsequently consider four explanations that might explain the persistent and substantial underestimation of costs. These are technical, psychological, economic and political explanations. Technical explanations include: a lack of data, honest mistakes, a lack of experience and imperfect techniques. If these were present, the probabilities of over- and underestimating costs should be approximately the same. However, as noted above, Flyvbjerg *et al.* (2002:286-287) show that 86% of all projects had significantly underestimated costs. This led them to reject the technical explanation.

“Appraisal optimism” is the main psychological explanation and refers to the proneness of project developers, officials, politicians and others involved in a project towards being optimistic regarding costs and outcomes. However, Flyvbjerg *et al.* (2002:288-289) dismiss psychological explanations too. They argue that, in the course of time, practitioners must have noticed such proneness. With such learning taking place, mistaken estimates should

decrease over time and thereby reduce, if not eliminate, “appraisal optimism”. However, their results indicate that the extent to which costs have been underestimated did not decrease in the 70 years covered by their data. Therefore, “appraisal optimism” cannot serve as an explanation for the underestimation of cost. However, as discussed below, a question exists as to how much learning really does take place. Very often, actual and estimated cost and time-delay data exist for the construction phase of projects, while only estimated but no actual whole-of-life project-by-project data exist for benefits and operational and maintenance costs.²²

This leaves economic and political explanations; these refer to the incentive structure that officials face. To increase the probability of a project being accepted, officials and politicians may intentionally underestimate the costs and overestimate the benefits of the project (Flyvbjerg *et al.*, 2002:287-288, 289-290). As Flyvbjerg *et al.* argue, the incentive to present optimistic estimates intentionally is very strong, while the penalty for doing so is small, if not negligible.²³ In addition, Flyvbjerg *et al.* (2002:288) argue that, where officials have to compete for funds from a limited budget (which is more often than not the case), there is even more of an incentive to underestimate the costs of the project.

Therefore, Flyvbjerg *et al.* (2002:287-288, 289-290) argue that economic and political explanations, i.e. the incentive structure that officials face to intentionally underestimate the costs of their projects, largely explain the actual underestimation of costs, while technical and psychological explanations such as “appraisal optimism” fail to explain. They conclude by arguing that the problem might be addressed by: i) increased transparency; ii) the use of performance specifications; iii) the explicit formulation of the regulatory regimes that apply to project development and implementation; and iv) the involvement of private risk capital in public projects (Flyvbjerg *et al.*, 2002:291). A fifth way is to estimate costs and benefits and then adjust them for “appraisal optimism”. This is done in the United Kingdom, where the government recognised the bias to underestimate costs (HM Treasury, 2003b). As a result, the government *Green Book* (HM Treasury, 2003b:29-30, 85-87), which sets out guidelines for project preparation, recommends that government departments should adjust their cost and benefit estimates of projects to allow for the underestimation of cost and the overestimation of benefits (also see British Department of Transport, 2004, and HM Treasury, 2006a and 2006b, where the adjustments are made for PFI projects). As far as possible, this should be done on the basis of empirical evidence about the degree of the observed bias present in similar projects. Therefore, even if the estimated cost of a project seems affordable, the inclusion of an adjustment to allow for optimism bias may render it unaffordable.

The fourth way to address “appraisal optimism” is the involvement of private risk capital in public projects. This implies the use, among others, of PPPs. The use of PPPs raises the question of how PPPs perform relative to traditionally procured projects. Are PPPs also as prone to the underestimation of costs and, if so, is this underestimation of the same order of magnitude? Several studies have been undertaken for Australia, the United Kingdom and the United States to establish whether or not PPPs deliver improved value for money compared to traditional procurement. For the United Kingdom, these studies include the Arthur Andersen and Enterprise LSE report (2000), the Mott MacDonald review (2002) and the National Audit Office report (2003). Three studies exist for Australia: the Fitzgerald review (2004), the Allen Consulting Group report (2007) and the University of Melbourne report (2008). For the United States, there is the Haskins, Gale and Kelly report (2002). Also see Grimsey and Lewis (2007:174-176) for a succinct summary of the findings of many of the above-cited studies as well as others. These studies all compared the *ex post* performance of PPPs and traditional infrastructure procurement in terms of the actual cost and time used to put the project into operation. A common finding among all these studies is that PPPs outperform traditional procurement in terms of both cost and time overruns, with outperformance in terms

of cost being the most significant. (As reported in Section 3 above, the survey conducted for this article asked respondents to report on the performance of PPPs relative to TIP in their respective countries. Although many of the countries reported that PPPs outperform traditionally procured projects in terms of time and budget, some countries also reported that they do not have sufficient information to report on the budgetary performance of PPPs.)

The University of Melbourne (2008:9) argues that, depending on the measures used, one reason why PPPs may seem to outperform traditionally procured projects stems from the more thorough cost and time estimates required from PPPs versus traditionally procured projects. In the case of a PPP, a public sector comparator (PSC) or reference project might be required. Usually a PSC requires more detail than the budget of a traditionally procured project that is tested in competitive bidding (University of Melbourne, 2008:9).²⁴ More thorough cost and time estimates may reduce what the report calls the optimism bias (i.e. the underestimation of cost) in PPPs relative to that of traditionally procured projects.

The problem, though, is that “optimism bias” or “appraisal optimism” is not necessarily limited to the estimation of construction cost and time. As noted in the United Kingdom *Green Book* (HM Treasury, 2003b), the Mott MacDonald review (2002) and the University of Melbourne report (2008:9), the “optimism bias” could also be present when officials calculate the value for money that a project may create over the whole of its life. To measure the extent of such optimism bias would require data on actual and estimated operating and maintenance costs, as well as outputs (and outcomes) and the relative weighing and discounting of risks over the project life cycle as part of the estimates. However, as noted by the University of Melbourne (2008:9), all the above-cited studies have one common drawback: data on whole-of-life performance for traditionally procured projects do not exist. This means that, beyond the comparison of construction cost and time, it is extremely difficult to really establish whether or not PPPs outperform traditionally procured projects, particularly in terms of delivering value for money. The absence of whole-of-life data on project performance, of course, does not mean that value-for-money criteria are absent from traditionally procured projects. Indeed, as the survey for this article indicates, most governments of OECD countries use cost-benefit analysis when assessing *ex ante* whether or not a project represents value for money. In addition, governments may also use outcome indicators to establish *ex post* whether or not traditionally procured projects represent value for money. However, the difference in data available with regard to PPPs and traditionally procured projects does make it difficult, if not impossible, to compare the operational performance of PPPs and traditionally procured projects.

Because more often than not a whole-of-life assessment of project performance is not made in the case of a traditionally procured project, there might be little learning about the degree of optimism bias/appraisal optimism and thus limited scope to reduce the optimism bias/appraisal optimism *ex ante* (i.e. the underestimation of maintenance and operating cost and the overestimation of benefits). Therefore, in the event that performance is measured *ex post*, traditional procurement may exhibit a bigger failure to achieve expected value for money compared to PPPs that undergo much more value-for-money scrutiny.

It should be noted that the optimism bias/underestimation of cost and the resultant disappointment are not inherent as such in traditional procurement. Indeed, as pointed out by Flyvbjerg *et al.* (2002), the bias results from the incentives officials face. Given the limited learning that follows an absence of measurement, the bias may also result from the technical and psychological explanations that Flyvbjerg *et al.* highlighted. Therefore,

the optimism bias may be present in all longer-term projects, be these PPPs or traditionally procured projects. Nevertheless, the presence of the bias is more significant in the case of traditionally procured projects because of the absence of rigorous whole-of-life assessments of performance in many projects. The absence of such assessments in the case of traditionally procured projects might however create an incentive for officials to prefer traditional procurement. This might be true particularly if procuring entities are afraid that a thorough whole-of-life assessment of performance made in the future may bring to light an absence of value for money. This fear might be very real if, as Flyvbjerg *et al.* (2002) argue, budgeting entities succumbed to the incentive to underestimate costs and overestimate benefits.

In the case of a PPP, the procuring department or entity usually has to indicate why the PPP route will deliver more value for money than the traditional public procurement route. However, the reverse is not true, meaning that a department taking the traditional public procurement route does not have to indicate why that route will deliver more value for money than the PPP route. As argued above, such a comparison might not be feasible in practice, as a government might be unable to foresee what the private sector option would entail. (If the government can foresee it, it would in principle also be able to deliver the project itself, obviating the need for a PPP.) Nevertheless, it leaves traditional procurement as the default procurement option, demanding less from procuring departments in terms of demonstrating value for money. This means that, in principle, it is possible that service provision through a PPP could have delivered more value for money. However, since the comparison is not made, the question as to whether the project delivers maximum value for money cannot be answered.²⁵ This, of course, could explain some of the difference in performance that several studies found between PPPs and traditional procurement. If, according to the government:

- to become a PPP requires the application of a whole-of-life approach that includes the requirement that a project *ex ante* outperforms traditional procurement;
- while, in the case of traditional procurement, it is not necessary that the traditionally procured project outperforms a PPP;
- and if, in the absence of a whole-of-life assessment of performance for traditionally procured projects, there is room for a larger optimism bias in traditionally procured projects; then

it will not be surprising that, when an *ex post* assessment is made on occasion, PPPs indeed do *ex post* outperform traditional procurement. But whether this is due to “optimism bias” or PPPs really delivering improved value for money will be difficult, if not impossible, to say. A related factor is the possibility of cherry picking: *i.e.* one reason why PPPs may *ex post* outperform TIP projects (especially in terms of construction cost and delivery time) is that the projects selected were good projects to begin with. Had these projects been procured through TIP, they probably would also have performed well.

Therefore, what is required is the recording and reporting of data on a whole-of-life project-by-project basis and the subsequent *ex post* assessment of both PPPs and traditionally procured projects. This should be done not only to establish and compare performance in terms of construction cost and time delays, but also in terms of outputs (and outcomes) and operating and maintenance cost.

Furthermore, to deal with optimism bias and to ensure a more robust comparison between procurement options, both traditionally procured and PPP projects should *ex ante*

include an adjustment for possible cost and time overruns and revenue shortfalls. This should be done for the construction phase as well as the operating phase. Where possible, the estimated degree of the optimism bias should be based on empirical evidence collected from similar projects.

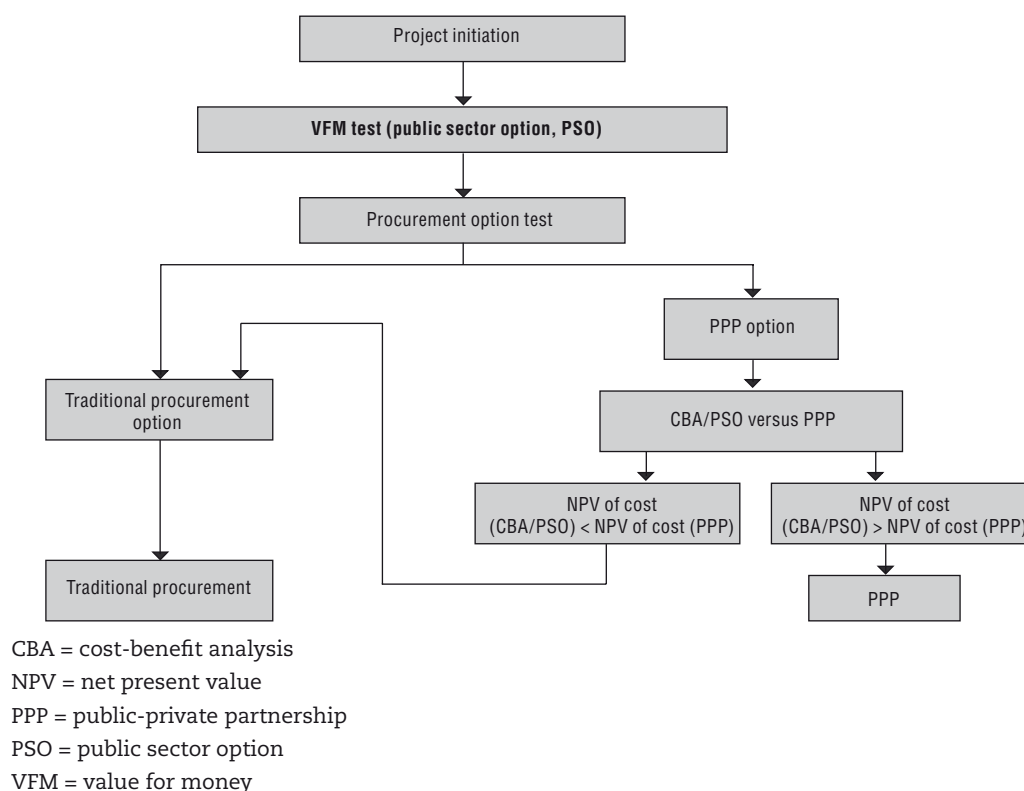
Thus, to conclude, this sub-section suggests that governments record and report data on a whole-of-life project-by-project basis. It also recommends that the data be used to conduct an *ex post* assessment of both PPPs and traditionally procured projects. This should be done with regard to construction costs and time, as well as operating and maintenance cost. It should also be done for outputs and outcomes of projects.

In addition, governments should deal with optimism bias by *ex ante* including an adjustment for possible cost and time overruns and revenue shortfalls, both for the construction phase as well as the operating phase. This should be done for both traditionally procured and PPP projects. Doing so will ensure a more robust comparison between procurement options. In addition, if possible, the estimated degree of the optimism bias should be based on empirical evidence collected from similar projects. By including an adjustment for optimism bias, *ex post* value-for-money assessments will become more reliable and governments can be sure that if a PPP outperforms a TIP, it cannot be ascribed to optimism bias. Instead, such an outperformance will clearly originate in actual value-for-money improvements.

5.4. A unified framework for public procurement options

From the survey results, officials in a significant number of countries clearly noted that the rules in place impede attaining value for money by creating incentives to prefer traditional infrastructure procurement over PPPs. Very often, for a project to proceed as a PPP requires the provision of more detail and the compliance with more prescriptions. Hence, officials in line departments would prefer to follow the easier route towards the realisation of the project. In addition, officials in line departments are also more used to traditional procurement, which in itself creates an incentive to steer clear of unknown, unfamiliar or less well-known procedures. Some officials participating in the survey also reported unfamiliarity among officials in line departments with a whole-of-life planning approach that includes an integrated approach towards construction and operation. As discussed above, this is something that is key to PPP contracting, as it ensures that the private partner has an incentive to incur additional construction cost if this will reduce future operating and maintenance cost. As discussed, this incentive does not exist in traditional procurement. Furthermore, officials in a significant number of countries also reported that political preferences contributed in the past towards a preference for procurement through traditional infrastructure procurement (while no such preferences were reported for procurement through PPPs).

To partially overcome this problem, the discussion above noted the necessity to conduct a procurement option test. This will ensure that the PPP route is not just taken on an *ad hoc* basis, but that clear and explicit consideration is given to procurement options prior to the undertaking of a project. To unify the procurement process further, governments could also shift the value-for-money assessment to earlier in the procurement process and place it prior to the procurement option test (see Figure 4). This will ensure that the public sector option always represents value for money irrespective of the procurement option chosen.

Figure 4. **Unified framework for public procurement options**

This forward shift can be justified on the grounds that an assessment of the value for money of a public sector option is always needed, irrespective of the method of procurement ultimately used. Even in the case of a PPP, the public sector option (becoming the public sector comparator) always needs to be a real and credible alternative to private delivery. Thus, a public sector option that does not deliver value for money should not be the benchmark for a PPP to attain, even if that PPP itself can deliver value for money.

This value-for-money estimation that is brought forward in the procurement cycle might be a broader cost-benefit analysis. However, as a subcomponent it should also contain a narrower estimate of direct costs and benefits (including revenue benefits) for the government. This could simply be called a “public sector option” (PSO), which is akin to a public sector comparator (or the value-for-money assessment for the public sector alternative that is done for PFIs in the United Kingdom; see the value-for-money assessment guidance and spreadsheet for HM Treasury [2006a; 2006b]). Compared to the broader social costs and benefits included in a cost-benefit analysis (CBA), narrower, more direct costs and benefits are easier to define and measure. Furthermore, a PSO done for all projects will bring public sector officials into the habit of always thinking in terms of a lifetime approach to a project’s direct costs and revenues for government. Thus, it forces them to simultaneously consider the construction and operating phases of the project. If the narrower numbers are less difficult to define and measure, it will also render the comparison between procurement options more credible.

Thus, with the PSO in existence, it can also serve as a public sector comparator/ value-for-money (PSC/VfM) assessment model for a PPP and thereby streamline the

procurement process. Should the PPP option then not demonstrate an improvement in value for money over and above the value demonstrated in the PSO, then delivery through public procurement follows.²⁶ Once a project is allocated to either the PPP or the traditional procurement stream, development of the project will reflect the characteristics common to the type of procurement selected. For instance, in traditionally procured projects, the design of the project is specified in detail even before the project is put out to tender. The design specifications are also very often set out in the contract. This leaves little room for contractors to change the design of the service or the output.²⁷ In contrast, in PPP projects the PPP contract specifies the output it requires and the price it will pay for that output, but not the design of the project. Given that a significant part of the efficiency improvement (and hence profit) is contained in the design of the project, the design is left to the private partner.

5.5. Concluding discussion

In addition to being the most common procurement mode, traditional procurement in many of the surveyed countries still constitutes the default mode of procurement. Though it will probably remain the most common procurement mode, it need not remain the default mode. The survey indicated that, although most of the surveyed countries test PPP candidates against the alternative of a public sector option, many countries still do not have clear criteria to identify how projects get to be either PPP candidates or TIP candidates. In some countries, it is left to the discretion of line departments and so-called project champions to identify PPP candidates.

With the above analysis as background, this article developed three sets of recommendations:

- With regard to *ex ante* value-for-money assessment, the article suggested that early in the procurement process a project should be subjected to a procurement option test. This test is meant to guide the government in selecting which mode of procurement is likely to deliver the most value for money. The article set out a list of criteria that should be considered in a procurement option test: drawn from the discussion in Section 5, Box 2 highlights the issues addressed by the criteria.
- With regard to *ex post* value-for-money assessment, the article suggested that:
 - Data are recorded and reported on a whole-of-life project-by-project basis and that subsequently an *ex post* assessment of both PPPs and traditionally procured projects is made. This should be done not only to establish and compare performance in terms of construction cost and time delays, but also in terms of outputs (and outcomes) and operating and maintenance cost.
 - Furthermore, to deal with optimism bias and to ensure a more robust comparison between procurement options, both traditionally procured and PPP projects should *ex ante* include an adjustment for possible cost and time overruns and revenue shortfalls. This should be done for the construction phase as well as the operating phase. Where possible, the estimated degree of the optimism bias should be based on empirical evidence collected from similar projects. The inclusion of such adjustments will render *ex post* value-for-money assessments more reliable – i.e. if a PPP outperforms a TIP, it would be clear that this is not due to an optimism bias but to the actual improvements in value for money and efficiency.
- The article also suggests a unified framework within which to deal with the choice between procurement options. As such, the article suggests that governments could shift the value-for-money assessment to earlier in the procurement process and place it

prior to the procurement option test. This ensures that the public sector option always represents value for money no matter which procurement method is selected. As argued above, the public sector option might form part of a broader cost-benefit analysis. However, the focus of the public sector option (PSO) is narrower, because narrower, more direct costs and benefits are easier to define and measure. The PSO will then merely become the public sector comparator should the procurement option test that follows the estimation of the PSO indicate that a PPP might deliver more value for money than traditional procurement. Should the received PPP bids outperform the PSO, the project becomes a PPP. Should the received bids fall short of the PSO, the project reverts back to the traditional procurement stream since the PSO already indicated that it represents value for money (assuming, of course, the existence of the necessary funds and political will that identified the project as a priority).

Box 2. **Criteria that should be considered in a procurement option test**

- Can risk be defined, identified and measured?
- Can the right type of risk be transferred?
- Is the size of risk large enough to serve as an incentive towards value for money?
- Are private partners willing to accept the risk to be transferred to them?
- How much competition is there for the market?
- How much competition is there in the market?
- How large are the benefits from combining the construction phase and the operating phase of the project in a whole-of-life contract?
- Can the quality and quantity of service output that the private partner must deliver be clearly measured so as to deal with possible cost and quality trade-offs?
- How much innovation is required?
- What is the availability in the public sector of the skills needed to operate the asset?
- How rapidly and significantly does the technology needed for the project change?
- How much flexibility does the government want to change the output specifications of the service to be delivered?

The choice between a pure PPP (depending on the government for its revenue stream) and a concession (depending on user charges levied directly on the beneficiaries of the service) adds further criteria:

- Is demand sufficient to render the levying of user charges a viable source of income for a concessionaire?
- Does the service create externalities that might give rise to a free-rider problem and hence lead to demand not being revealed by beneficiaries?
- To what extent is there a need for/desire by the government to subsidise all or part of the beneficiaries of a service?

APPENDIX

Defining Value for Money

As mentioned in the introduction, the concept of value for money includes both qualitative and quantitative aspects. In addition, it typically involves an element of judgment on the part of a government. As such, a precise indicator to measure value for money does not exist. Value for money can broadly be defined as what a government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime.

The typical definition for value for money found in the literature defines it in terms of three elements: economy, efficiency and effectiveness (Diamond, 2005:162). Economy is the minimisation of the costs of inputs, while efficiency is the minimisation of inputs for a given set of outputs, or the maximisation of outputs for a given set of inputs. Efficiency entails both technical and economic efficiency. Technical inefficiency, also known as X-inefficiency, refers to when resources are not technically employed in the best way; it usually means that the levels of some inputs can be reduced while still delivering the same outputs (Diamond, 2005:161). A typical example is over-staffed programmes where the level of staff can be reduced without any need to reduce output levels. Economic inefficiency results from the combination of inputs that is not optimal given the relative prices of inputs. Usually, different combinations of inputs can deliver the same level of output (e.g. one might substitute teachers for computerised teaching aids or *vice versa*). However, given the relative prices of inputs, only one of these combinations will minimise cost. Therefore, if by changing the combination of inputs the cost of delivering a service can be lowered, the new combination will represent an improvement in economic efficiency. Economic efficiency is maximised when no further cost reductions can be made by altering the composition of inputs. Effectiveness refers to the impact of policy, i.e. whether or not the outputs reached (e.g. a certain teacher/pupil ratio) deliver the desired outcome (improvements in educational attainment as measured by indicators such as throughput rates). According to Diamond (2005:163), there are two forms of ineffectiveness: technical and economic. Even when delivery of a service is technically and economically efficient, the service itself may technically fall short of addressing the needs it was designed to address. It is then said to be technically ineffective. Economic ineffectiveness exists when the overall effectiveness of public resources can be improved by reallocating resources.

The above argument is sometimes summarised as:

- Economy in the use of resources: maximise inputs per dollar, euro, pound, yen, etc.
- Efficiency: maximise outputs per input.
- Effectiveness: maximise outcomes per output.

Following from these three components, the maximisation of value for money is defined as the maximisation of outcomes with respect to every dollar, euro, etc., spent on inputs. This is only possible if outcomes are maximised with respect to outputs (effectiveness) and if outputs are maximised with respect to inputs (efficiency), which in turn are maximised with respect to every dollar, euro, etc., spent on the inputs (economy).

Although appearing straightforward when stated as ratios to be maximised, such an appearance is deceptive. Defining value for money in terms of outcomes per dollar, euro, etc., spent on inputs addresses only supply-side efficiencies and effectiveness, while leaving out demand-side efficiency. Demand-side efficiency is more commonly known as allocative or Pareto efficiency. This form of efficiency might be the most difficult to measure, but it is nevertheless key to whether or not a service really represents value for money. When considering value for money, the question is “value for whom?” Presumably the answer is not government, but the recipient of the service/taxpayer.²⁸ As in private goods markets, allocative efficiency refers to the allocation of consumers’ purchasing power to various goods and services in a manner that will maximise their welfare (utility). Thus, it refers to the welfare of those receiving a service. An improvement in allocative efficiency can be attained if one can improve the welfare position of one agent (i.e. recipient of the service) without causing a deterioration in the welfare position of another agent. This is attained by reallocating resources spent on services so as to deliver the quantity and quality of different types of outputs (with the desired output features) that will maximise welfare. When no reallocation can improve the welfare of one agent without causing a deterioration in the welfare of another, the allocation of resources is said to be allocatively or Pareto efficient.

Unfortunately, the welfare that individuals derive from consuming goods and services cannot be measured directly. In a private goods market this is not a problem, because individuals are forced to translate the welfare that they expect from consuming a good into a demand for that good (they are said to “reveal their demand”). However, many of the goods that governments deliver suffer from the free-rider problem, which means that demand (and therefore what will maximise welfare) is not revealed. Therefore, it is possible that a service is delivered in a technically efficient way, also reaching all output and outcome goals, but that it is not something society wants and thus wanted to allocate resources to. This renders the service allocatively inefficient and hence also means that, even though all output and outcome objectives might have been reached (supply-side efficiency and effectiveness), the service nevertheless represents no or limited value for money (because it lacks demand-side efficiency). This situation is of course aggravated by budgetary constraints that require the government to set priorities and to trade off the benefits and welfare improvements of different spending programmes.

In essence, the problem is that the composition of goods that will maximise welfare can only be approximated by voters revealing their preferences in elections – an approximation that is quite imperfect at times, as the public choice literature has demonstrated. In addition, allocative efficiency depends on demand, which in turn depends (among other things) on wealth and income. Thus, should the government also pursue redistributive goals, it will indirectly affect the allocative efficiency of its programmes and hence render the decision as to what constitutes value for money even more difficult.

All of the above discussion serves to indicate that what constitutes value for money is not just a quantitative exercise. Because of all the difficulties highlighted above, what constitutes value for money usually also requires a significant level of qualitative judgment on the part of the government. A government needs to judge the unrevealed demand for

different services. Thus, it needs to judge what are the appropriate services to deliver and, in the case of each service, what will constitute the optimal combination of quantity, quality and features. It then needs to deliver these services with economy, technical and economic efficiency, and technical and economic effectiveness.

Notes

1. In some countries, the pursuit towards the use of PPPs has been premised on access to additional and alternative sources of finance. However, it is increasingly understood that PPPs do not necessarily increase the public expenditure envelope, in particular when the future liabilities and payment commitments of PPPs are taken into consideration. As such, the premise of additional and alternative sources of finance might be largely false (cf. OECD, 2008). This leaves the pursuit of value for money as the legitimate premise underlying the drive towards PPPs (cf. OECD, 2008).
2. Mostly PPPs operate through a special purpose vehicle (SPV). An SPV is usually the vehicle through which the construction and operation of the asset is managed by the private partners. The SPV can take many forms. Ye (2008:184) notes that SPVs can be incorporated companies, contractual joint ventures (unincorporated joint ventures), general or limited partnerships and trusts. Furthermore, the SPV can be a single entity responsible for all activities related to the PPP. It can also be a dual-entity structure where one entity is a borrowing entity and the other the managing entity, or alternatively, where one entity is the leasing company and the other the project company. Lastly, a PPP can be a multi-entity structure, with a borrowing vehicle, a management vehicle and a leasing vehicle (see Ye, 2008, for more details).
3. Within the category of public-private partnerships, a number of different models exist and can also give rise to different definitions. These are influenced not only by the responsibilities of the private partner but also the ownership and conceptualisation of the asset. For example, the private partner may design, build, own, operate and manage an asset with no obligation to transfer ownership to the government (e.g. design-build-finance-operate). Alternatively, the private partner may buy/lease an existing asset from the government, modernise and/or expand it before operating the asset but have no obligation to transfer ownership back to the government (e.g. buy-build-operate). Finally, the private partner may design, build and operate an asset before transferring it back to the government when the operating contract ends or at some other pre-specified time (e.g. build-operate-transfer). A large soup of acronyms for public-private partnerships has emerged. This article refers to public-private partnerships in general and does not go into specific types – which, indeed, vary significantly between countries. There exist a number of variations on design-build-finance-operate (DBFO), buy-build-operate (BBO) and build-operate-transfer (BOT) schemes. Variations of DBFO include build-own-operate (BOO), build-develop-operate (BDO), and design-construct-manage-finance (DCMF) schemes. Variations of BBO include lease-develop-operate (LDO) and wrap-around addition. Finally, variations of BOT include build-own-operate-transfer (BOOT), build-rent-own-transfer (BROT), build-lease-operate-transfer (BLOT) and build-transfer-operate (BTO) schemes (see Hemming et al., 2006).
4. The Statistics Office of the European Communities (Eurostat) considers that the main issue in classifying a public-private partnership depends on who bears the most risk. The recommendation in Eurostat's decision is that assets involved in a public-private partnership should be classified outside the government sector if both of the following conditions are met: i) the private partner bears the construction risk; and ii) the private partner bears either the availability risk or the demand risk. The bearer of risk is not always easy to define, and contract design varies. In cases where it is not possible to classify a public-private partnership as on or off the government books, other contract features can be considered, such as if the asset is supposed to be transferred from the private partner to the government at the end of the contract period and at what price. This event is also an important part of the risk sharing (see Eurostat, 2004).
5. A long-standing alternative to traditional infrastructure procurement is the use of processes where the government buys the raw material and other inputs necessary for the construction of an asset and then constructs the asset itself; large public works programmes very often function in this way.
6. Questionnaires were sent to both the federal government and the government of New South Wales. The federal government response covered both the federal and state level, while the response for New South Wales applied to the state level. To prevent double counting for Australia, the responses from the federal and New South Wales governments were consolidated. As one would expect, by far most of the replies to questions by these two respondents were the same. Where a difference

exists, the most encompassing answer was selected. For instance, if one response indicated that the provincial government plays a role, while the other did not select the provincial government as playing a role, the former was selected as the Australian response. Where one indicated “Yes” while the other indicated “Sometimes”, or if one indicated “No” while the other indicated “Sometimes”, “Sometimes” was selected as the response.

7. The United Kingdom count includes only private finance initiatives (PFIs) and not PPPs falling under a wider definition. Italy reported a much higher number (approximately 2 000), but this number includes all concessions.
8. Excludes concessions, and includes only those PPPs falling under the authority of the PPP unit.
9. Contingent liabilities are obligations that have been entered into, but the timing and amount of which are contingent on the occurrence of some uncertain future event. Contingent liabilities are not expected to realise. They are therefore not yet liabilities, and may never be if the specific contingency does not materialise.
10. Contingent costs – like contingent liabilities – are obligations that have been entered into, but the timing and amount of which are contingent on the occurrence of some uncertain future event. However, unlike contingent liabilities that are not expected to realise (although there is a probability that they might realise), contingent costs are expected to realise. An example is the future payment of fees by a government to a private partner for services delivered. Given that the payment of these fees is contingent upon meeting the standards and fulfilling the requirements of the PPP contract, there is a probability that the private partner will not meet the standards and fulfil the requirements. Nevertheless, the private partner is expected to meet the standards and fulfil the requirements, turning this into a contingent cost and not a contingent liability.
11. This disadvantage exists with regard to the ability of the public sector to both negotiate and manage the contract. Although the public sector can use outside consultants for the relatively short time that it takes to negotiate the contract, doing so for the long-term management of the contract is rarely feasible. This might lead to a situation where, although the government does not have the skills to manage the project or oversee private partners to manage it, the government may fear that a PPP might cost more than traditional procurement. Thus, despite its lack of skill, the government might prefer traditional procurement.
12. See OECD (2008:122) on the TUPE agreement in the United Kingdom that dealt with PPPs and labour.
13. Complexity very often means that it is difficult to foresee how all the elements involved in the project might interact and thereby affect outcomes. Measuring the risk (i.e. the probability of outcomes) therefore becomes difficult. Redundancy occurs with the introduction of new technology into a market. The nature and effect of new technology on cost and output can very often not be predicted. As such, innovation and technological change introduce uncertainty (i.e. immeasurable risk) as opposed to what is conventionally understood as risk (i.e. measurable risk).
14. The authors would like to express their gratitude to the relevant authorities for participating and for providing the information necessary to compile this section.
15. The MAPPP (*Mission d'appui aux PPP*) is responsible for supporting and regulating partnership contract projects and procedures, but not for managing tender processes.
16. To be noted: the PPP law of 28 July 2008 widely opened the application field for PPPs to cases that are defined neither by the criterion of complexity nor by the criterion of urgency, but simply by the criterion of economic efficiency. In such cases, the public authority freely chooses competitive dialogue or tender.
17. And even if PPPs constitute just 10% of total public sector infrastructure investment, the amounts involved might be quite significant and, as such, oblige governments to pursue maximum value for money.
18. Further alternatives such as “alliancing”, incremental partnerships and integrator models also exist (cf. Miller et al., 2009; HM Treasury, 2008; Grimsey and Lewis, 2007). They usually represent variations on the theme of either PPPs or TIP. However, they are beyond the scope of this article.
19. In the absence of competition during the bidding process, the best that the government can do is to compare the one bid received to the public sector comparator (PSC). However, some governments do not entertain a single bid on the grounds that the lack of competition means that there is a danger that the government will not obtain value for money.
20. Flyvbjerg et al. (2002:293) also note that the smallest projects are usually stretches of roads, while rail, bridges and tunnels are usually larger projects.
21. According to Flyvbjerg et al. (2002:281), questions have been raised as to whether or not the correct comparison is to compare the actual data with cost estimates that were made when the decision

to undertake the project was taken. The question is raised because, depending on the stage of the project cycle, different cost estimates exist: cost estimates are made at the time when the decision to build is taken, when the project goes to tender, when the contract is concluded and when changes were made to the contract. The later these estimates are made in the project cycle, the more accurate one can expect them to be. Thus, estimates included in the contract can be expected to be closer to actual costs, than estimates made when the decision was taken to build. However, Flyvbjerg *et al.* (2002:291) argue that the focus should be on the cost estimate that is used when the actual decision to build is taken, because that is the information used in the decision.

22. It should be noted that this does not mean that data on operational and maintenance cost are not recorded and reported, but that they are not necessarily recorded and reported on a whole-of-life project-by-project basis.
23. Flyvbjerg *et al.* (2002:288) also mention that cost forecasters may underestimate costs in an effort to pressure officials to cut down on costs. However, they still argue that, even though the intention might be “noble”, the underestimation of cost still means that the viability of the projects has not been established.
24. The University of Melbourne (2008) uses data coming from the project finalisation sequence. This sequence starts with the original project announcement, then continues to the budget approval, the contractual commitment and lastly the actual finalisation and the readying of the project for commencement of service. The report argues that data from the later stages suffer from less optimism bias, largely because the rigour with which costs and time estimates are made improves for both PPPs and traditionally procured projects during the later stages. However, the point made in note 21 above by Flyvbjerg *et al.* (2002:281) should be remembered here: when measuring the extent of cost underestimation, it is better to use the cost estimate made at the time when the decision to build was taken, because that is the estimate on which the decision is based.
25. At best what can be said is that the project has delivered (or is expected to deliver) value for money relative to some preset standard.
26. It should be noted that this is also the stage in the procurement process where alternatives such as alliancing are considered. These are very often variations on PPPs and TIP. However, they fall outside the scope of this article.
27. This is very often also a source of major cost overruns in traditionally procured projects: after a contract is concluded, the government may realise that it wants to change the design and output. Given that the government is already at that stage locked into a contract that details the design, the design can only be changed at great cost to the government.
28. Discussing value for money only in terms of the supply-side efficiencies and effectiveness might also explain why some critics of PPPs base their comments on a criticism of the value-for-money concept. Ignoring the demand-side efficiency might create the impression that the answer to the question “value for whom?” is government. To include demand-side efficiency refocuses attention on who policy is ultimately designed for: the taxpayer/voter/citizen.

References

- Allen Consulting Group (2007), “Performance of PPPs and Traditional Procurement in Australia”, report to Infrastructure Partnerships Australia, Melbourne, Australia.
- Arthur Andersen and Enterprise LSE (London School of Economics) (2000), “Value for Money Drivers in the Private Finance Initiative”, report commissioned by the Treasury Taskforce, 17 January, London.
- British Department for Transport (2004), “Procedures for Dealing with Optimism Bias in Transport Planning – Guidance Document”, June, British Department for Transport, London, www.hm-treasury.gov.uk/green_book_guidance_optimism_bias.htm.
- Deloitte (Ireland) (2009), interview and correspondence.
- Diamond, J. (2005), “Establishing a performance management framework for government”, *Presupuesto y Gasto Público*, 40/2005, pp. 159-183.
- EIB (European Investment Bank) (2004), *The EIB's Role in Public-Private Partnerships (PPPs)*, European Investment Bank, Luxembourg, www.eib.org/Attachments/thematic/eib_ppp_en.pdf.
- Estache, A., A. Iimi and C. Ruzzier (2009), “Procurement in Infrastructure: What does theory tell us?”, *Policy Research Working Paper No. 4994*, The World Bank, Washington DC.

- Eurostat (2004), "New Decision of Eurostat on Deficit and Debt: Treatment of Public-Private Partnerships", News Release No. 18, 11 February, Statistical Office of the European Communities, Luxembourg.
- Fitzgerald, P. (2004), *Review of Partnerships Victoria Provided Infrastructure: Final Report to the Treasurer*, Growth Solutions Group, Melbourne, Australia.
- Flyvbjerg, B., M.S. Holm and S. Buhl (2002), "Underestimating costs in public works projects: Error or lie?", *Journal of the American Planning Association*, 68(3), pp. 279-295.
- Grimsey, D. and M. Lewis (2007), "Public Private Partnerships and Public Procurement", *Agenda*, 14(2), pp. 171-188.
- Guasch, J.L. (2004), *Granting and Renegotiating Infrastructure Concessions: Doing it Right*, The World Bank, Washington DC.
- Haskins, S., D. Gale and L. Kelly (2002), "Creating and optimizing new forms of public-private partnerships in Seattle", *Water Science and Technology: Water Supply*, 2(4), pp. 211-218.
- Hemming, R., M. Alier, B. Anderson, M. Cangiano and M. Petrie (2006), *Public-Private Partnerships, Government Guarantees, and Fiscal Risk*, International Monetary Fund, Washington DC.
- HM Treasury (2003a), *PFI: Meeting the Investment Challenge*, The Stationery Office, London.
- HM Treasury (2003b), *The Green Book: Appraisal and Evaluation in Central Government*, The Stationery Office, London, www.hm-treasury.gov.uk/data_greenbook_index.htm.
- HM Treasury (2006a), "Value for Money Assessment Guidance", www.hm-treasury.gov.uk/ppp_vfm_index.htm.
- HM Treasury (2006b), "PFI value for money quantitative assessment", www.hm-treasury.gov.uk.
- HM Treasury (2008), "Infrastructure procurement: delivering long-term value", www.hm-treasury.gov.uk.
- KPMG (Klynveld, Peat, Marwick and Goerdeler) (2007), *Effectiveness of Operational Contracts in PFI 2007*, KPMG LLP, London, www.kpmg.co.uk.
- Kumaraswamy, M.M. and S.M. Dissanayaka (2001), "Developing a Decision Support System for Building Project Procurement", *Building and Environment* 36:337-349.
- Love, P.E.D., P. Davis, D. Baccarini, G. Wilson and R. Lopez (2008), *Procurement Selection in the Public Sector: A Tale of Two States*, conference proceedings from "Clients Driving Innovation: Benefitting from Innovation", 12-14 March, Gold Coast, Australia.
- Luu, D.T., S.T. Ng and S.E. Chen (2003), "A Case-Based Procurement Advisory System for Construction", *Advances in Engineering Software* 34:429-438.
- Miller, G., C.W. Furneaux, P. Davis, P. Love and A. O'Donnell (2009), "Built Environment Procurement Practice: Impediments to Innovation and Opportunities for Changes", report commissioned by the Built Environment Industry Innovation Council, Canberra, available at www.innovation.gov.au/Industry/BuildingandConstruction/BEIIC/Documents/BuiltEnvironmentProcurementPractice.pdf.
- Mott MacDonald (2002), *Review of large public procurement in the UK*, report for HM Treasury, Mott MacDonald, Croyden, United Kingdom.
- National Audit Office (2003), *PFI: Construction Performance. Report by the Comptroller and Auditor General*, HC 371 Session 2002-2003: 5 February, The Stationery Office, London.
- NEDO (National Economic Development Office) (1985), *Thinking about Building*, NEDO/HMSO, London.
- OECD (2008), *Public-Private Partnerships: In Pursuit of Risk Sharing and Value for Money*, OECD Publishing, Paris.
- OECD (2009), "Enhancing Integrity in Public Procurement: A Toolbox", www.oecd.org/governance/procurement/toolbox.
- OECD (2010), *Dedicated Public-Private Partnership Units: A Survey of Institutional and Governance Structures*, OECD Publishing, Paris.
- PWF (Public Works Financing) (2009), *Public Works Financing Newsletter*, Vol. 242, October, www.PWFinance.net.
- University of Melbourne (2008), *National PPP Forum – Benchmarking Study, Phase II: Report on the performance of PPP projects in Australia when compared with a representative sample of traditionally procured infrastructure projects*, University of Melbourne Report, Melbourne Engineering Research Institute, Melbourne, Australia.
- Ye, S. (2008), "Patterns of Financing PPP Projects" in A. Akintoye and M. Beck (eds.), *Policy, Management and Finance for Public-Private Partnerships*, Wiley-Blackwell, London.

Fiscal and Monetary Institutions in Central, Eastern and South-Eastern European Countries

by

Zsolt Darvas and Valentina Kostyleva *

This article studies the role of fiscal and monetary institutions in macroeconomic stability and budgetary control in central, eastern and south-eastern European countries (CESEE) in comparison with other OECD countries. CESEE countries tend to grow faster (or at least tended to grow faster before the crisis) and have more volatile output than non-CESEE OECD countries, which has implications for macroeconomic management: better fiscal and monetary institutions are needed to avoid pro-cyclical policies. The article develops a Budgetary Discipline Index to assess whether good fiscal institutions underpin good fiscal outcomes. Even though most CESEE countries have low scores, the debt/GDP ratios declined before the crisis. This was largely the consequence of a very favourable relationship between the economic growth rate and the interest rate, but such a favourable relationship is not expected in the future. Econometric estimations confirm that better monetary institutions reduce macroeconomic volatility and that countries with better budgetary procedures have better fiscal outcomes. All these factors call for improved monetary institutions, stronger fiscal rules and better budgetary procedures in CESEE countries.

JEL classification: E32, E50, H11, H60

Keywords: CESEE countries, Budgetary Discipline Index, budget process, fiscal institutions, budgetary institutions, monetary institutions, macroeconomic stability, econometric analysis, budgetary procedures, fiscal outcomes, fiscal rules

* Zsolt Darvas is a research fellow at Bruegel and at the Institute of Economics of the Hungarian Academy of Sciences, and associate professor at the Corvinus University of Budapest (e-mail: zsolt.darvas@bruegel.org). Valentina Kostyleva is a policy analyst in the Budgeting and Public Expenditures Division of the OECD Public Governance and Territorial Development Directorate (e-mail: valentina.kostyleva@oecd.org). The authors thank Mark Hallerberg, Dirk-Jan Kraan, Peter Van den Berg and the participants at the 6th annual meeting of CESEE Senior Budget Officials in Budva, Montenegro, 23-24 September 2010, for comments and suggestions, and Rita Orsolya Tóth and Lucia Granelli for research assistance.

1. Introduction

This article aims to identify the major institutional determinants of macroeconomic stability and aggregate budgetary control in central, eastern and south-eastern European (CESEE) countries.¹ The region grew fast before the crisis, but the crisis hit most of these countries hard – more so than any other country group of the world – and the recovery from the crisis is also generally slow. As a consequence, the pre-crisis seemingly smooth economic progress and good budgetary record suddenly came to an end.

Have fiscal² and monetary institutions played important roles in macroeconomic stability and aggregate budgetary control? Since the crisis had a decisive impact on both macroeconomic stability and budgetary control, the impact of these institutions on the build-up of pre-crisis vulnerabilities and on crisis response has a crucial relevance to this question. The article defines fiscal institutions as a set of arrangements directing budgetary preparation (including expenditure frameworks and fiscal rules), approval and execution. Monetary institutions are associated with the exchange rate regime, the quality of financial regulation and supervision, the independence of central banks, and the transparency of central bank decision making. Causal links from fiscal and monetary institutions to budgetary control and macroeconomic stability can be hypothesised as follows:

- Fiscal institutions and macroeconomic stability: Countries with better fiscal frameworks are presumably following counter-cyclical fiscal policy. Letting automatic stabilisers run and implementing counter-cyclical discretionary fiscal policy through the business cycle can dampen macroeconomic volatility.
- Fiscal institutions and budgetary control: Better fiscal institutions can directly lead to better budgetary outcomes (i.e. low deficit or surplus, and low public debt) by constraining fiscal policy.
- Monetary institutions and macroeconomic stability: The ultimate goal of monetary policy should be the stabilisation of the economy through the business cycle, and better monetary institutions should be more successful in achieving this goal. Monetary institutions are defined broadly, and the role of financial stability is considered through regulation and supervision. The crisis has proven even more clearly that financial stability has strong implications for macroeconomic stability.
- Monetary institutions and budgetary control: There should not be a direct causal link from monetary institutions to budgetary control. However, the indirect channel through a higher level of macroeconomic stability can work.

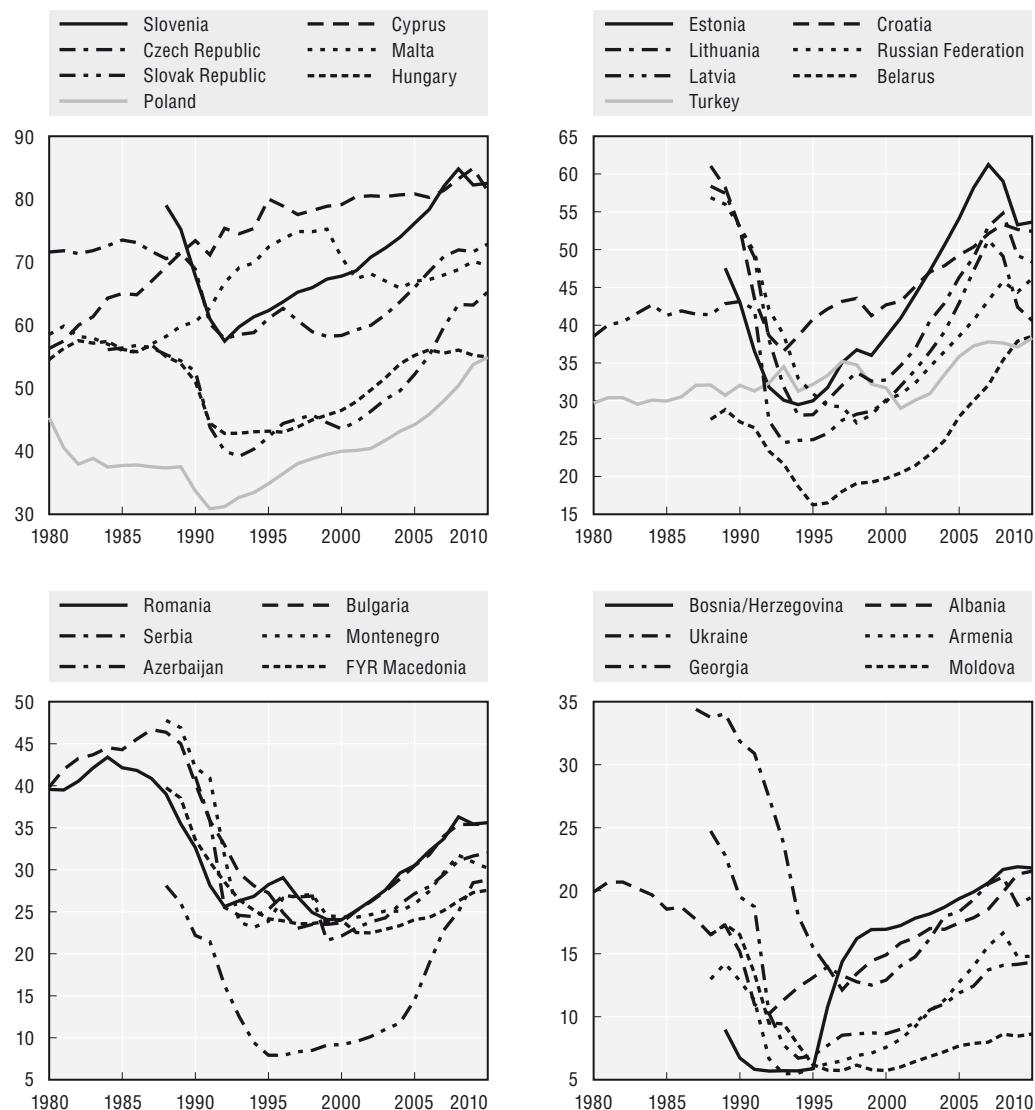
The article is structured as follows. Section 2 describes macroeconomic stability and budgetary outcomes. Budgetary institutions are assessed in Section 3: the “Budgetary Discipline Index” deviates from similar indices in the literature as it considers a set of institutional features that focus specifically on budgetary discipline. Section 4 discusses monetary institutions. Section 5 presents the empirical analysis on the impact of fiscal and monetary institutions on macroeconomic stability and budgetary control. Section 6 presents some concluding remarks.

2. Macroeconomic stability and fiscal outcomes

2.1. Development of GDP

Most of the CESEE countries went through an historically unprecedented transition from socialist political systems towards democracies and from centrally planned economies towards market economies. The extraordinarily deep recession after the collapse of the communist regimes was followed by a fast and apparently smooth economic recovery – that is, growth of per capita GDP has well exceeded the growth in the CESEE region's main trading partners (Figure 1).³

Figure 1. GDP per capita at purchasing power parity (EU15=100), 1980-2010¹



1. Countries are ranked according to their 2010 forecast values.

Source: Authors' calculations based on data from the IMF World Economic Outlook April 2010 and EBRD database on main macroeconomic indicators.

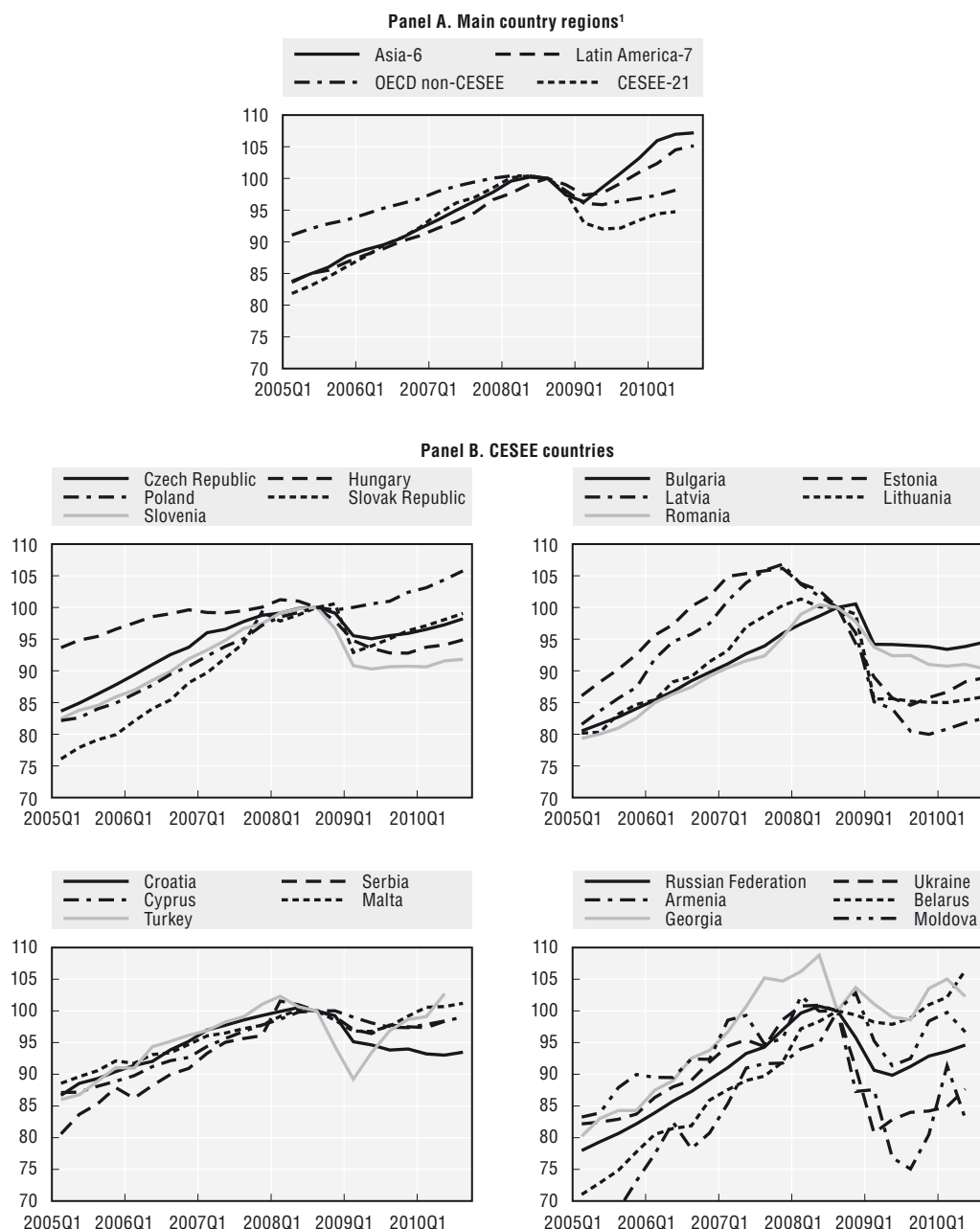
Figure 1 also indicates that the duration of the recession in the 1990s (the transition period) varied substantially across CESEE countries, which complicates the selection of a start date for the sample period for the econometric analysis in this study. The current global financial and economic crisis complicates the selection of the end date of the sample period. Figure 1 indicates that the recovery has halted in several CESEE countries and even reversed in some of them. Quarterly GDP indicators also show that recovery from the crisis is in general slow in CESEE countries and much slower than in other emerging country groups (Figure 2). For example, in the six small and open Asian economies shown in Panel A of Figure 2, output growth is currently faster than it was before the crisis, implying that these countries may converge to their pre-crisis trend line. But in CESEE countries, the speed of recovery so far falls behind pre-crisis growth, even though there is heterogeneity: Albania and Poland have not suffered from a recession in 2009, while in Armenia, Estonia, Latvia, Lithuania and Ukraine the drop in output was close to or even above 20%.

The reasons behind both the more serious average impact of the crisis on CESEE countries and the diversity among those countries have been studied (see, for example, Mitra, Selowsky and Zalduendo, 2009; Darvas, 2010; and Becker *et al.*, 2010), so only the main issues are summarised here.

The pre-crisis development model pursued by CESEE countries had many special features compared to other emerging economies. It was based on deep political, institutional, financial and trade integration with the EU⁴ which was also accompanied by substantial labour mobility into EU15 countries. Other emerging country regions did not have an anchor similar to the role the EU played for CESEE countries. Economic growth in the CESEE region relied on net private capital inflows, which have reached higher levels than elsewhere. In the aftermath of the dramatic crises in Asia and Latin America in the late 1990s and early 2000s, the CESEE region was the only emerging region of the world that had persistent current account deficits. Economic recovery was accompanied by real exchange rate appreciations – again a largely unique feature of the CESEE development model – and real interest rates fell.

But the CESEE development model had two important variants within the region. Some countries, most notably countries in central Europe, were more successful in making use of the development model. In these countries, pre-crisis growth was accompanied by small and even improving trade balances, as a reflection of reindustrialisation after the collapse that followed the fall of communist regimes. In most of the other countries, however, the trade and current account balances deteriorated sharply before the crisis, reaching double-digit levels in several cases. As a consequence, external debt rose fast before the crisis. Also, housing prices rose much faster and real exchange rate appreciation was also more rapid, while real interest rates fell to lower levels than in central European countries and inflation also rose considerably before the crisis. All of these factors suggest that economic growth in this group of countries was to a considerable extent fuelled by unsustainable booms. Indeed, there was extremely rapid growth of credit to the private sector, and the composition of foreign direct investment (FDI) was also biased in favour of banking, real estate and other domestic sectors.

When the crisis started, most people thought that the CESEE region would not be hit too hard. For example, the April 2008 *Regional Economic Outlook Europe* of the IMF foresaw that “emerging Europe’s convergence trend is set to continue, based on good fundamentals, although its pace is likely to slow” (IMF, 2008), and other institutions and commentators shared this view. However, after the collapse of Lehman Brothers, there was a sudden

Figure 2. **Quarterly GDP developments (2008Q3=100), 2005Q1-2010Q3**

1. Country group averages in panel A are non-weighted averages. Asia-6: Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand. Latin America-7: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico and Peru. CESEE-21: the average of the 21 countries shown in Panel B. OECD non-CESEE: 27 OECD countries except Czech Republic, Hungary, Poland, Slovak Republic, Slovenia and Turkey.

Sources: Eurostat (EU countries and Croatia), OECD (other OECD countries and Russian Federation), and national statistical offices, IMF and EBRD quarterly GDP database (other countries). Whenever seasonally adjusted series were not available, the Census X-12 method for seasonal adjustment was used.

interruption, and even reversal in some countries, of capital inflows to CESEE countries. This led to a credit crunch which, combined with the subsequent export and investment declines, has depressed economic activity. Commodity exporters, such as Azerbaijan, the

Russian Federation or Ukraine, were also hit by falling commodity prices. As the crisis unfolded, the credit crunch was replaced by falling demand for credit, caused by increased uncertainty and lowered expectations with respect to future growth prospects (Ghosh, 2009).

The diversity of responses to the crisis within the CESEE region could be related to different reliance on pre-crisis capital inflows, trade and commodity exports. But the crisis responses have likely been influenced by the fiscal and monetary policies during the crisis: only a few CESEE countries (e.g. Azerbaijan, Czech Republic, Poland, Russian Federation, Slovenia, Turkey) implemented fiscal stimulus in order to dampen the crisis. Most other countries had to consolidate public finances, thereby likely amplifying the downturn (Darvas, 2010).⁵ Furthermore, monetary policy could not be eased at a time when capital was moving out, and indeed several countries had to raise interest rates as well.

2.2. Macroeconomic stability

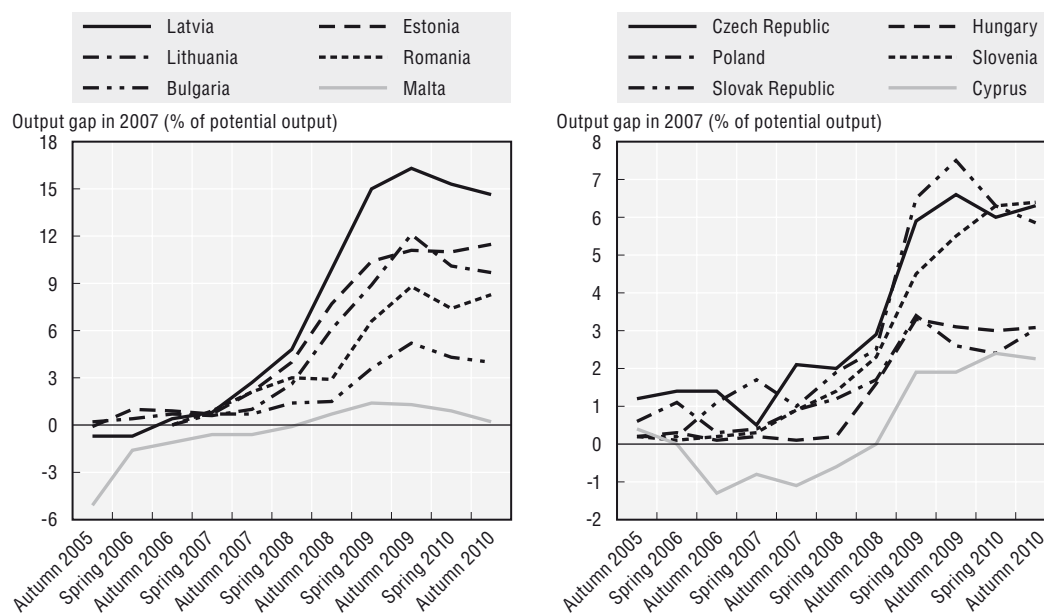
Two measures of macroeconomic stability are used for the econometric analysis of Section 5 below:

- volatility of GDP growth rates, 2000-10
- output decline in 2009

The first one can be regarded as an average measure of stability, while the second can be regarded as a “tail” event. The selection of these measures is based on the following.

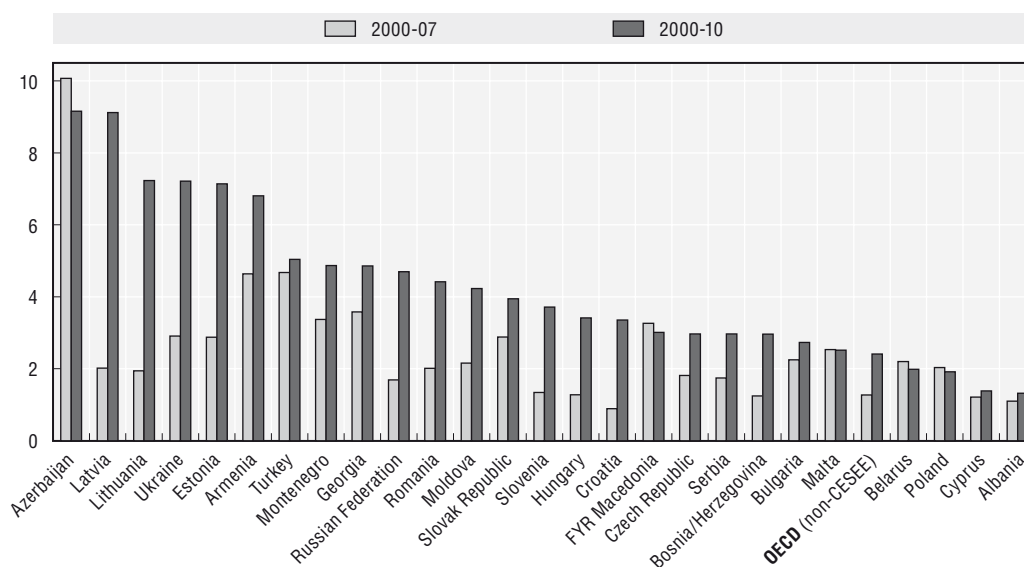
The developments described in the previous sub-section suggest that considering the pre-crisis period only would be misleading, since pre-crisis economic growth has led to economic structures that made CESEE countries more prone to the crisis. In particular, the seemingly fast and smooth growth before the crisis has led to vulnerabilities in several CESEE countries, which eventually resulted in huge output falls and slow recoveries so far. Therefore, the crisis should be included in the sample. On the other hand, the 1990s was burdened with so many structural changes that the inclusion of this sample period would not be informative. Therefore, whenever data availability allows, the sample period of 2000-10 is used when studying macroeconomic stability, but a pre-crisis sample period (2000-07) is also used for comparison.

Macroeconomic stability has various interpretations.⁶ The focus here is on GDP volatility, which of course can also reflect internal and external disequilibrium. Ideally, GDP volatility should be measured as the volatility of the deviation from potential output. However, measures of potential output are especially uncertain for countries like those of central, eastern and south-eastern Europe and at the time of the global crisis. An example is given in Figure 3 which depicts the 2007 output gap in EU member CESEE countries as seen at different dates, using data from the European Commission. The figure shows huge revisions in potential output calculations. The EC first published forecasts for the 2007 output gap in autumn 2005, when it predicted, for example, that the output gap of Latvia in 2007 would be -0.7%. This forecast was maintained in the spring of 2006, but later it was substantially revised upward. In the spring of 2008, the 2007 output gap was seen as 4.8% and in autumn 2009 it was seen as 16.3%. Therefore, we do not study the volatility of the output gap, but concentrate on GDP growth.

Figure 3. **The 2007 output gap as seen at different dates**

Source: European Commission forecasts made at the dates indicated on the horizontal axis.

Figure 4 shows the standard deviation of real GDP growth rates in 2000-07 and in 2000-10 in order to assess the possible increase in volatility in response to the crisis. Indeed, considering the pre-crisis period of 2000-07, volatility was seemingly low in several CESEE countries. In some cases, volatility was even below the average of non-CESEE OECD

Figure 4. **Standard deviation of annual GDP growth rates**

Source: Authors' calculations using data from the IMF World Economic Outlook April 2010.

countries. However, data for 2000-10 suggest that the seemingly low pre-crisis volatility has indeed masked underlying vulnerabilities. In some cases, such as Estonia, Latvia, Lithuania and Ukraine, the rise in volatility is quite dramatic. On the other hand, there are four countries (Albania, Belarus, Cyprus and Poland) where volatility is below the non-CESEE OECD average in the 2000-10 period.

2.3. Fiscal outcomes

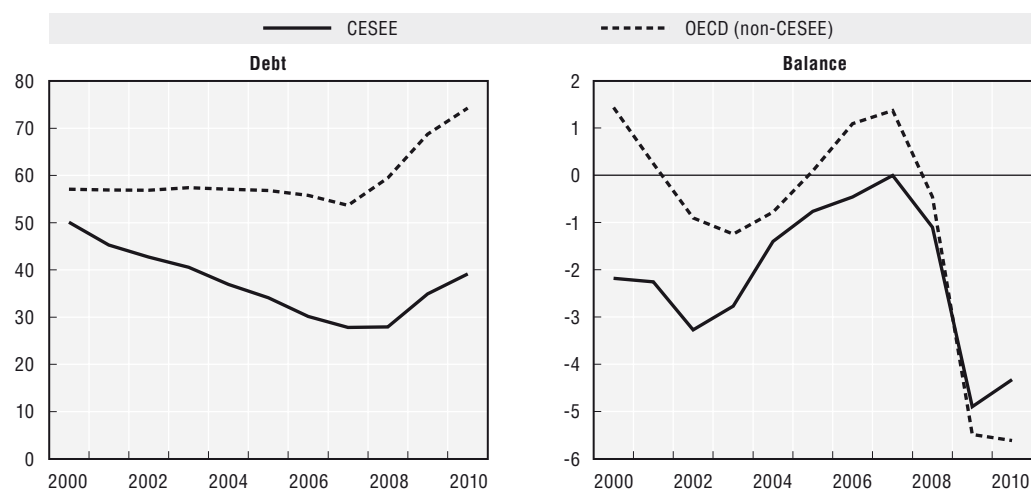
Two measures of fiscal outcomes are used for the econometric analysis of Section 5 below:

- average general government balance (as a per cent of GDP) in 2000-10
- change in general government gross debt (as a per cent of GDP) from 2000 to 2010

The two measures are related, but not perfectly, as will be demonstrated below. The second measure considers the change in the debt/GDP ratio (as opposed to the level of the debt/GDP ratio) because good fiscal institutions in a given year cannot impact the inherited stock of debt, but can impact the change in debt. Of course, the econometric analysis controls for the initial level of debt and other potential determinants. Similarly to the study of macroeconomic stability, the pre-crisis period (2000-07) is also used for comparison to the preferred sample of 2000-10.

Figure 5 shows developments in general government balance and debt as a per cent of GDP. The trend in general government gross debt has been much more favourable in CESEE countries than in non-CESEE OECD countries. The average ratio of debt to GDP has decreased by more than 20 percentage points between 2000 and 2008 in CESEE countries, whereas it has been stable (or showed just slight decreases) in (other) OECD countries. One reason for this development could be differences in budget balances. However, this is certainly not the case, since the budget balance⁷ was better in non-CESEE OECD countries than in CESEE countries. Therefore, the two measures described at the beginning of this sub-section are not perfectly correlated.

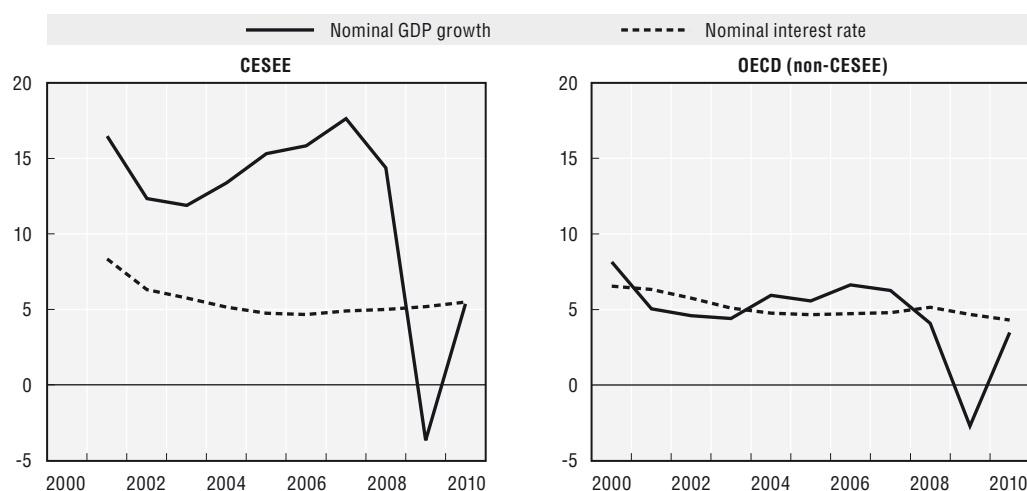
Figure 5. **General government balance and gross debt (% GDP), 2000-10**



Sources: IMF World Economic Outlook April 2010 and EBRD database on main macroeconomic indicators.

The explanation for the divergent trends in debt/GDP ratios is most likely the consequence of a highly favourable relationship between the economic growth rate and the interest rate. As Figure 6 indicates, economic growth in CESEE countries largely exceeded the interest rate before the crisis, while in (other) OECD countries the two variables broadly moved together. The favourable relationship in CESEE countries was supported by financial integration (by reducing borrowing costs), higher real GDP growth rates and higher inflation rates.⁸

Figure 6. **Implicit nominal interest rate¹ on government debt and nominal GDP growth (per cent), 2000-10**



1. Interest rate = government interest expenditures/previous year gross debt.

Source: Authors' calculations using data from the IMF World Economic Outlook April 2010 and Eurostat website (implicit interest rate).

3. Fiscal institutions

This section identifies budgetary institutions which may contribute to aggregate control and fiscal discipline, and proposes a new index called “Budgetary Discipline Index”. The “Fiscal Institutions Index” of Fabrizio and Mody (2008) and the budgetary institutions indexes of Hallerberg, Strauch and von Hagen (2007) have motivated the development of this Budgetary Discipline Index which nevertheless differs by according more importance to different or additional aspects and by omitting some criteria analysed by the previous authors. This article develops a set of institutional features which are considered to be crucial for mechanisms of fiscal discipline at the three stages of the budgetary cycle: the preparation stage (when the budget is drafted), the authorisation stage (when the budget is approved by parliament) and the implementation stage (when the budget is implemented and may be amended). The set provides a benchmark for assessing the countries and a basis for constructing the Budgetary Discipline Index.

3.1. Budget preparation stage

For the stage of budgetary preparation, three leading parameters contribute to budgetary control: fiscal rules, the medium-term expenditure framework and multi-annual expenditure estimates.

3.1.1. Fiscal rules

According to the definition of a fiscal rule proposed by Kopits and Symanski (1998, p. 2), a fiscal rule is “a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. ...A critical feature of a fiscal rule is that ... it is intended for application on a permanent basis by successive governments in a given country.”

Fiscal rules can serve different goals, and their role in promoting budgetary control varies. Depending on how they affect fiscal discipline, the rules are classified as follows:⁹

- **Expenditure rules** usually set permanent or medium-term limits on total, primary or current spending in absolute terms, in growth rates, or in per cent of GDP. Expenditure rules in their essence include expenditure frameworks with fixed ceilings (ceilings that cannot be changed from year to year). Expenditure rules are always anchored in a budget balance rule over the cycle (see below). Expenditure rules can provide an operational tool to trigger the required fiscal consolidation consistent with sustainability. Steering on the expenditure side rather than on a cyclically adjusted deficit constraint is more transparent and possibly less susceptible to manipulation (Anderson and Minarik, 2006). Therefore, the largest value is assigned to expenditure rules.
- **Budget balance rules**, which can be set as headline balance and structural (or cyclically adjusted) balance, help to ensure that the debt-to-GDP ratio converges to a finite level. (Sometimes the “balance rule” is referred to as a “deficit rule”.)
 - Headline balance rules have certain disadvantages. The revenue side of the budget is almost entirely determined by substantive legislation, namely tax legislation, and the expenditure side is partly determined by substantive legislation, in particular social security and health legislation (entitlements). This means that forecasts for the actual deficit are permanently moving, not only during the formulation phase of the budget process but also during the execution phase. Focus on the headline balance therefore requires that the budget be amended often during both phases of the budget process to react to the latest predictions. This hampers an orderly decision-making process and tranquillity in the budget numbers. Moreover, it leads to a volatile fiscal stance that changes from month to month in the light of the latest forecasts. Budgetary adjustments motivated by short-term macroeconomic fluctuations bring a pro-cyclical element into budgetary policy and hamper the stabilising effect of the budget (Kraan *et al.*, 2006).
 - A structural (or cyclically adjusted) balance rule may solve some issues associated with the headline balance rule and improve the trade-off between concerns about sustainability and cyclical stability. The cyclically adjusted fiscal balance is obtained by removing the cyclical component from the headline fiscal balance. The cyclical component, in turn, depends on two factors: the size of the output gap; and the output elasticity of the tax yield, which indicates the extent to which the tax yield reacts to fluctuations in GDP. However, one disadvantage of a cyclically adjusted deficit constraint is that there are arbitrary elements in the calculation of the output gap on which the cyclically adjusted deficit is based.¹⁰ Moreover, the concept of the cyclically adjusted balance rule is not always transparent to politicians and the public.
 - Some variant of cyclically adjusted balance rules is now used by about 11% of countries around the world (IMF, 2009). However, none of the CESEE countries have adopted cyclically adjusted balance rules. Concerns about the accuracy of calculations might

be the main reason for the countries' abstinence. Given the relatively high volatility of macroeconomic variables in the CESEE region, it would be difficult to produce an accurate cyclical component. Therefore, this article does not separate structural and headline balance rules, but rather assigns them the same score (after expenditure rules).

- **Debt rules** set an explicit limit or target for public debt in per cent of GDP. This type of rule is, by definition, the most effective in terms of ensuring convergence to a debt target. However, it does not provide sufficient guidance for fiscal policy when debt is well below its ceiling. Therefore, debt rules score low in the calculation.

A significant proportion of countries frequently combine balance and debt rules, which reflects governments' preferences for rules with a close link to fiscal sustainability.

Finally, the absence of a fiscal rule of any kind does not contribute to fiscal discipline; thus a zero is assigned to the countries with no fiscal rules.

3.1.2. *Medium-term expenditure framework*

Almost all OECD countries currently work with a medium-term expenditure framework. Most of them adjust the framework from year to year in the light of the previous year's outcomes, new estimates of the consequences of current policies and new political priorities. This framework can be called a flexible one. The major advantage of a flexible framework in comparison to no framework is that, at the time of budget formulation, the multi-annual consequences of all changes (setbacks and windfalls on the revenue and expenditure sides, and new priorities) have to be traded off against each other and against the adjustment of medium-term targets for expenditures, revenues or the deficit.

A few countries (notably the Netherlands, Sweden and the United Kingdom) have a medium-term expenditure framework that is not adjusted from year to year; this can be called a fixed framework. It is characteristic for a fixed framework that, during budget formulation, all line-item budget numbers and all line-item multi-year estimates have to be squeezed under the overall ceiling over the entire term of the framework. The first major advantage of a fixed expenditure framework in comparison to no framework is identical to that of a flexible framework: all trade-offs have to be considered. A second major advantage is that a fixed framework is (more) effective than a flexible framework in realising multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realised as long as the framework is maintained. Although only a few OECD countries work with a fixed expenditure framework, many others seek to keep their expenditure framework as stable as possible from year to year (without formally committing to a fixed framework).

Medium-term expenditure frameworks sometimes contain not only overall ceilings or broad sectoral ceilings for central government, local government or the social security funds, but also ceilings at the level of ministries or expenditure areas. Ministerial ceilings are important because, once established, they impose a certain discipline on ministers and help to prevent overspending.

CESEE countries have also adopted expenditure frameworks in their budgetary process. The frameworks are characterised by different degrees of flexibility. For the purposes of this article, the highest score was attributed to the countries that have fixed ceilings for the ministries at the very beginning of the budget formulation process and that try to keep them as stable as possible from year to year. If a country has targets which may be

substantially changed and renegotiated during the budget drafting process, the country was given a score of zero.

3.1.3. Multi-annual estimates

Multi-annual estimates should be integrated into the annual budget to ensure consistency with the expenditure framework. Multi-annual line-item estimates on the basis of current policy or current law are essential for the allocation of financial resources in the annual budget negotiation, and they help to ensure the consistency of current law or policy with the multi-annual ceilings. Multi-annual estimates on the basis of current policy or current law ("baseline estimates") should be produced and agreed between the line ministry and the finance ministry at least twice a year. Such estimates are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution: during execution, they alert at an early stage to possible overspending, which may trigger corrective measures.

Establishing the expenditure framework can be seen as a top-down process, and preparing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line-item estimates is central to a programme-based budget process. Government spending programmes in OECD countries have reached such levels of size and complexity that it is frequently difficult to make policy changes in the current year that substantially affect the next year's budget.

Therefore, the maximum score was attributed to the countries where multi-annual line-item estimates based on current policy are updated twice or several times per year, a lower score to the countries where multi-annual line-item estimates based on current policy are available at the start of the budget preparation, and zero to the countries where the estimates are prepared on an *ad hoc* basis or are not produced at all.

3.2. Budget authorisation stage (legislation)

In the legislative stage of the budgetary process, parliament can amend the budget bill and either pass or reject it. Two indicators in this second stage are important for promoting fiscal discipline: constraints on parliament to amend the budget bill, and independent assessment of fiscal policy by a fiscal council.

3.2.1. Constraints on parliament to amend the budget bill

The approval stage of the budget cycle serves as an important opportunity for debate of the executive's policy and expenditure priorities. Without intending to study the meaning of political representation or the confidence in the legislature held by civil society, the argument is that a restricted formal amendment power of parliament contributes to better budgetary discipline. If the legislature can only make budget amendments under the condition that the budget balance (surplus or deficit) within the executive's budget proposal is unchanged – or, alternatively, if the legislature can only amend downwards any aggregates of expenditure – the constraints on the executive budget are maintained and the budgetary cycle is not fragmented. This situation will contribute to fiscal discipline. The highest score was attributed to countries where the amendment power of parliament is restricted, and a score of zero to the countries where the legislature may increase or decrease the level of revenues and/or expenditures without the consent of the executive.

3.2.2. Fiscal councils

An independent fiscal agency or a fiscal council can help in the formulation and implementation of sound fiscal policies. Fiscal councils analyse and assess budgetary developments and policies, offer advice, and stimulate public debate and scrutiny while leaving the policy mandate with the elected representatives. Fiscal councils can provide independent input into the budgetary process and contribute to greater transparency by alerting about the political cost of inappropriate policy.

The desirable form of a fiscal council is specific to each country. The best form depends on the nature of a country's political environment, including the constitutional set-up, the legal traditions and the policy-making customs. A fiscal council can complement the role played by existing institutions and enhance the effectiveness of fiscal rules (see Debrun, Hauner and Kumar, 2009).

For the analysis in this article, only fiscal agencies which are fully independent (or a nonpartisan government agency) and whose role consists in assessing fiscal policy were considered. The premise is that the larger the guarantee of independence from political interference, the greater the likelihood of perceived or actual impact on fiscal outcomes.

3.3. Budget implementation stage

In the third stage, the budget law is executed and further modifications of the law may be possible. Two parameters were selected to indicate the level of budgetary control: the rules for carryovers of unused funds to the next fiscal year, and the quality of external audit.

3.3.1. Carryovers of unused funds

The issue of carryovers of unused funds to the next fiscal year arises in the stage of budgetary execution. Any automatic carryover arrangement, whether cash-based or accruals-based, will lead to stacks of unused appropriations that will increase from year to year. Any general rule limiting carryover will lead to "December fever". Therefore, the most sensible solution is bilateral negotiation between the line minister and the finance minister on a case-by-case basis. Under a cash regime, each agreed carryover will have to be compensated in the next budget year and the finance minister should see to that (Kraan, 2007). Therefore, the rules allowing carryovers within certain limits with authorisation of the finance ministry were given the highest score, prohibited carryovers were given an average score, and unlimited carryover rules (which do not contribute to fiscal discipline) were given a value of zero.

3.3.2. Quality of external audit

The quality of external audit is probably the most arbitrary parameter. It encompasses various issues related to external audit, namely the openness and availability of audit reports to the public, timeliness of such publications, the nature of audit reports (for instance, performance audit reports are considered as a more advanced level of auditing with greater outcomes than compliance reports), the mechanism provided for follow-up measures, and some other criteria which can differ depending on countries' circumstances. Therefore, the countries with both financial and performance audits complemented by strong mechanisms for follow-up measures score high in the ranking. A focus on financial audit and/or insufficient use of audit reports indicates an insufficient level of development of audit institutions (zero score).

3.4. Design of the index

Table 1 provides an overview of the design of the Budgetary Discipline Index and indicates the preferred weights.

It should be kept in mind that the study looks at budgetary institutions from the perspective of how well they contribute to the fulfilment of one particular function of the budget: control of spending, taxation and borrowing. Therefore, other functions of the budget – namely the efficient allocation of resources, the cost-efficient management of spending programmes, the democratic authorisation of and accountability for taxation, spending and borrowing – are not considered. This focus determines the set of variables in the construction of the Budgetary Discipline Index. Institutional characteristics that promote co-ordinated and cohesive decision making are expected to be more conducive to fiscal discipline and therefore receive a higher score in the quantitative index used for the empirical analysis.

Table 1. **Construction of the Budgetary Discipline Index: index parameters**¹

	Index	Sub-index	Numerical coding
Budget preparation	0.50		
Fiscal rules		0.50	
Expenditure rule			4.00
Budget balance rule			2.67
Debt rule			1.33
None			0.00
Medium-term expenditure framework		0.25	
Multi-annual ceilings are decided at the start of the budget preparation.			4.00
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00
Multi-annual line-item expenditure estimates		0.25	
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00
There are no multi-annual estimates based on current policy.			0.00
Budget authorisation	0.25		
Constraints on parliament to amend the budget bill		0.50	
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00
No constraints.			0.00
Fiscal council		0.50	
There is a fiscal council to assess fiscal policies independently.			4.00
No fiscal council.			0.00
Budget implementation	0.25		
Carryover of unused funds to the next fiscal year		0.50	
Allowed within certain limits with authorisation of the finance ministry.			4.00
Not permitted.			2.00
Unlimited.			0.00
Quality of external audit		0.50	
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00
Focus on financial audit and/or insufficient use of audit reports.			0.00

1. By construction, the index can take values between zero and four.

3.5. Data

Limited availability of data on CESEE countries restricts the research, and the major concern is that the data do not always contain enough information to enable solid conclusions to be drawn. Two main sources have been used: OECD budget reviews (www.oecd.org/gov/budget) and the OECD *International Budget Practices and Procedures Database* 2007/08 (www.oecd.org/gov/budget/database).

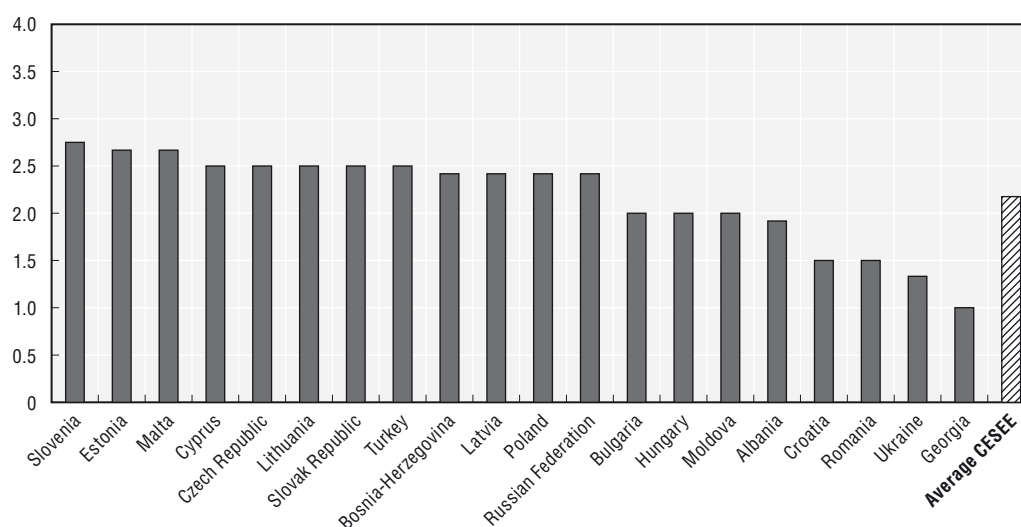
The objective of the budget reviews is to provide a comprehensive overview of the budget process in the country under examination, to evaluate national experiences in the light of international best practice and to provide specific policy recommendations, as well as to offer other countries an opportunity to comment on specific budgeting issues in the country under examination (“peer review”).¹¹ The reviews look at the budget institutions or the rules of the budget process and the way they function. Therefore, the budget reviews provided the required facts and analyses of institutional features in CESEE countries.

The *International Budget Practices and Procedures Database* is a database maintained by the OECD.¹² Therefore, the Budgetary Discipline Index calculated here is a snapshot of the situation between 2007 and 2008. The index does not reflect emerging trends or reforms since 2008, or the general economic slowdown. For instance, all the progress achieved in such countries as Hungary (introduction of advanced fiscal rules and a fiscal council) is not reflected in this article.

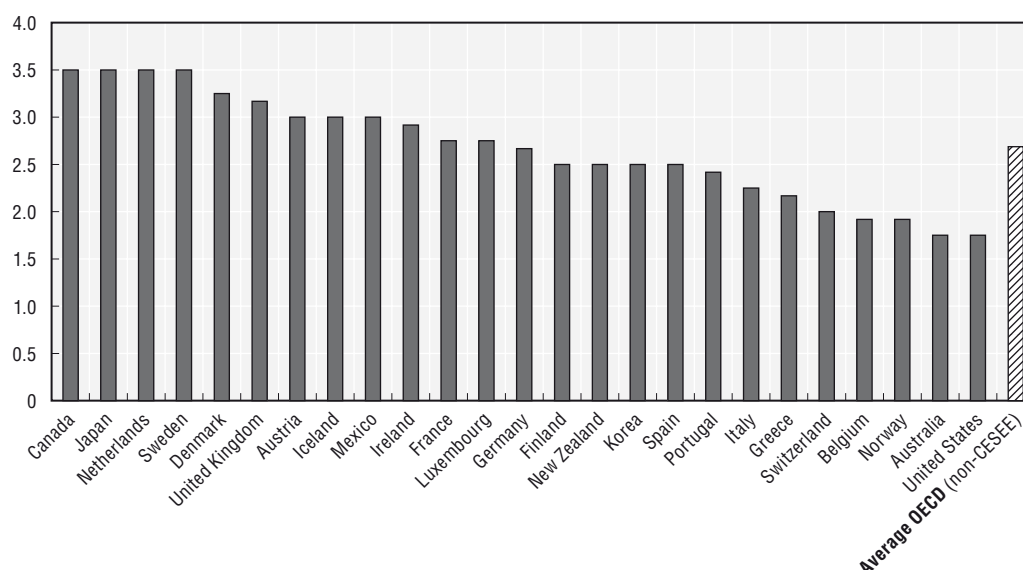
3.6. Results

On the basis of the premises and parameters discussed in the previous sub-section, a quantitative Budgetary Discipline Index was constructed for 20 CESEE countries for which data were available: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Malta, Moldova, Poland, Romania, the Russian Federation, the Slovak Republic, Slovenia, Turkey and Ukraine. For comparative reasons, the same indices were created for OECD countries. Figures 7 and 8 show the overall index for CESEE and OECD countries¹³ (the OECD countries do not include the ones which are also CESEE countries: Czech Republic, Hungary, Poland, Slovak Republic and Turkey). Tables 2 and 3 detail the calculations.

Figure 7. **Budgetary Discipline Index for CESEE countries (2007/08)**



Source: Authors' calculations based on OECD budget reviews and the OECD *International Budget Practices and Procedures Database*.

Figure 8. **Budgetary Discipline Index for non-CESEE OECD countries (2007/08)**

Source: Authors' calculations based on OECD budget reviews and the OECD *International Budget Practices and Procedures Database*.

Among CESEE countries, there is a relatively large disparity in terms of scores. Globally, EU member countries have higher scores than non EU members, with the notable exception of Romania scoring relatively low. Slovenia, Estonia and Malta had the strongest budgetary institutions at the time. Overall, countries which adopted fiscal rules score the highest in the ranking.

By comparing the indices of CESEE countries (Figure 7) with the indices of OECD countries (Figure 8), the OECD indices appear to be generally higher, and the average index among OECD countries (2.7) is significantly higher than the average index in CESEE countries (2.2). However, there is a relatively large heterogeneity among OECD countries as well, and some OECD countries – namely the United States, Australia, Norway, Belgium and Switzerland – show relatively low rates.

The low scores in some OECD countries might be due to the fact that this article looks at the legal framework of a country (at the central level) and coalition agreements to examine the presence and the nature of fiscal rules and expenditure frameworks. The fact that some countries (for example, Australia, Norway or the United States) have long-standing customs which are not necessarily reflected in the legislation is not taken into consideration. Therefore, even if these countries have no legal provisions regarding fiscal control measures, they may have other strong tools to promote aggregated budgetary control.

Table 2. **Budgetary Discipline Index for CESEE countries**

	Index	Sub-index	Numerical coding	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Cyprus	Czech Republic	Estonia
Budget preparation	0.50									
Fiscal rules		0.50								
Expenditure rule			4.00			1		1	1	
Budget balance rule			2.67	1	1					1
Debt rule			1.33							
None			0.00				1			
Score				2.67	2.67	4.00	0.00	4.00	4.00	2.67
Medium-term expenditure framework		0.25								
Multi-annual ceilings are decided at the start of the budget preparation.			4.00		1	1	1	1	1	1
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00	1						
Score				0.00	4.00	4.00	4.00	4.00	4.00	4.00
Multi-annual line-item expenditure estimates		0.25								
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00						1	
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00			1	1	1		1
There are no multi-annual estimates based on current policy.			0.00	1	1					
Score				0.00	0.00	2.00	2.00	2.00	4.00	2.00
Score for budget preparation				1.34	2.34	3.50	1.50	3.50	4.00	2.84
Budget authorisation	0.25									
Constraints on parliament to amend the budget bill		0.50								
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00	1	1		1	1	1	1
No constraints.			0.00			1				
Score				4.00	4.00	0.00	4.00	4.00	4.00	4.00
Fiscal council		0.50								
There is a fiscal council to assess fiscal policies independently.			4.00							
No fiscal council.			0.00	1	1	1	1	1	1	1
Score				0.00	0.00	0.00	0.00	0.00	0.00	0.00
Score for budget authorisation				2.00	2.00	0.00	2.00	2.00	2.00	2.00
Budget implementation	0.25									
Carryover of unused funds to the next fiscal year		0.50								
Allowed within certain limits with authorisation of the finance ministry.			4.00							
Not permitted.			2.00	1	1	1	1	1		1
Unlimited.			0.00						1	
Score				2.00	2.00	2.00	2.00	2.00	0.00	2.00
Quality of external audit		0.50								
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00	1	1					1
Focus on financial audit and/or insufficient use of audit reports.			0.00			1	1	1	1	
Score				4.00	4.00	0.00	0.00	0.00	0.00	4.00
Score for budget implementation				3.00	3.00	1.00	1.00	1.00	0.00	3.00
Overall index				1.92	2.42	2.00	1.50	2.50	2.50	2.67

Table 2. **Budgetary Discipline Index for CESEE Countries** (cont.)

	Index	Sub-index	Numerical coding	Georgia	Hungary	Latvia	Lithuania	Malta	Moldova	Poland
Budget preparation	0.50									
Fiscal rules		0.50								
Expenditure rule			4.00				1			
Budget balance rule			2.67			1		1		1
Debt rule			1.33							
None			0.00	1	1				1	
Score				0.00	0.00	2.67	4.00	2.67	0.00	2.67
Medium-term expenditure framework		0.25								
Multi-annual ceilings are decided at the start of the budget preparation.			4.00	1	1		1	1	1	
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00			1				1
Score				4.00	4.00	0.00	4.00	4.00	4.00	0.00
Multi-annual line-item expenditure estimates		0.25								
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00		1			1		1
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00	1		1	1		1	
There are no multi-annual estimates based on current policy.			0.00							
Score				2.00	4.00	2.00	2.00	4.00	2.00	4.00
Score for budget preparation				1.50	2.00	1.84	3.50	3.34	1.50	2.34
Budget authorisation	0.25									
Constraints on parliament to amend the budget bill		0.50								
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00			1	1		1	1
No constraints.			0.00	1	1			1		
Score				0.00	0.00	4.00	4.00	0.00	4.00	4.00
Fiscal council		0.50								
There is a fiscal council to assess fiscal policies independently.			4.00							
No fiscal council.			0.00	1	1	1	1	1	1	1
Score				0.00	0.00	0.00	0.00	0.00	0.00	0.00
Score for budget authorisation				0.00	0.00	2.00	2.00	0.00	2.00	2.00
Budget implementation	0.25									
Carryover of unused funds to the next fiscal year		0.50								
Allowed within certain limits with authorisation of the finance ministry.			4.00		1	1		1		
Not permitted.			2.00	1			1		1	1
Unlimited.			0.00							
Score				2.00	4.00	4.00	2.00	4.00	2.00	2.00
Quality of external audit		0.50								
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00		1	1		1	1	1
Focus on financial audit and/or insufficient use of audit reports.			0.00	1						
Score				0.00	4.00	4.00	0.00	4.00	4.00	4.00
Score for budget implementation				1	4.00	4.00	1.00	4.00	3.00	3.00
Overall index				1.00	2.00	2.42	2.50	2.67	2.00	2.42

Table 2. **Budgetary Discipline Index for CESEE Countries** (cont.)

	Index	Sub-index	Numerical coding	Romania	Russian Federation	Slovak Republic	Slovenia	Turkey	Ukraine	Average CESEE
Budget preparation	0.50									
Fiscal rules		0.50								
Expenditure rule			4.00			1	1			
Budget balance rule			2.67		1					
Debt rule			1.33						1	
None			0.00	1				1		
Score				0.00	2.67	4.00	4.00	0.00	1.33	2.20
Medium-term expenditure framework		0.25								
Multi-annual ceilings are decided at the start of the budget preparation.			4.00	1		1	1	1		
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00		1				1	
Score				4.00	0.00	4.00	4.00	4.00	0.00	3.00
Multi-annual line-item expenditure estimates		0.25								
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00			1		1		
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00	1	1		1			
There are no multi-annual estimates based on current policy.			0.00						1	
Score				2.00	2.00	4.00	2.00	4.00	0.00	2.30
Score for budget preparation				1.50	1.84	4.00	3.50	2.00	0.67	2.43
Budget authorisation	0.25									
Constraints on parliament to amend the budget bill		0.50								
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00	1	1		1	1	1	
No constraints.			0.00			1				
Score				4.00	4.00	0.00	4.00	4.00	4.00	3.00
Fiscal council		0.50								
There is a fiscal council to assess fiscal policies independently.			4.00							
No fiscal council.			0.00	1	1	1	1	1	1	
Score				0.00	0.00	0.00	0.00	0.00	0.00	0.00
Score for budget authorisation				2.00	2.00	0.00	2.00	2.00	2.00	1.50
Budget implementation	0.25									
Carryover of unused funds to the next fiscal year		0.50								
Allowed within certain limits with authorisation of the finance ministry.			4.00		1		1	1		
Not permitted.			2.00	1						
Unlimited.			0.00			1			1	
Score				2.00	4.00	0.00	4.00	4.00	0.00	2.30
Quality of external audit		0.50								
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00		1	1		1	1	
Focus on financial audit and/or insufficient use of audit reports.			0.00	1			1			
Score				0.00	4.00	4.00	0.00	4.00	4.00	2.40
Score for budget implementation				1.00	4.00	2.00	2.00	4.00	2.00	2.35
Overall index				1.50	2.42	2.50	2.75	2.50	1.33	2.18

Source: Authors' calculations based on OECD budget reviews and the OECD *International Budget Practices and Procedures Database*.

Table 3. **Budgetary Discipline Index for non-CESEE OECD countries**

	Index	Sub-index	Numerical coding	Australia	Austria	Belgium	Canada	Denmark	Finland	France	Germany	Greece
Budget preparation	0.50											
Fiscal rules		0.50										
Expenditure rule			4.00		1		1	1	1	1		
Budget balance rule			2.67			1					1	1
Debt rule			1.33									
None			0.00	1								
Score				0.00	4.00	2.67	4.00	4.00	4.00	4.00	2.67	2.67
Medium-term expenditure framework		0.25										
Multi-annual ceilings are decided at the start of the budget preparation.			4.00		1			1	1	1	1	
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00	1		1	1					1
Score				0.00	4.00	0.00	0.00	4.00	4.00	4.00	4.00	0.00
Multi-annual line-item expenditure estimates		0.25										
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00	1	1	1	1	1			1	
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00						1	1		1
There are no multi-annual estimates based on current policy.			0.00									
Score				4.00	4.00	4.00	4.00	4.00	2.00	2.00	4.00	2.00
Score for budget preparation				1.00	4.00	2.34	3.00	4.00	3.50	3.50	3.34	1.84
Budget authorisation	0.25											
Constraints on parliament to amend the budget bill		0.50										
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00	1			1			1		1
No constraints.			0.00		1	1		1	1		1	
Score				4.00	0.00	0.00	4.00	0.00	0.00	4.00	0.00	4.00
Fiscal council		0.50										
There is a fiscal council to assess fiscal policies independently.			4.00			1	1	1				
No fiscal council.			0.00	1	1				1	1	1	1
Score				0.00	0.00	4.00	4.00	4.00	0.00	0.00	0.00	0.00
Score for budget authorisation				2.00	0.00	2.00	4.00	2.00	0.00	2.00	0.00	2.00
Budget implementation	0.25											
Carryover of unused funds to the next fiscal year		0.50										
Allowed within certain limits with authorisation of the finance ministry.			4.00		1		1				1	
Not permitted.			2.00	1		1		1	1			1
Unlimited.			0.00							1		
Score				2.00	4.00	2.00	4.00	2.00	2.00	0.00	4.00	2.00
Quality of external audit		0.50										
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00	1	1		1	1	1	1	1	1
Focus on financial audit and/or insufficient use of audit reports.			0.00			1						
Score				4.00	4.00	0.00	4.00	4.00	4.00	4.00	4.00	4.00
Score for budget implementation				3.00	4.00	1.00	4.00	3.00	3.00	2.00	4.00	3.00
Overall index				1.75	3.00	1.92	3.50	3.25	2.50	2.75	2.67	2.17

Table 3. **Budgetary Discipline Index for non-CESEE OECD countries (cont.)**

	Index	Sub-index	Numerical coding	Iceland	Ireland	Italy	Japan	Korea	Luxembourg	Mexico	Netherlands	New Zealand
Budget preparation	0.50											
Fiscal rules		0.50										
Expenditure rule			4.00	1		1	1		1	1	1	
Budget balance rule			2.67		1							
Debt rule			1.33									
None			0.00					1				1
Score				4.00	2.67	4.00	4.00	0.00	4.00	4.00	4.00	0.00
Medium-term expenditure framework		0.25										
Multi-annual ceilings are decided at the start of the budget preparation.			4.00	1	1		1	1	1	1	1	1
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00			1						
Score				4.00	4.00	0.00	4.00	4.00	4.00	4.00	4.00	4.00
Multi-annual line-item expenditure estimates		0.25										
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00	1		1	1		1		1	1
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00		1			1		1		
There are no multi-annual estimates based on current policy.			0.00									
Score				4.00	2.00	4.00	4.00	2.00	4.00	2.00	4.00	4.00
Score for budget preparation				4.00	2.84	3.00	4.00	1.50	4.00	3.50	4.00	2.00
Budget authorisation	0.25											
Constraints on parliament to amend the budget bill		0.50										
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00		1		1	1		1	1	1
No constraints.			0.00	1		1			1			
Score				0.00	4.00	0.00	4.00	4.00	0.00	4.00	4.00	4.00
Fiscal council		0.50										
There is a fiscal council to assess fiscal policies independently.			4.00					1		1		
No fiscal council.			0.00	1	1	1	1		1			1
Score				0.00	0.00	0.00	0.00	4.00	0.00	4.00	4.00	0.00
Score for budget authorisation				0.00	2.00	0.00	2.00	4.00	0.00	4.00	4.00	2.00
Budget implementation	0.25											
Carryover of unused funds to the next fiscal year		0.50										
Allowed within certain limits with authorisation of the finance ministry.			4.00	1	1		1					1
Not permitted.			2.00			1		1	1	1		
Unlimited.			0.00								1	
Score				4.00	4.00	2.00	4.00	2.00	2.00	2.00	0.00	4.00
Quality of external audit		0.50										
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00	1	1	1	1	1	1		1	1
Focus on financial audit and/or insufficient use of audit reports.			0.00							1		
Score				4.00	4.00	4.00	4.00	4.00	4.00	0.00	4.00	4.00
Score for budget implementation				4.00	4.00	3.00	4.00	3.00	3.00	1.00	2.00	4.00
Overall index				3.00	2.92	2.25	3.50	2.50	2.75	3.00	3.50	2.50

Table 3. **Budgetary Discipline Index for non-CESEE OECD countries (cont.)**

	Index	Sub-index	Numerical coding	Norway	Portugal	Spain	Sweden	Switzerland	United Kingdom	United States	Average non-CESEE
Budget preparation	0.50										
Fiscal rules		0.50									
Expenditure rule			4.00			1	1	1			
Budget balance rule			2.67	1	1				1		
Debt rule			1.33								
None			0.00							1	
Score				2.67	2.67	4.00	4.00	4.00	2.67	0.00	2.99
Medium-term expenditure framework		0.25									
Multi-annual ceilings are decided at the start of the budget preparation.			4.00				1	1	1		
No framework or ceilings may be substantially and frequently changed during the budget preparation.			0.00	1	1	1				1	
Score				0.00	0.00	0.00	4.00	4.00	4.00	0.00	2.56
Multi-annual line-item expenditure estimates		0.25									
Multi-annual estimates based on current policy are updated twice or several times per year.			4.00	1			1		1	1	
Multi-annual estimates based on current policy are available at the start of the budget preparation.			2.00		1	1		1			
There are no multi-annual estimates based on current policy.			0.00								
Score				4.00	2.00	2.00	4.00	2.00	4.00	4.00	3.28
Score for budget preparation				2.34	1.84	2.50	4.00	3.50	3.34	1.00	2.95
Budget authorisation	0.25										
Constraints on parliament to amend the budget bill		0.50									
Amendments leading to spending increases or decreases of tax revenue are required to be offset by savings or tax increases.			4.00			1			1		
No constraints.			0.00	1	1		1	1		1	
Score				0.00	0.00	4.00	0.00	0.00	4.00	0.00	1.92
Fiscal council		0.50									
There is a fiscal council to assess fiscal policies independently.			4.00		1		1			1	
No fiscal council.			0.00	1		1		1	1		
Score				0.00	4.00	0.00	4.00	0.00	0.00	4.00	1.44
Score for budget authorisation				0.00	2.00	2.00	2.00	0.00	2.00	2.00	1.68
Budget implementation	0.25										
Carryover of unused funds to the next fiscal year		0.50									
Allowed within certain limits with authorisation of the finance ministry.			4.00		1		1		1		
Not permitted.			2.00	1		1		1		1	
Unlimited.			0.00								
Score				2.00	4.00	2.00	4.00	2.00	4.00	2.00	2.64
Quality of external audit		0.50									
Financial and performance audits with detailed scrutiny completed by strong mechanisms for follow-up measures.			4.00	1	1	1	1		1	1	
Focus on financial audit and/or insufficient use of audit reports.			0.00					1			
Score				4.00	4.00	4.00	4.00	0.00	4.00	4.00	3.52
Score for budget implementation				3.00	4.00	3.00	4.00	1.00	4.00	3.00	3.08
Overall index				1.92	2.42	2.50	3.50	2.00	3.17	1.75	2.67

Source: Authors' calculations based on OECD budget reviews and the OECD *International Budget Practices and Procedures Database*.

4. Monetary institutions

Four measures of monetary institutions are used:

- exchange rate regime
- central bank independence
- central bank transparency
- financial regulation and supervision

The importance of these factors and their relation to monetary institutions are explained in the following sub-sections.

4.1. Exchange rate regime

The nature of the exchange rate regime is the dominant determinant of monetary institutions. Table 4 indicates a wide diversity of exchange rate regimes, both across countries and over time. It is interesting to observe that sometimes even countries with similar circumstances often opted for different regimes: for example, the Czech Republic (float) and the Slovak Republic (euro); Romania (float) and Bulgaria (currency boards); Serbia and Albania (float) and the other four western Balkan countries (various kinds of fixed exchange rates). This diversity suggests that it could be quite difficult to identify the reasons behind exchange rate regime choices apart from, for example, market-forced exit from pegs such as the move of the Czech Republic in 1997, the Russian Federation in 1998, Turkey in 2002, or Ukraine in late 2008.

Another interesting observation is the disappearance of intermediate regimes. While in the 1990s several countries adopted crawling or horizontal bands, these regimes have passed, and there are more countries with either (more or less) freely floating exchange rate regimes or currency pegs. This finding is in line with global trends. Yet it is also important to note that, while several countries moved from a peg to a float, only two countries so far have moved in the opposite direction (Bulgaria and the Slovak Republic). Finally, it is also interesting to observe that even neighbouring countries move away from United States dollar pegs.

Have exchange rate regimes played a role in macroeconomic developments? Table 5 presents rough evidence that they may have. Countries with fixed exchange rate regimes had higher macroeconomic volatility, larger current account deficits, higher inflation, faster credit growth, and a higher share of finance and real estate sectors in FDI inflows.

For economies that are catching up with developed countries, the adoption of fixed exchange rate regimes carries a risk (see, for example, Darvas and Szapáry, 2008). When the exchange rate is fixed, price level convergence – which accompanies economic catching-up – translates into higher inflation. (In floating exchange rate countries, nominal exchange rate appreciation can also accommodate price level convergence.) But when the exchange rate peg is credible, nominal interest rates decline, and borrowers are also more willing to take foreign currency loans because they do not observe the exchange rate risk. But higher inflation and low interest rates (either domestic currency interest rates, or foreign currency interest rates) fuel credit booms which can lead to real estate booms and overheating of the economy, which in turn raise inflation above its equilibrium value, leading to a vicious circle. All these factors can lead to a misallocation of capital and labour.

However, it also has to be emphasised that a floating exchange rate regime is not a panacea. For example, Hungary (a floating exchange rate country) was the first to turn to the IMF for help after the collapse of Lehman Brothers. Romania and Serbia, two other

Table 4. **Exchange rate arrangements in CESEE countries, 1996-2009**

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	
EU members	Bulgaria	Floating	Currency board, DEM		Currency board, EUR											
	Czech Republic	Band65%DEM, 35% USD +/- 7.5%	Floating													
	Cyprus	ECU/euro peg									ERM-II, narrow band			Euro		
	Estonia	Currency board to DEM						Currency board to EUR			ERM-II, Currency board					
	Hungary	Crawling band, +/-2.25%, 30%USD 70% ECU	70% DEM		70% EUR	Crawling band, EUR +/-2.25%	EUR band +/-15%						Floating			
	Latvia	Peg to SDR, +/- 1%									Peg €	ERM-II +/-1%				
	Lithuania	Currency board to USD						Currency board to EUR			ERM-II, Currency board					
	Malta	Peg to a basket of ECU/euro, USD, and GBP									ERM-II, narrow band			Euro		
	Poland	Crawling band 45% USD, 35% DEM, 10% GBP, 5% FRF, 5% CHF +/-7%				55% EUR, 45% USD +/-12.5	Floating									
	Romania	Floating														
	Slovak Republic	60% DEM, 40% USD +/-3% +/-5%	+/-7%		Floating							ERM-II +/-15%, de facto float with revaluations			Euro	
	Slovenia	Managed floating, de facto peg or crawling peg to DEM/euro									ERM-II narrow band			Euro		
	EU candidates	Albania	Floating (1992.07. -)													
Bosnia and Herzegovina		Currency board to DEM			Currency board to euro											
Croatia		Managed floating			Managed floating, de facto peg to EUR											
FYR Macedonia		De facto peg to the DEM/EUR														
Montenegro		Peg DEM						Euro adoption								
Serbia		Peg DEM						Managed floating								
Turkey		Crawling peg to a basket				Peg to a basket			Floating							
Neighbours	Azerbaijan	Peg to USD										Crawling peg			Euro-dollar basket	
	Armenia	Floating														
	Belarus	Peg to USD						Crawling band/managed against the RUB, later USD as well							Basket	
	Moldova	Peg to USD										Managed floating				
	Russian Federation	USD			Floating											
	Ukraine	Peg or de facto peg to USD													Floating	
		Peg/band to USD		Peg/band to a basket		Peg/band to DEM/euro		ERM-II		Euro		Float				

	Peg/band to USD		Peg/band to a basket		Peg/band to DEM/euro		ERM-II		Euro		Float
--	-----------------	--	----------------------	--	----------------------	--	--------	--	------	--	-------

Note: For basket pegs and bands, the composition of the basket is indicated. Whenever a band is adopted, its width is indicated (e.g. +/- 7%). CHF = Swiss franc; DEM = German deutschmark; ECU = European currency unit; ERM-II = (European) exchange rate mechanism II; EUR = euro; FRF = French franc; GBP = United Kingdom pound; RUB = new Russian ruble; SDR = special drawing rights (monetary unit of international reserve assets defined and maintained by the International Monetary Fund); USD = United States dollar.

Sources: For EU member states: updated from Szapáry, György (2009), "Regional Perspectives: Euro Area Neighboring Countries" in Jean Pisani-Ferry and Adam S. Posen (eds.), *The Euro at Ten: The Next Global Currency?*, Peterson Institute for International Economics and Bruegel, Washington DC, pp. 121-138. For other countries: IMF and central bank reports.

floating rate countries, also had to rely on an IMF financing programme. Therefore, while the evidence in Table 5 is telling, other factors should be at work in addition to the exchange rate regime.

Table 5. Exchange rate regimes and main macroeconomic developments

	GDP volatility	Current account balance/ GDP (%), 2008	Inflation, 2008	Credit/GDP: % change from 2004 to 2008	Foreign direct investment to finance and real estate sectors (% of total FDI), 2007
Floating	3.7	-7.8	7.8	20	26
Fixed	4.7	-12.3	11.1	36	40

Source: Authors' calculations using data from the IMF (first four indicators) and the Vienna Institute for International Economic Studies, WIIW (sectoral composition of FDI).

4.2. Central bank independence

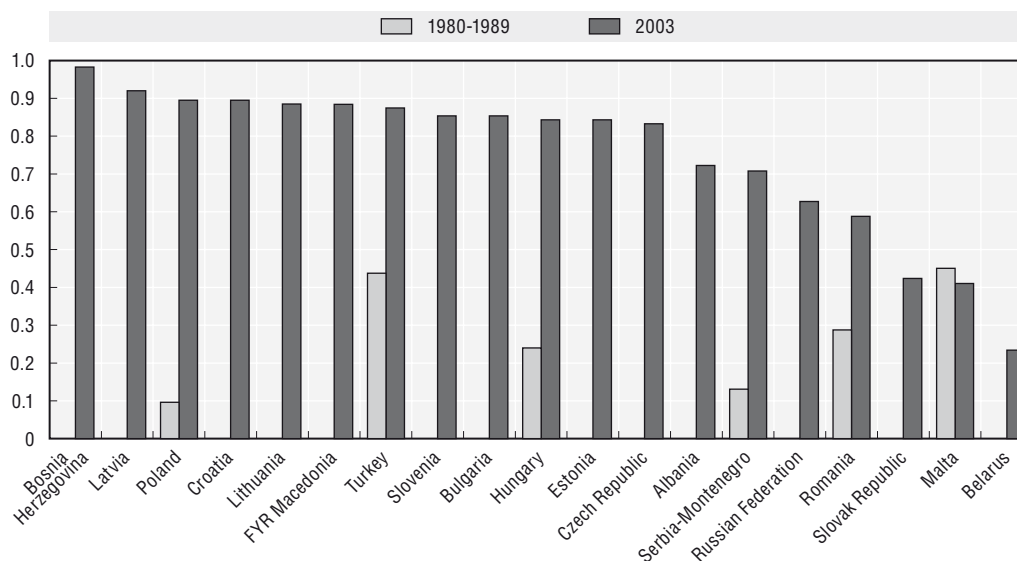
Central bank independence is an important metric of monetary institutions. In a seminal work, Kydland and Prescott (1977) developed a model of the so-called time inconsistency problem. Central bankers not isolated from political pressures would have ended up running inflationary policies without being able to boost the economy, which probably characterised a couple of central banks in the 1970s when inflation was high and growth was low in advanced countries. Solutions to the problem of time inconsistency were offered by Rogoff (1985) and Walsh (1995): either hiring a central banker who is strongly opposed to inflation or giving the central banker incentives to keep inflation as low as possible. Since then, a consensus has developed that the central bank's management has to be isolated from the government.

The literature has developed ways to measure central bank independence. This article uses the index developed by Cukierman, Webb, and Neyapti (1992) which has been updated by Crowe and Meade (2007). Unfortunately, the most recent year for which this index is available is 2003. Figures 9 and 10 below show the 2003 value in comparison to the average of 1980-99 whenever available. CESEE countries rank reasonably well along this metric, and most of them have even more independent central banks than non-CESEE OECD countries.

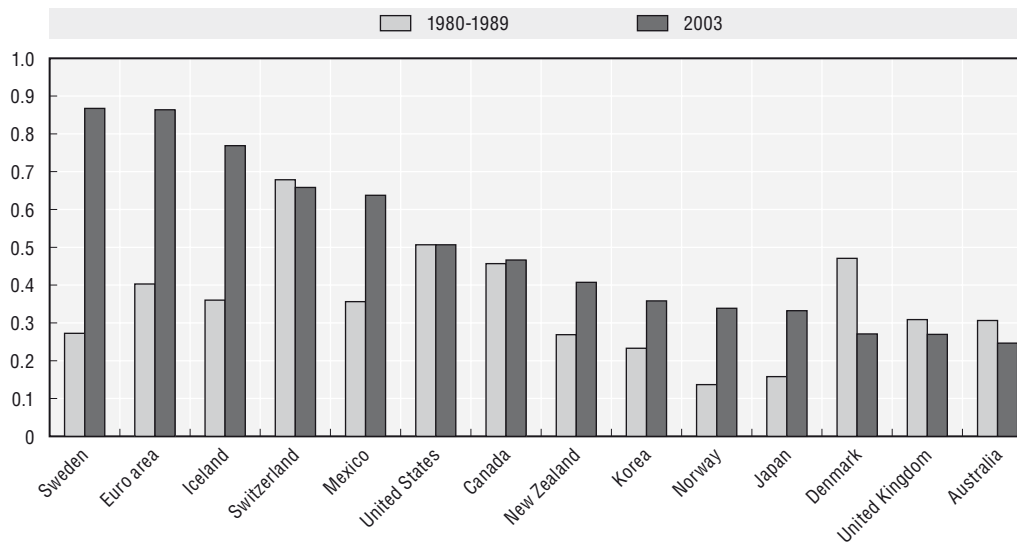
4.3. Central bank transparency

In addition to central bank independence, central bank transparency also plays an important role in improving monetary policy making. A major change in conduct of monetary policy over the last twenty years has been improvements in transparency (Dincer and Eichengreen, 2007, 2009; Geraats, 2006, 2008, 2009). Transparency of monetary policy refers to the absence of information asymmetries between monetary policy makers and the private sector. A higher degree in transparency should allow economic agents to interpret central bank policies and hence to better align their decisions with those of the central bank and forecast more accurately the time path of relevant variables. Dincer and Eichengreen (2007) have shown that a higher degree of transparency seems to be positively correlated with the higher level of stability of a country and with a more advanced stage of development of financial markets.

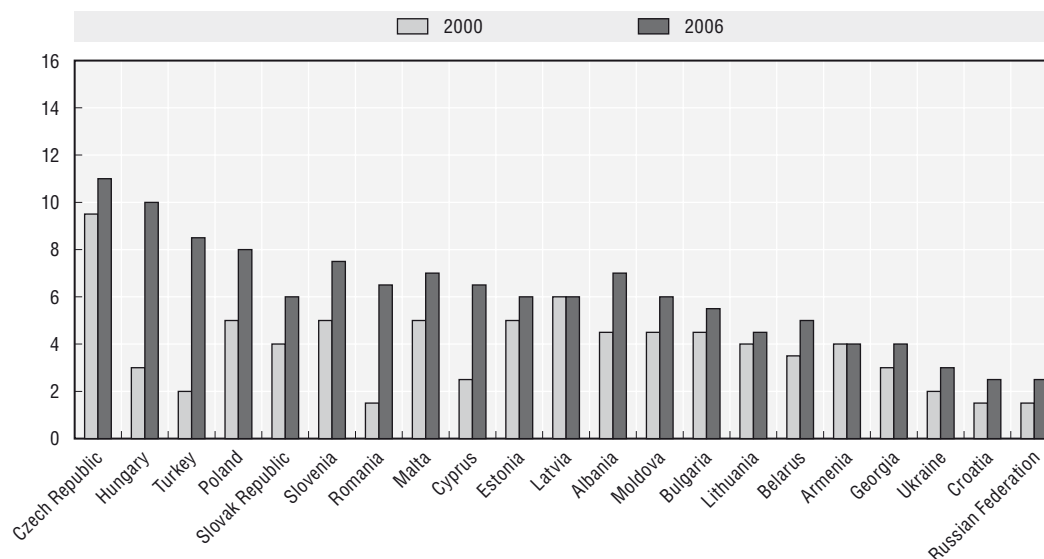
This study uses the index developed by Dincer and Eichengreen (2007). Figure 11 shows the transparency index for 2000 and 2006. Improvements can be observed in some CESEE countries, but several of these countries still have a large gap compared to OECD countries (Figure 12).

Figure 9. **Central bank independence in CESEE countries**

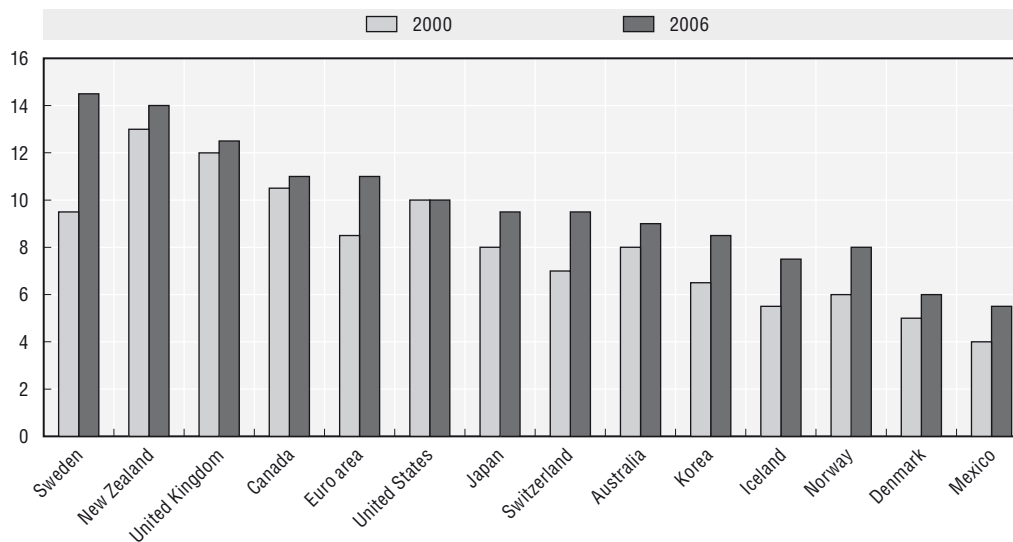
Source: Crowe, Christopher and Ellen E. Meade (2007), "Evolution of Central Bank Governance around the World", *Journal of Economic Perspectives* 21(4):69-90.

Figure 10. **Central bank independence in non-CESEE OECD countries**

Source: Crowe, Christopher and Ellen E. Meade (2007), "Evolution of Central Bank Governance around the World", *Journal of Economic Perspectives* 21(4):69-90.

Figure 11. **Central bank transparency in CESEE countries**

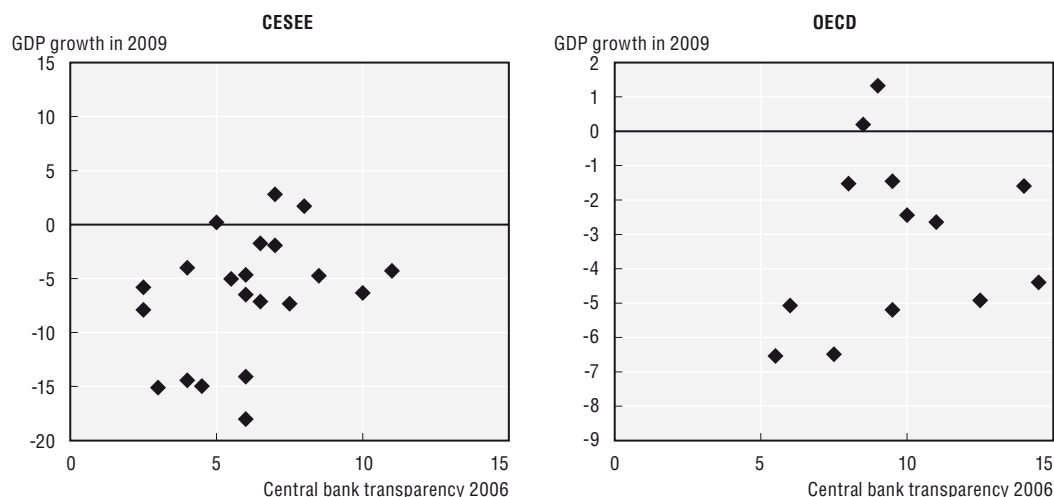
Source: Dincer, Nergiz and Barry Eichengreen (2007), "Central Bank Transparency: Where, Why and With What Effects?", NBER Working Paper No. 13003, National Bureau of Economic Research, Cambridge, Massachusetts, United States.

Figure 12. **Central bank transparency in non-CESEE OECD countries**

Source: Dincer, Nergiz and Barry Eichengreen (2007), "Central Bank Transparency: Where, Why and With What Effects?", NBER Working Paper No. 13003, National Bureau of Economic Research, Cambridge, Massachusetts, United States.

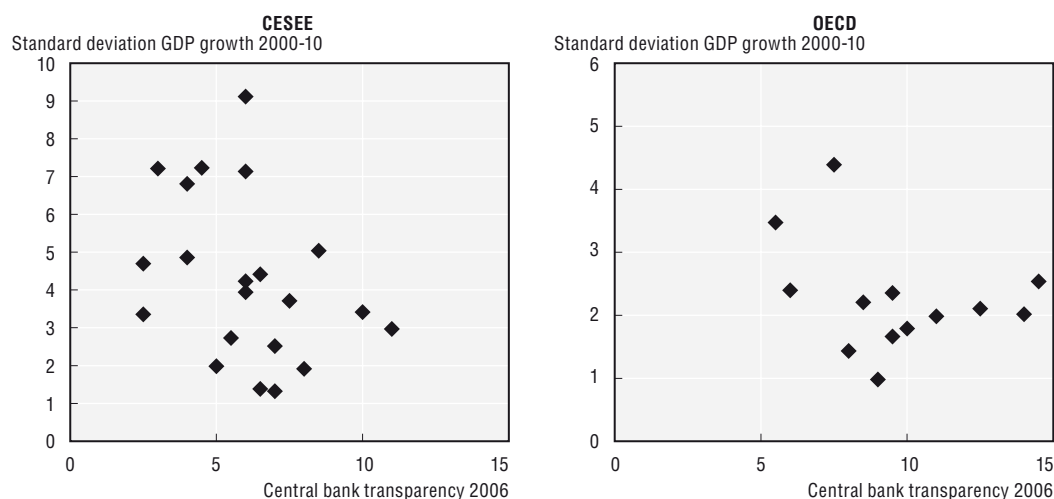
Figures 13 and 14 reveal that central bank transparency correlates well with both the 2009 GDP developments and the GDP volatility during 2000-10.

Figure 13. Central bank transparency versus GDP growth in 2009



Source: Authors' calculations based on data from Dincer, Nergiz and Barry Eichengreen (2007), "Central Bank Transparency: Where, Why and With What Effects?", NBER Working Paper No. 13003, National Bureau of Economic Research, Cambridge, Massachusetts, United States, and the IMF World Economic Outlook April 2010.

Figure 14. Central bank transparency versus GDP volatility



Source: Authors' calculations based on data from Dincer, Nergiz and Barry Eichengreen (2007), "Central Bank Transparency: Where, Why and With What Effects?", NBER Working Paper No. 13003, National Bureau of Economic Research, Cambridge, Massachusetts, United States, and the IMF World Economic Outlook April 2010.

4.4. Financial regulation and supervision

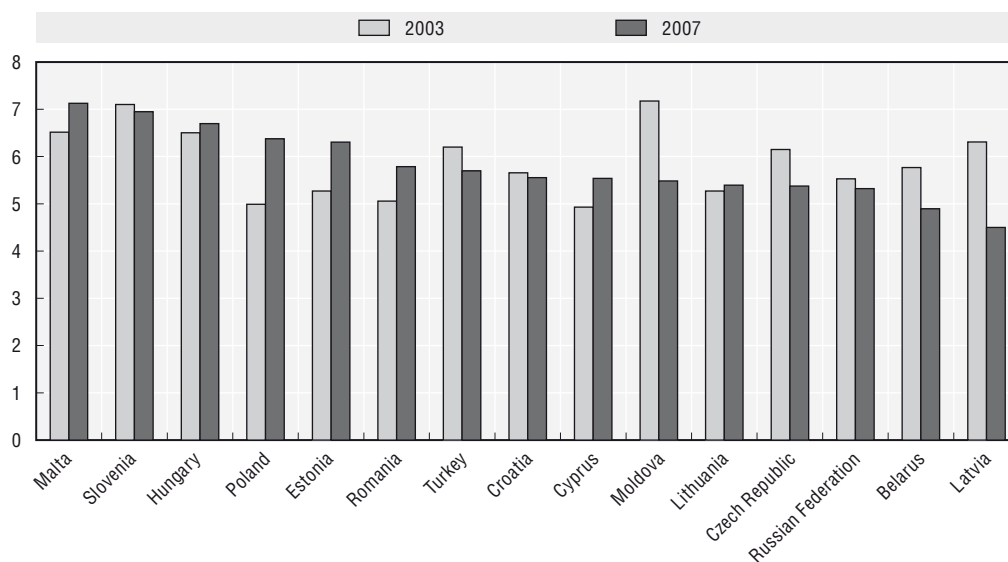
Financial regulation and supervision are crucial elements of the macroeconomic policy mix, and essential complements to monetary policy. The crisis has indicated that the combination of lax monetary policy with lax financial regulation and supervision may lead to financial excesses and unsustainable booms.

Unfortunately, it is extremely difficult to measure the "quality" of financial regulation because it has so many dimensions (see, for example, Hilbers *et al.*, 2005). Also, in an

integrated market, domestic financial regulation may not be very effective after all. On average, 70% of the domestic banking systems in CESEE countries are owned by mostly western European banking groups (Berglöf et al., 2009) and, under free capital mobility, domestic regulations could be circumvented.

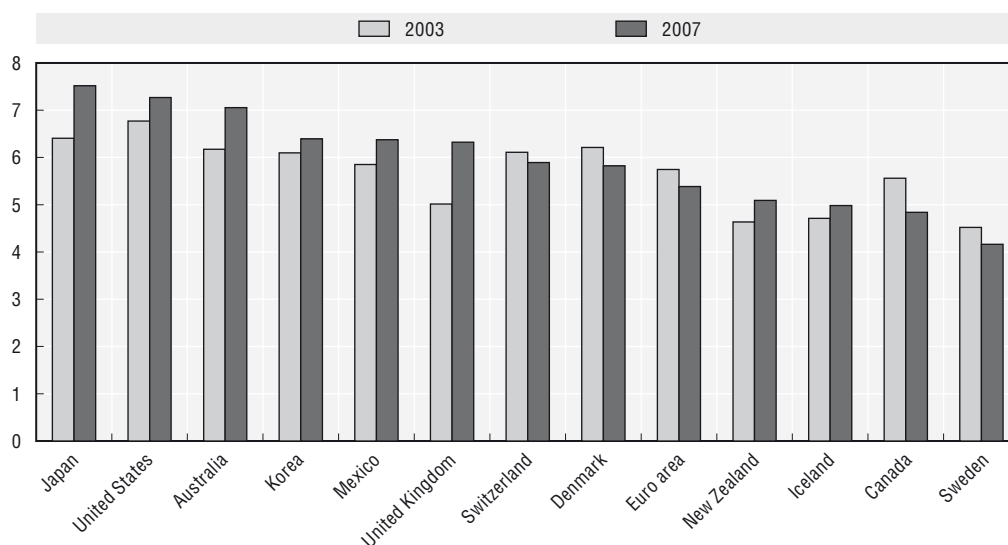
A set of indicators to measure regulation and supervision has been developed by Barth, Caprio and Levine (2008). Figures 15 and 16 report their results. On average, CESEE countries do not lag behind OECD countries, though there is heterogeneity within the region; and while some countries improved from 2003 to 2007, others fell behind.

Figure 15. **Quality of financial regulation and supervision in CESEE countries**



Source: Barth, James R., Gerard Caprio Jr. and Ross Levine (2008), "Bank Regulations are Changing: For Better or Worse?", *Comparative Economic Studies* 50:537-563.

Figure 16. **Quality of financial regulation and supervision in non-CESEE OECD countries**

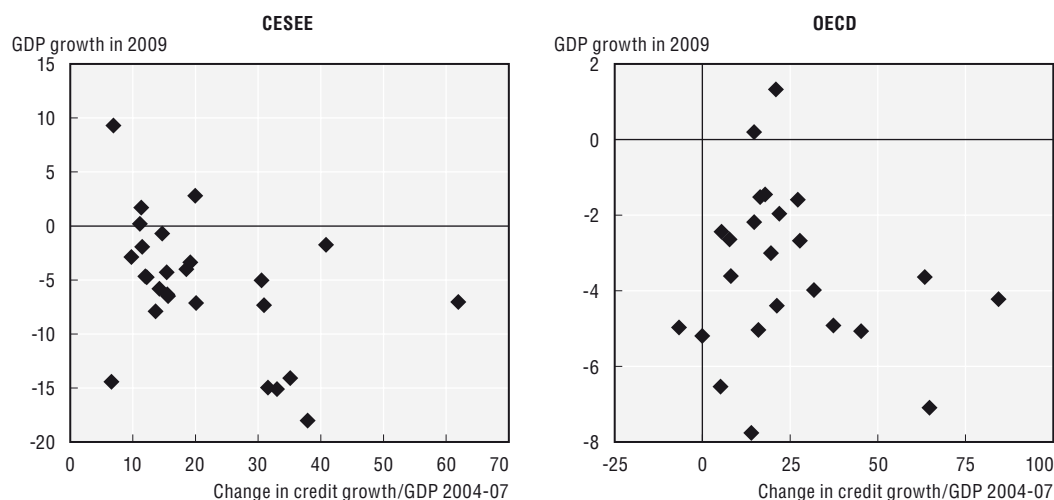


Source: Barth, James R., Gerard Caprio Jr. and Ross Levine (2008), "Bank Regulations are Changing: For Better or Worse?", *Comparative Economic Studies* 50:537-563.

However, the assessment of financial regulation and supervision is complicated by the fact that the lack of strict financial regulation has led to unsustainable credit booms in certain countries, but not in others. These differing outcomes could most likely be explained by the appropriateness of other elements of the macroeconomic policy mix. To put it another way, one cannot claim that the lack of strict regulation and supervision was a policy mistake. One can only claim that it was a likely policy mistake in countries in which credit growth reached extraordinarily high levels. Not surprisingly, the pre-crisis speed of credit growth correlates strongly with pre-crisis current account imbalances and also with output falls in 2009 in CESEE countries, as Figure 17 indicates. The correlation in non-CESEE OECD countries is weaker, but this is not surprising since there were just a few non-CESEE OECD countries that followed a growth model similar to that of CESEE countries, like the Mediterranean euro area members. The correlation of pre-crisis credit growth and GDP volatility reveals a similar relationship (Figure 18).

For the reasons previously discussed, this article uses both the index derived by Barth, Caprio and Levine (2008) and the actual speed of credit growth from 2003 to 2007 as a proxy of proper regulation and supervision.

Figure 17. **Credit growth in 2004-07 versus GDP growth in 2009**

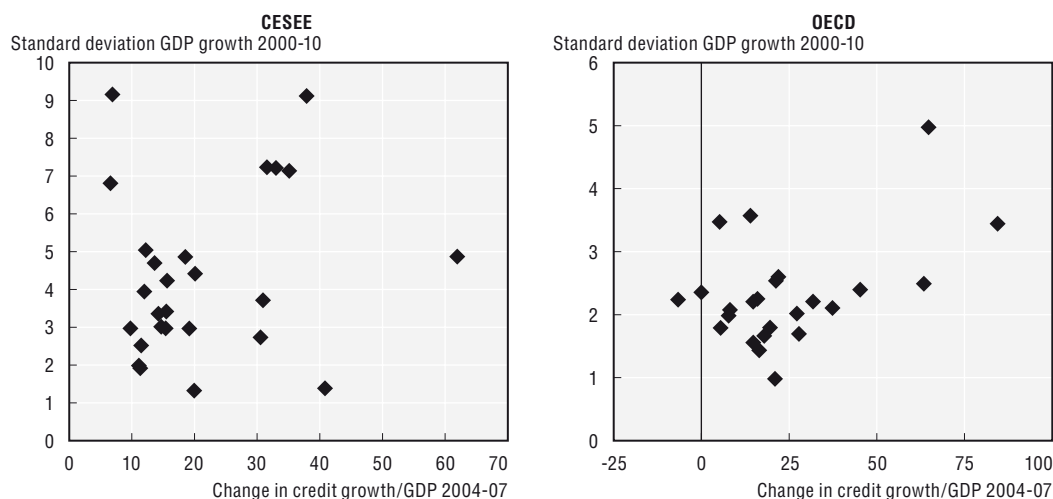


Source: Authors' calculations based on data from the IMF World Economic Outlook April 2010 and International Financial Statistics (www.imfststatistics.org).

5. Econometric analysis

Having established certain measures of fiscal and monetary institutions in the previous sections, this section presents formal econometric models for studying the impact of these institutions on macroeconomic stability and budgetary control.

Figure 18. Credit growth in 2004-07 versus GDP volatility



Source: Authors' calculations based on data from the IMF World Economic Outlook April 2010 and International Financial Statistics (www.imfstatistics.org).

5.1. Macroeconomic stability

As indicated in Section 2.2, two measures of macroeconomic stability are used for the econometric analysis: volatility of GDP growth rates (for two periods: 2000-07 and 2000-10) and output decline in 2009. The regression framework adopted is the following:

- (1) $\log(\sigma_i^y) = \alpha + \beta \text{mon.inst.}_i + \gamma \text{fisc.inst.}_i + \delta' \text{controls}_i + v_i$
- (2) $\Delta y_{2009} = \alpha + \beta \text{mon.inst.}_i + \gamma \text{fisc.inst.}_i + \delta' \text{controls}_i + v_i$

where $\log(\sigma_i^y)$ denotes the logarithm of GDP volatility (a logarithmic transformation is adopted in order to ensure that the fitted volatility will be positive), denotes the real change in GDP in 2009, denotes a measure of monetary institutions, denotes a measure of fiscal institutions, denotes a set of control variables, and denotes the error term. Cross-section regressions are run, and therefore there is no time dimension in the regression.

For fiscal institutions, the Budgetary Discipline Index is used. For monetary institutions, the four indicators discussed in Section 4 are used: exchange rate regime; central bank independence;¹⁴ central bank transparency; and financial regulation and supervision, as well as credit growth (which is used as a proxy for financial regulation and supervision). In addition, various controls have been used that can impact macroeconomic volatility: volatility of terms of trade, trade openness, GDP per capita, government expenditures/GDP, debt/GDP, pre-crisis speed of credit growth, and the overall institutional quality index of the World Economic Forum.¹⁵

Table 6 shows the Ordinary Least Squares (OLS) estimation results. The columns of the table correspond to different regressions. The rows of the table indicate the variables included in a particular regression. Two equations are presented for each indicator: one without controls and one controlling for GDP per capita (since poorer countries used to show more output volatility) and trade openness (since more open countries used to be more volatile). Other possible control variables did not prove to be significant.

Table 6. **Ordinary Least Squares (OLS) regressions for GDP volatility**A. Dependent variable¹ is GDP volatility in 2000-07

Expected sign		A	B	C	D	E	F	G	H	I	J	K	L	M
–	BDI	–0.13	0.00											
	<i>t</i> -ratio	–1.1	0.0											
?	FIXED			0.05	–0.16									
	<i>t</i> -ratio			0.4	–1.2									
–	CBI					0.10	–0.23							
	<i>t</i> -ratio					0.3	–0.8							
–	CBT							–0.048	0.003					0.007
	<i>t</i> -ratio							–1.9	0.1					0.2
–	R&S									–0.050	–0.058			
	<i>t</i> -ratio									–0.6	–0.9			
+	CREDIT											0.0003	0.0010	0.0018
	<i>t</i> -ratio											0.2	0.5	1.3
–	GDP per capita		–0.006		–0.009		–0.007		–0.009		–0.006		–0.009	–0.009
	<i>t</i> -ratio		–3.6		–4.3		–4.0		–2.8		–2.8		–4.4	–3.1
+	Trade open		0.004		0.005		0.004		0.000		0.003		0.004	0.000
	<i>t</i> -ratio		2.7		3.2		2.8		0.2		2.4		2.7	0.1
	R ² bar	0.03	0.26	0.00	0.33	0.00	0.27	0.11	0.35	0.01	0.22	0.00	0.32	0.38
	Nobs	45	44	51	49	44	43	34	33	39	38	51	49	33

B. Dependent variable¹ is GDP volatility in 2000-10

Expected sign		A	B	C	D	E	F	G	H	I	J	K	L	M
–	BDI	–0.11	0.06											
	<i>t</i> -ratio	–1.1	0.8											
?	FIXED			0.19	0.05									
	<i>t</i> -ratio			1.5	0.4									
–	CBI					0.61	0.30							
	<i>t</i> -ratio					2.3	1.4							
–	CBT							–0.087	–0.035					–0.029
	<i>t</i> -ratio							–4.2	–1.8					–1.5
–	R&S									–0.124	–0.105			
	<i>t</i> -ratio									–1.4	–1.4			
+	CREDIT											0.0019	0.0029	0.0026
	<i>t</i> -ratio											1.9	4.3	4.4
–	GDP per capita		–0.009		–0.009		–0.006		–0.009		–0.008		–0.010	–0.010
	<i>t</i> -ratio		–4.6		–5.0		–3.8		–3.0		–3.9		–5.7	–3.7
+	Trade open		0.004		0.004		0.003		0.002		0.004		0.003	0.001
	<i>t</i> -ratio		3.7		3.3		3.5		0.9		3.0		3.2	0.7
	R ² bar	0.02	0.37	0.04	0.38	0.08	0.33	0.28	0.48	0.05	0.38	0.02	0.43	0.53
	Nobs	45	45	51	50	44	44	34	34	39	39	51	50	34

C. Dependent variable¹ is GDP growth in 2009

Expected sign		A	B	C	D	E	F	G	H	I	J	K	L	M
+	BDI	0.02	–0.96											
	<i>t</i> -ratio	0.0	–1.2											
?	FIXED			–1.13	–0.67									
	<i>t</i> -ratio			–0.9	–0.5									
+	CBI					–5.72	–4.98							
	<i>t</i> -ratio					–2.2	–1.9							
+	CBT							0.62	0.47					0.43
	<i>t</i> -ratio							2.7	2.2					2.1
+	R&S									0.867	0.771			
	<i>t</i> -ratio									1.0	0.9			
–	CREDIT											–0.019	–0.022	–0.017
	<i>t</i> -ratio											–1.9	–2.2	–2.0
+	GDP per capita		0.048		0.021		0.011		0.023		0.041		0.028	0.030
	<i>t</i> -ratio		2.5		1.0		0.6		0.8		1.8		1.3	1.1
–	Trade open		–0.024		–0.012		–0.010		–0.012		–0.019		–0.012	–0.011
	<i>t</i> -ratio		–2.6		–1.5		–1.0		–0.6		–1.6		–1.3	–0.5
	R ² bar	0.00	0.14	0.02	0.04	0.09	0.10	0.15	0.17	0.03	0.14	0.03	0.07	0.19
	Nobs	45	45	51	50	44	44	34	34	39	39	51	50	34

1. The dependent variable is the logarithm of the standard deviation of annual GDP growth rates between 2000 and 2010 (Panel A) and between 2000 and 2010 (Panel B); the 2009 real GDP growth rate is the dependent variable in Panel C.

BDI: Budgetary Discipline Index; FIXED: fixed exchange rate (all euro area members are classified as having a fixed exchange rate); CBI: Central bank independence; CBT: Central bank transparency; R&S: Financial regulation and supervision; CREDIT: change in credit/GDP from 2004 to 2008. Constant is also included in the regression; heteroskedasticity robust standard errors are used; the *t*-ratios are shown below the parameter estimates. Parameter estimates that are statistically significant (at least at the 10% level) are in bold.

Source: Authors' calculations.

Considering volatility during the pre-crisis period, practically none of the indicators are significant.¹⁶ However, Section 2 above argued that considering the pre-crisis period only is misleading, because the seemingly smooth development of CESEE countries has in fact led to the build-up of various vulnerabilities. It is much more preferable to include the bust phase of the business cycle as well.

Indeed, Panels B and C do indicate that countries with better monetary institutions tended to have less GDP volatility. In particular, lower output volatility is associated with more transparent central banks and lower pre-crisis credit growth, and these results are robust to various controls (see columns H and L). Including both variables along with the controls (see column M) does not change the results much: both variables continue to be significant.

Central bank independence is significant only when other controls are not considered, though this variable is significant at the level of 11% when the 2009 growth is considered. The parameter estimate of financial regulation and supervision is correct, but this variable is not significant (columns I and J). Countries with fixed exchange rates tend to have more volatile business cycles, but the parameter estimate is not significant (columns C and D).

Central bank transparency explains about one-third of the variation in the dependent variable and, when combined with GDP per capita and trade openness, explain more than one-half of the cross-sectional variation of GDP volatility in 2000-10.

Finally, the Budgetary Discipline Index (see columns A and B) does not have a significant parameter estimate, and in some cases even the point estimate of the parameter has an incorrect sign. There might be two reasons why the premise that better fiscal institutions can dampen macroeconomic volatility did not prove true. First, not all parameters used in the construction of the Budgetary Discipline Index are important for macroeconomic stabilisation. In fact, institutions that foster stabilisation (expenditure rules or a medium-term expenditure framework) were often overwhelmed by some other features used in the index design. Thus the index is not fully adapted to testing the influence on macroeconomic volatility.

Second, the design of the Budgetary Discipline Index is tailored to CESEE countries and takes into consideration specific circumstances of the region. A number of parameters which could also be important for fostering macroeconomic stabilisation (for instance, structural balance rule and not just headline balance rule, and the existence of compensation requirements in case of overspending) are not considered in the index construction because they do not exist or are not frequent in the region. This focus on specific regional circumstances may have impaired the confirmation of the hypothesis, but obviously also reflects real facts (namely the absence of institutions that may be particularly relevant for stabilisation, which lends plausibility to the research result).

5.2. Fiscal outcomes

This sub-section studies the impact of the Budgetary Discipline Index on fiscal outcomes: on government debt and balance developments. As argued in Section 2.3, the study regresses the change in the debt/GDP ratio and not the level of that ratio, because current fiscal institutions do not have an impact on the inherited stock of debt which largely determines the actual level of debt.¹⁷ Of course, the study controls for the initial level of debt (by including the debt level of 2000) because countries with higher debt/GDP ratios may make more efforts to reduce their debt. The study also controls for the interest

rate/GDP growth rate differential because, as argued in Section 2.3, this differential had a significant impact on debt developments. These controls are included in every regression. Other control variables are also added one by one: overall institutional quality, the four measures of monetary institutions, and GDP volatility. Therefore, the regression has the following form:

$$(3) \quad \Delta \left(\frac{\text{debt}}{\text{DDP}} \right)_i = \alpha + \beta_1 \text{BDI}_i + \beta_2 (i - g)_i + \beta_3 \left(\frac{\text{debt}}{\text{DDP}} \right)_{2000,i} + \delta' \text{controls}_i + v_i$$

The following parameter signs would be in line with our priors: $\beta_1 < 0$ (better fiscal institutions decrease the debt/GDP ratio), $\beta_2 > 0$ (lower interest rate and faster growth reduce the debt/GDP ratio) and $\beta_3 < 0$ (higher initial debt/GDP level may induce efforts to cut decrease ratio). The expected sign of the control parameters varies. A negative parameter is expected for the overall institutional quality and monetary institutions (better institutions lead to a fall in debt), while a positive parameter is expected for GDP volatility (higher volatility makes it more difficult to reduce the debt). The key results are shown in Table 7.

Table 7. **Regression of change in debt/GDP on Budgetary Discipline Index**

		Dependent variable: change in debt/GDP from 2000 to 2007				Dependent variable: change in debt/GDP from 2000 to 2010			
Expected sign		OECD + CESEE	OECD + CESEE	CESEE only	CESEE only	OECD + CESEE	OECD + CESEE	CESEE only	CESEE only
–	BDI	2.0	2.4	–8.3	–12.9	9.6	10.0	–28.3	–33.2
	<i>t-ratio</i>	0.2	0.3	–1.0	–1.4	0.8	0.9	–2.8	–3.5
+	Interest rate – GDP growth	2.2	2.0	2.4	2.2	2.9	2.4	3.2	2.9
	<i>t-ratio</i>	5.5	4.4	6.0	4.7	2.9	1.9	5.6	4.1
–	Debt/GDP in 2000	–0.2	–0.1	–0.6	–0.6	–0.1	–0.1	–0.9	–0.9
	<i>t-ratio</i>	–0.9	–0.7	–5.0	–3.1	–0.5	–0.3	–4.3	–3.1
–	Institutional quality		–1.2		7.2		–0.6		7.3
	<i>t-ratio</i>		–0.4		1.3		–0.1		0.9
	R2bar	0.41	0.30	0.83	0.79	0.30	0.22	0.78	0.73
	Nobs	41	40	17	16	41	40	17	16

Notes: BDI: Budgetary Discipline Index. Constant is also included in the regression; heteroskedasticity robust standard errors are used; the *t*-ratios are shown below the parameter estimates. Parameter estimates that are statistically significant (at least at the 10% level) are in bold.

Source: Authors' calculations.

The Budgetary Discipline Index is not significant for the combined sample of OECD and CESEE countries, but this result is due to the inclusion of OECD countries. When the sample is restricted to CESEE countries only, the point estimate is negative as expected, and the results are highly significant when considering the 2000-10 sample. It has already been argued that the 2000-10 sample is preferable to the 2000-07 sample.

The interest rate/growth rate differential is highly significant with a proper positive coefficient in all regressions, and the initial level of debt is highly significant with a proper negative sign for the CESEE countries.

A couple of additional control variables have been included. First, we controlled for the overall institutional quality, because we have found that countries with better overall institutions tend to have better budgetary institutions as well. However, as Table 7 reveals, the BDI variable continues to be significant when controlling for the overall institutional quality, while this latter variable is not significant (and even contradictory has a positive point estimate). Second, we controlled for all four measures of monetary institutions (we

have added them to the equation one by one) to see whether they have an impact on debt developments: none of the four indicators had a significant parameter estimate. Third, we also controlled for macroeconomic stability, but again, this variable turned out to be insignificant. The BDI variable retained its significantly negative estimate (for the CESEE sample) when using any of these additional control variables. Therefore, a higher BDI implies a fall in debt, and this result is robust to various controls.

The poor results of the index for the OECD countries can be explained by the existence of some outliers like Japan (highest BDI and debt) or Norway (low BDI and low debt) with country-specific circumstances. Moreover, the parameters selected for designing the index are rather tailored to the CESEE area and do not reflect a number of nuances characteristic for advanced countries. Therefore, it can impair the index results for the OECD area.

Regarding the estimates for the average budget balance, the explanatory variables are identical to the debt regressions:

$$(4) \quad \left(\frac{\text{balance}}{DDP} \right)_i = \alpha + \gamma_1 BDI_i + \gamma_2 (i - g)_i + \gamma_3 \left(\frac{\text{debt}}{DDP} \right)_{2000,i} + \delta' \text{controls}_i + v_i$$

The expected result is exactly the opposite parameter signs to the debt regressions – that is, $\gamma_1 > 0$, $\gamma_2 < 0$ and $\gamma_3 > 0$ – and the expected parameter signs of the control variables are also the opposite. The main results are shown in Table 8.

Table 8. Regression of average balance/GDP on Budgetary Discipline Index

		Dependent variable: average balance from 2000 to 2007				Dependent variable: average balance from 2000 to 2010			
Expected sign		OECD + CESEE	OECD + CESEE	CESEE only	CESEE only	OECD + CESEE	OECD + CESEE	CESEE only	CESEE only
+	BDI	0.4	–0.9	4.9	5.1	0.0	–1.0	4.5	4.5
	<i>t-ratio</i>	0.3	–0.7	5.7	4.6	0.0	–0.8	5.5	4.8
–	Interest rate – GDP growth	–0.1	–0.4	–0.4	–0.5	–0.1	–0.4	–0.4	–0.5
	<i>t-ratio</i>	–1.2	–2.8	–10.9	–8.2	–1.2	–2.5	–8.7	–7.5
+	Debt/GDP in 2000	–0.03	–0.01	0.02	0.04	–0.03	–0.01	0.02	0.03
	<i>t-ratio</i>	–1.94	–0.81	1.03	1.19	–1.98	–1.00	0.82	1.04
+	Institutional quality		2.8		0.2		2.6		0.4
	<i>t-ratio</i>		3.6		0.3		3.2		0.6
	R2bar	0.11	0.48	0.77	0.78	0.10	0.46	0.66	0.68
	Nobs	41	40	17	16	41	40	17	16

Notes: BDI: Budgetary Discipline Index. Constant is also included in the regression; heteroskedasticity robust standard errors are used; the t-ratios are shown below the parameter estimates. Parameter estimates that are statistically significant (at least at the 10% level) are in bold.

Source: Authors' calculations.

In general, the results are similar to the results obtained for the debt regression, though there are important differences. The Budgetary Discipline Index is not significant for the combined sample of OECD and CESEE countries, but is significant, with a proper sign, for the CESEE sample. The results are now significant for both time periods. The interest rate/growth rate differential is significant with a proper parameter sign, but the initial debt level is not significant.¹⁸

6. Conclusions

This article studied the role of fiscal and monetary institutions in macroeconomic stability and budgetary control. To this end, a new index of budgetary discipline was created (using available data from 2007/08) which combines rules and procedures for the three main stages of budgeting: the preparation stage (when the budget is drafted), the authorisation stage (when the budget is approved by parliament) and the implementation stage (when the budget is implemented and may be amended). For monetary institutions, four indicators were studied: the type of exchange rate regime, an index of central bank independence, an index of central bank transparency, and an index of financial regulation and supervision. Since the latter suffers from deficiencies, the pre-crisis speed of credit growth has been used as a proxy for proper financial regulation and supervision.

The article studied the impact of these indicators on macroeconomic stability and budgetary control. It has been noted that CESEE countries tend to grow faster (or at least tended to grow faster before the crisis) and have more volatile growth than non-CESEE OECD countries. This phenomenon has implications for macroeconomic management. More volatile output developments lead to more volatile budget revenues, and expenditures (both through automatic stabilisers and possibly through discretionary stimulus) are also expected to be more volatile. In the absence of sound fiscal institutions, this could lead to pro-cyclical fiscal policy. Indeed, using structural vector-autoregressions, Darvas (2010) found that fiscal policy was pro-cyclical in most CESEE countries (with a few exceptions). This calls for strong fiscal institutions. Yet the Budgetary Discipline Index suggests that fiscal institutions are considerably weaker in several CESEE countries than in non-CESEE OECD countries. Therefore, there is significant room for improvement in most countries.

The recent global financial and economic crisis hit CESEE countries harder than other emerging country regions of the world. Recovery from the crisis is also slower. These developments raise question marks about the pre-crisis development model of the region, which was largely based on institutional, financial and trade integration with the EU and was accompanied by substantial labour mobility. Recent research suggests that the good features of this model should be preserved, but several CESEE countries have to implement significant changes to this economic model in a much less benign domestic and international environment. Economic growth will likely fall substantially behind pre-crisis economic growth trends.

It has been shown that the general decline in government debt/GDP ratios of most CESEE countries before the crisis was the consequence of a highly favourable relationship between economic growth and the interest rate: economic growth well exceeded the interest rate. Therefore, government debt/GDP ratios fell in CESEE countries but not in non-CESEE OECD countries, even though the budget balance was better in the non-CESEE OECD group. Since growth will likely slow down and interest rates will rise after the crisis, a less favourable relationship is expected between the growth rate and the interest rate which also calls for enhanced budgetary frameworks.

By comparing the budgetary discipline indices of CESEE countries with the indices of OECD countries, the latter appear to be generally higher, and the average index among OECD countries is significantly higher than the average index in CESEE countries. However, there is a relatively large heterogeneity among OECD countries as well.

The final part of the article used econometric models for studying the impact of fiscal and monetary institutions on macroeconomic stability and fiscal outcomes. Some evidence

was found that better monetary institutions dampen macroeconomic volatility. But the hypothesis that better fiscal institutions promote macroeconomic stability could not be confirmed. This result can possibly be explained by the fact that various parameters which are important for macroeconomic stability have only weak impact on the index values. Moreover, the index is specifically tailored to the CESEE region and therefore omits some important characteristics which are frequent in advanced countries but do not exist in CESEE countries. When controlling for the difference between interest rate and growth rate and initial level of debt, the Budgetary Discipline Index significantly explains debt and balance developments in CESEE countries: countries with a higher index had a smaller increase in the debt/GDP ratio and better budget balances. This result was robust to the inclusion of several control variables, including an indicator of overall institutional quality. All of these results call for better budgetary procedures and improved monetary frameworks.

Notes

1. This article analyses 26 countries of central, eastern and south-eastern Europe: 12 central European and Baltic members of the EU (Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, Slovenia), the six European CIS countries (Armenia, Azerbaijan, Belarus, Moldova, Russian Federation, Ukraine), five non-EU countries of former Yugoslavia (Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia), and Albania, Georgia and Turkey.

The information in this article with reference to “Cyprus” relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey will preserve its position concerning the “Cyprus issue”.
2. For the purposes of this article, “budgetary” and “fiscal” have the same meaning.
3. Of course, the three non-transition CESEE countries (Cyprus, Malta and Turkey) show a different pattern.
4. There are also differences within the CESEE region, however. The new EU member states have reached the highest level of integration, followed by the countries of the western Balkans and Turkey that have the status of either EU candidate or potential candidate. The six Eastern Partnership countries, which were part of the Soviet Union, have reached varying degrees of integration with the EU15, and the Russian Federation still remains an important anchor for these countries.
5. The appendix table in Darvas (2010) details the fiscal measures taken by CESEE countries in response to the crisis.
6. At the broadest level, macroeconomic stability can be defined as the volatility of output. It could also be defined, for example, as the level and volatility of inflation (representing internal equilibrium in the economy) or the level and volatility of the current account balance (representing external equilibrium). However, the assessment of both internal and external equilibrium is complicated by the economic developments of CESEE countries.
7. The primary balance is unfortunately not available for several CESEE countries.
8. It should be noted that, during the crisis, the interest rate risk premium has increased and may remain at about pre-crisis levels in the coming years, while nominal GDP growth may be squeezed. Therefore, such a highly favourable relationship between the growth rate and the interest rate may not return. Also, this article uses the actual implicit interest rate, which is largely determined by past interest rates due to long maturity bonds. A rise in spot interest rates will be shown in the implicit interest rates after a lag.
9. See IMF (2009) for further details.
10. See Figure 3 for an example of the uncertainty of output gap estimates.
11. The following countries have been reviewed: Romania and Slovenia in 2005; Croatia, Georgia and Hungary in 2006; Turkey in 2007; Estonia and the Russian Federation in 2008; Bulgaria and Latvia in 2009, Lithuania and Moldova in 2010.

12. It contains among other things the results of the 2007 OECD survey of budget practices and procedures in OECD countries and the 2008 World Bank/OECD survey of budget practices and procedures in Asia and other regions. Information on budget institutions from 97 countries is available including the 31 OECD member countries and 66 non-member countries. The data refer to the years 2007 and 2008.
13. Estonia and Slovenia were not member countries of the OECD in 2008, but joined the Organisation later.
14. For the first 12 members of the euro area, central bank transparency relates to the European Central Bank (ECB). Countries in the euro area have been excluded because of the large divergences within the euro area in terms of various indicators, including fiscal ones.
15. The “Quality of Institutions Index” of the World Economic Forum is the average of 19 sub-indices: property rights, intellectual property protection, diversion of public funds, public trust of politicians, judicial independence, favouritism in decisions of government officials, wastefulness of government spending, burden of government regulation, efficiency of legal framework in settling disputes, efficiency of legal framework in challenging regulations, transparency of government policy making, business costs of terrorism, business costs of crime and violence, organised crime, reliability of police services, ethical behaviour of firms, strength of auditing and reporting standards, efficacy of corporate boards, and protection of minority shareholders’ interests.
16. The only exception is central bank transparency when controls are not included.
17. The historical developments of fiscal institutions likely have an impact on historical debt developments. If fiscal institutions are persistent, then past fiscal institutions can impact both current fiscal institutions and current debt levels. However, even in this case current fiscal institutions likely impact the change in debt; therefore, the regression is correct in this case. Furthermore, fiscal institutions change in time, which further calls for the analysis of the change in debt and not in the level of debt.
18. Considering the other controls: overall institutional quality is significant (with a proper positive parameter) for the OECD countries, but not for the CESEE countries; the four monetary institutional variables have properly signed parameter estimates, but are generally not significant (the most significant variable is central bank independence, which is significant at a 10% level). When considering the CESEE sample, the Budgetary Discipline Index remained highly significant when adding any of these control variables, and therefore these regressions also underline that better fiscal institutions lead to better fiscal outcomes.

References

- Anderson, B. and J.J. Minarik (2006), “Design Choices for Fiscal Policy Rules”, *OECD Journal on Budgeting* 5(4):159-208.
- Badinger, Harald (2009), “Fiscal rules, discretionary fiscal policy, and macroeconomic stability: an empirical assessment for OECD countries”, *Applied Economics* 41(7):829-847.
- Barth, James R., Gerard Caprio Jr. and Ross Levine (2008), “Bank Regulations are Changing: For Better or Worse?”, *Comparative Economic Studies* 50:537-563.
- Becker, Torbjörn, Daniel Daianu, Zsolt Darvas, Vladimir Gligorov, Michael A. Landesmann, Pavle Petrovic, Jean Pisani-Ferry, Dariusz K. Rosati, André Sapir and Beatrice Weder Di Mauro (2010), “Whither Growth in Central and Eastern Europe? Policy lessons for an integrated Europe”, 24 November, Bruegel and The Vienna Institute for International Economic Studies (WIIW), Brussels, www.bruegel.org/publications/publication-detail/publication/453-whither-growth-in-central-and-eastern-europe-policy-lessons-for-an-integrated-europe/.
- Berglöf, Erik, Yevgeniya Korniyenko, Alexander Plekhanov and Jeromin Zettelmeyer (2009), “Understanding the crisis in emerging Europe”, *EBRD Working Paper* No. 109.
- Crowe, Christopher and Ellen E. Meade (2007), “Evolution of Central Bank Governance around the World”, *Journal of Economic Perspectives* 21(4):69-90.
- Cukierman, Alex, Steven B. Webb and Bilin Neyapti (1992), “Measuring the Independence of Central Banks and Its Effect on Policy Outcomes”, *The World Bank Economic Review*, September, 6(3):353-398.
- Darvas, Zsolt (2010), “The Impact of the Crisis on Budget Policy in Central and Eastern Europe”, *OECD Journal on Budgeting* 10(1):45-86.

- Darvas, Zsolt and György Szapáry (2008), "Euro area enlargement and euro adoption strategies", *European Economy – Economic Papers* No. 304, DG ECFIN, European Commission, Brussels.
- Debrun, Xavier, David Hauner and Manmohan S. Kumar (2009), "Independent Fiscal Agencies", *Journal of Economic Surveys* 23(1):44-81.
- Dincer, Nergiz and Barry Eichengreen (2007), "Central Bank Transparency: Where, Why and With What Effects?", *NBER Working Paper* No. 13003, National Bureau of Economic Research, Cambridge, Massachusetts, United States.
- Dincer, Nergiz and Barry Eichengreen (2009), "Central Bank Transparency: Causes, Consequences and Updates", www.econ.berkeley.edu/~eichengr/central_bank_transp_feb09.pdf.
- EBRD (European Bank for Reconstruction and Development) (n.d.), *Main macroeconomic indicators database*, www.ebrd.com.
- Fabrizio, Stefania and Ashoka Mody (2008), "Breaking the impediments to budgetary reforms: evidence from Europe", *IMF Working Paper* No. 08/82, International Monetary Fund, Washington DC.
- Fatás, Antonio and Ilian Mihov (2003), "The Case for Restricting Fiscal Policy Discretion", *The Quarterly Journal of Economics* 118(4):1419-1447.
- Geraats, Petra M. (2006), "Transparency of Monetary Policy: Theory and Practice", *CESifo Economic Studies* 52:111-152.
- Geraats, Petra M. (2008), "ECB Credibility and Transparency", *European Economy – Economic Papers* 330, Directorate General Economic and Monetary Affairs, European Commission, Brussels.
- Geraats, Petra M. (2009), "Trends in Monetary Policy Transparency", *CESifo Working Paper Series* No. 2584.
- Ghosh, Swati (2009), "Credit Crunch or Weak Demand for Credit?" in The World Bank, *EU10 Regular Economic Report*, October, 37-44.
- Hallerberg, Mark, Rolf Strauch and Jürgen von Hagen (2007), "The Design of Fiscal Rules and Forms of Governance in European Union Countries", *European Journal of Political Economy* 23(2):338-359.
- Hilbers, P., I. Otter-Robe, C. Pazarbasioglu and G. Johnsen (2005), "Assessing and Managing Rapid Credit Growth and the role of Supervisory and Prudential Policies", *IMF Working Paper* WP/05/151, International Monetary Fund, Washington DC.
- IMF (2008), *Regional Economic Outlook Europe*, International Monetary Fund, Washington DC, April.
- IMF (2009), *Fiscal Rules Anchoring Expectations for Sustainable Public Finances*, International Monetary Fund, Washington DC.
- IMF (2010), *World Economic Outlook*, April, International Monetary Fund, Washington DC.
- Kopits, G. and S. Symansky (1998), "Fiscal Policy Rules", *IMF Occasional Paper* No. 162, International Monetary Fund, Washington DC.
- Kraan, Dirk-Jan (2007), "Programme Budgeting in OECD Countries", *OECD Journal on Budgeting* 7(4).
- Kraan, Dirk-Jan, Daniel Bergvall, Ian Hawkesworth and Philipp Krause (2006), "Budgeting in Hungary", *OECD Journal on Budgeting* 6(3).
- Kydland, Finn and Edward Prescott (1977), "Rules Rather than Discretion: The Inconsistency of Optimal Plans", *Journal of Political Economy*, June, 85(3):473-490.
- Mitra, Pradeep, Marcelo Selowsky and Juan Zalduendo (2009), "Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union", The World Bank, Washington DC, November.
- Rogoff, Kenneth (1985), "The Optimal Degree of Commitment to an Intermediate Monetary Target", *The Quarterly Journal of Economics*, November, 100(4):1169-1189.
- Szapáry, György (2009), "Regional Perspectives: Euro Area Neighboring Countries" in Jean Pisani-Ferry and Adam S. Posen (eds.), *The Euro at Ten: The Next Global Currency?*, Peterson Institute for International Economics and Bruegel, Washington DC, pp. 121-138.
- Walsh, Carl (1995), "Optimal Contracts for Central Bankers", *American Economic Review*, March, 85(1):150-167.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Commission takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD Journal on Budgeting

Performance Budgeting in Poland: An OECD Review

by *Ian Hawkesworth, Lisa von Trapp and David Fjord Nielsen*

Fiscal Transformation in Turkey over the Last Two Decades

by *Fatih Kaya and Selihan Yilar*

Reforming the Budgeting Process in China

by *Shulian Deng and Jun Peng*

How to Attain Value for Money: Comparing PPP and Traditional Infrastructure Public Procurement

by *Philippe Burger and Ian Hawkesworth*

Fiscal and Monetary Institutions of Central, Eastern and South-Eastern European Countries

by *Zsolt Darvas and Valentina Kostyleva*

Please cite this publication as:

OECD (2011), *OECD Journal on Budgeting, Volume 11 Issue 1*, OECD Publishing.

<http://dx.doi.org/10.1787/budget-v11-1-en>

This work is published on the *OECD iLibrary*, which gathers all OECD books, periodicals and statistical databases. Visit www.oecd-ilibrary.org, and do not hesitate to contact us for more information.

Volume 2011/1

OECD publishing

www.oecd.org/publishing

ISSN 1608-7143

VOLUME 2011

(3 ISSUES)

42 2011 03 1 P

9



771608 714002